The Expert

Perspectives on Litigation Services

In this issue:

Build a solid foundation for your construction litigation

Kohler court rejects IRS expert's methods and valuation

Will electronic data make or break your case?

FLP update
Federal appellate court slaps down Tax Court valuation

Taxing nonphysical personal injury damages may be unconstitutional

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Build a solid foundation for your construction litigation

Construction contracts have always been vulnerable to disputes — particularly over delays and disruptions. Litigation can stem from delays caused by the owner or by the need to replace a general contractor or subcontractor. These cases can be challenging because issues frequently arise over economic damages, which require complicated financial analysis.

Delay vs. disruption

Delay claims typically arise because a project wasn't completed by the agreed-upon deadline. They may be brought by an owner, a contractor or both, depending on who was allegedly responsible for the delay.

Disruption, on the other hand, occurs when an owner instigates a change in the method of construction incorporated in the contractor's bid. Disruption claims may cite decreased productivity, loss of efficiency or hindrance, and usually are based on an express or implied duty of cooperation. While delay and disruption claims can spring from the same project, they're distinguishable because disruption doesn't always push back the original deadline.

> *Determining job site overhead can be especially tricky when employees such as supervisors are working on multiple sites, requiring them to allocate their time.*

Damages framework

Because the parties and elements on a construction project are interrelated, a breakdown in one process can bring the entire project to a halt — dramatically affecting costs and revenues. A variety of damages may be sought in connection with construction delays or disruptions. Owners, for example, might seek reimbursement for financial losses, such as interest payments, depreciation on equipment and lost income.

Or, a delay or disruption precipitated by the owner may require a contractor to extend the contract, leading to increased equipment and labor costs. Redirecting equipment and labor could make it more difficult for a contractor to launch other projects on schedule. Generally, contractors claim a wider range of direct and indirect damages, including:

- Lost profits,
- Job site overhead,
- Home office overhead,
- Wage escalation,
- Increased material costs,
- Loss of efficiency, and
- Interest on funds borrowed to finance delayed completion of a job.

In cases where damages are to be based on actual costs, the accurate calculation of damages usually requires the allocation of a contractor's costs and expenses.

Allocation of overhead

A contractor's overhead often is the subject of allocation and therefore debate. Contractors rarely segregate overhead costs by project, and courts haven't settled on a single method for calculating the recoverable costs of the two types of contractor overhead:

1. Job site. Job site overhead generally refers to costs that were required for a specific project, but that couldn't reasonably be allocated to any specific work item within the project. Job site overhead can include the costs of project managers', supervisors' and office workers' time, trailers and equipment rental, supplies, temporary electricity, water and sewer usage, and vehicles.

Determining job site overhead can be especially tricky when employees such as supervisors are working on multiple sites, requiring them to allocate their time. Allocation also can become necessary when delays produce a need for additional supervision, equipment, reporting, quality control and scheduling.

2. Home office. Claims for home office overhead (HOOH) rank among the most litigated in construction disputes. HOOH is the contractor's cost of doing business that can't be allocated directly to specific projects.

Examples of HOOH costs include staff salaries, administrative costs, insurance, rent, utilities, office equipment and supplies, depreciation, and marketing. When a job is delayed, fewer projects are available to absorb these costs. So each work-in-progress must assume a greater amount of the overhead, thereby reducing profits.

Courts have applied several methods to calculate HOOH damages, such as the Eichleay formula and direct allocation formulas (also known as the Allegheny and Carteret methods). The Eichleay formula is used in most jurisdictions, particularly in matters concerning federal contracts. But note, the Federal Acquisition Regulations exclude overhead for items such as interest, entertainment, depreciation, bid and proposal costs, and bad debts.

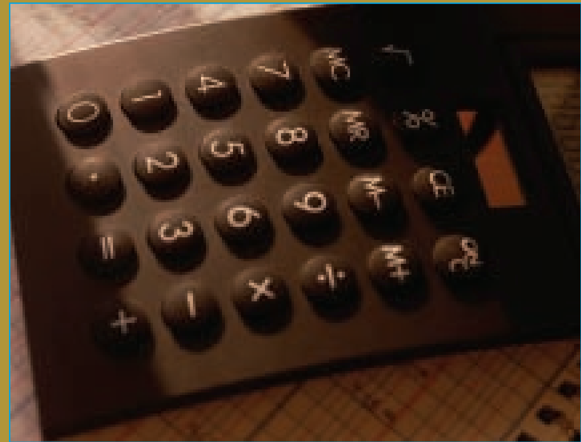
To recover under the Eichleay formula, a contractor must establish that a compensable delay occurred. For example, the contractor could show that it was working on standby and couldn't, therefore, take on other projects in the meantime.

Calculating damages with the total cost method

In the absence of detailed records documenting a contractor's additional costs attributable to a delay or disruption, a court might accept damages based on the total cost method. The contractor, however, must first demonstrate the impracticability of directly proving actual losses.

Under the total cost method, a contractor can recover damages equal to the difference between the total actual project costs and the bid costs — including reasonable markups on overhead and profit. A financial expert may need to make adjustments to exclude costs that are nonrecoverable under the project contract or to account for estimation errors.

The method essentially converts a fixed-price contract into a time-and-materials contract. A court likely will allow the method only where the original bid price was realistic, the actual costs were reasonable and the contractor wasn't responsible for the added costs. The modified total cost method deducts from the actual total any costs attributable to the contractor's inefficiencies. Owners have criticized and contested both approaches, asserting that contractors can use them to hide losses unrelated to owners' actions.



Don't delay

Construction cases can spin a sticky web of damages issues. Financial experts can help you and your clients accurately determine damages by ensuring both the appropriate allocation of costs and the reimbursement of only legitimate charges under the contract. ■

Kohler court rejects IRS expert's methods and valuation

In a recent taxpayer victory, the Tax Court dismissed the IRS expert's valuation, accepting the taxpayer's reported value without adjustment. The court's decision in *Kohler v. Comm'r* reemphasizes the importance of hiring a qualified valuation expert.

Plumbing the depths

Frederic C. Kohler held a minority interest in the Kohler Company, which was founded by his grandfather. While best known as a manufacturer of plumbing products, the company makes a range of other products and also owns and operates hospitality and real estate businesses. Kohler has been a private company since its founding and has paid dividends at least annually since about 1900. Its stated policy is to reinvest at least 90% of earnings in the business and to distribute between 7% and 10% as dividends.

When Kohler died on March 4, 1998, the company was undergoing a reorganization to bring it under total family control. This process was completed May 11, 1998. A reorganization plan created two new classes of stock with restrictions on transferability and participation.

Kohler's estate elected to value its assets as of six months after his death, so its valuation of the company stock considered the restrictions. The estate valued the stock at about $47 million. The IRS, on the other hand, valued it at $145 million.

That sinking feeling

Because the estate had introduced credible evidence, substantiated various items, maintained records and cooperated with reasonable IRS demands, the court shifted the burden of proof to the IRS. The IRS trial expert used the income and market valuation approaches to reach a fair market value of $156 million. But ultimately, the court rejected his appraisal.

Initially, it expressed concern that the expert's report wasn't submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). As the court observed, the USPAP certification "assures readers that the appraiser has no bias regarding the parties, no other persons besides those listed provided professional assistance and that the conclusions in the report were developed in conformity with USPAP." The court also noted the expert wasn't a member of the American Society of Appraisers or the Appraisal Foundation.

Further, the expert spent only 2.5 hours meeting with company management before deciding the expense structure in the company's projections was wrong and proposing his own. And he failed to discuss his own expense structure with management to test whether it was realistic. Additionally, he ignored the dividend method of the income valuation approach — despite Kohler's history of using dividend payments as the primary means of sharing its profits.

Finally, the expert may have cut off his own legs with an error in his pretrial report to the court; a mistake led him to overvalue the stock by more than 7%, or about $11 million. "This is not a minor mistake," the court said. "When we doubt the judgment of an expert witness on one point, we become reluctant to accept the expert's conclusions on other points."

By contrast, the court found the estate's experts thoughtful and credible. Both were published authors who spent significant time with management to understand the business. One had performed previous valuations for Kohler. They didn't invent their own projections, instead relying on management projections, and they applied the dividend method of valuation.

Long-term wisdom

The Tax Court's *Kohler* ruling seems to outline some of its expectations for valuations of large, privately held companies — specifically, the qualifications of experts. Your clients may hesitate to pay the extra fees associated with well-established valuators, but the case clearly demonstrates the long-term wisdom of spending a little more. ■

Will electronic data make or break your case?

In recent years, electronic data has played a critical role in many types of litigation. This is particularly true of transaction data. In-depth analysis of this data is required because it can prove crucial to damage calculations.

Digging deep

Financial experts increasingly employ systems consultants to analyze volumes of electronic transaction data. These analyses can dramatically affect the outcome of various types of litigation, such as where failures in a company's systems or controls have caused it to breach commercial contracts.

Disputes regarding royalty obligations provide a useful example. Consider a company that is contractually obligated to pay sales-based royalties to individuals and organizations that endorse its products. If one of the endorsers sues the company over royalties, systems consultants can conduct a royalty audit to ferret out discrepancies in the company's quarterly sales reports.

Traditional discovery approaches and damages analysis likely will come up short in cases involving extensive electronic data.

If discrepancies are found, the consultants can perform an extensive examination of sales transaction data for holes and inconsistencies. By demonstrating that the defendant company's internal systems were inadequate, these experts can calculate its actual sales more accurately than the defendant itself and build a successful damages claim for the endorser.

Discovery and electronic data

Because systems inadequacies potentially can result in a breach of contract, neither plaintiffs nor defendants can afford to ignore electronic data. But proper analysis of electronic data requires perseverance and diligence from the damages team. Traditional discovery approaches and damages analysis likely will come up short in cases involving extensive electronic data. So-called high-level reports can be irrelevant or misleading if based on faulty systems or incorrect data.

You can ease the process by routinely requesting certain kinds of electronic data, including e-mail, Word documents, spreadsheets, specialized files (such as notes in accounts receivable or payable files), and transaction data. This last, frequently representing the most detailed data available, provides an objective and accurate portrayal of facts. Transaction data often proves or disproves the damages claimed. For that reason, it generally receives the most attention from systems consultants.

Relevant data can come from several sources, including, but not limited to:

- The company's live servers,
- Archives, such as back-up tapes,
- Employee desktop computers, laptops and PDAs, and
- Employee CD-ROMs and other types of data storage media.

It's important that requests be tailored with extreme specificity to obtain all discoverable electronic data.

Keep in mind that complications can arise if a company has undergone technological upgrades since its data was created. The language or program originally used may be outdated, making data retrieval more burdensome. Take care, therefore, to hire a firm with the appropriate data recovery expertise.

Indispensable evidence

Many companies have experienced such rapid growth in recent years that they have outgrown their internal systems. Companies that attempt to manage and process more data than their infrastructures and internal controls can handle are bound to encounter difficulties. For this reason and others, discovery that neglects electronic data shouldn't be considered complete. ■

FLP update

Federal appellate court slaps down Tax Court valuation

The Fifth Circuit Court of Appeals has sided with taxpayers in the valuation of gifts of interests in a family limited partnership (FLP). The court in *McCord v. Comm'r* overturned a 117-page Tax Court decision that garnered much attention, criticizing that court for violating an "immutable" precept of valuation evidence.

Transfers at issue

In January 1996, the McCords used an assignment agreement to transfer all of their interests in an FLP to two tax-exempt organizations, their two sons and several trusts. They made the gifts in the form of dollar amounts, rather than percentage interests, under a "defined value clause" in the agreement. Such clauses commonly are used to ensure transfers fall within allowable tax exemptions for gifts by providing that donors convey an amount equal to the exemption.

The taxpayers' valuator concluded at the time of the transfer that the donees would receive almost $90,000 for each 1% of FLP interest. The valuator didn't present any evidence that the donees were expected to or could accept a percentage interest with a value less than the full dollar amount conveyed.

Approximately two months later, the donees entered a confirmation agreement without the donors' participation. This agreement translated the dollar value of each gift under the initial agreement's defined value formula into percentage interests.

The donees based their valuation for tax purposes on the valuation conducted at the time of the transfers. The IRS assessed more than $4 million in deficiencies, contending that the fair market value of a 1% interest was instead almost $172,000.

The Tax Court's independent valuation of the donated interests was "irrelevant" to the amount of gift taxes the taxpayers owed.

A Tax Court judge initially held for the taxpayers. But when the full court subsequently reviewed the case, the majority found for the IRS and valued the interests precisely halfway between the taxpayer and IRS experts' values.

Fifth Circuit steps in

According to the appellate court, the Tax Court "in essence suspended the valuation date of the property that the Taxpayers donated in January until the date in March on which the disparate donees acted, post hoc, to agree among themselves on the … percentages that each would accept as equivalents of the dollar amounts" transferred months earlier. The Fifth Circuit described the resulting values as the product of the Tax Court's "own imaginative but flawed methodology."

The appellate court found this methodology violated the principle that postgift occurrences may not be considered in the appraisal and valuation processes. Thus, the Tax Court's independent valuation of the donated interests was "irrelevant" to the amount of gift taxes the taxpayers owed.

A warning to the IRS?

In an interesting footnote, the appellate court noted that the IRS's "grossly exaggerated" deficiency assessment was a practice it saw with "disturbingly increased frequency." This observation, combined with the overall holding, could bode well for taxpayers in the Fifth Circuit. ■

Taxing nonphysical personal injury damages may be unconstitutional

Heads turned last year when a federal appellate court in *Murphy v. IRS* held it unconstitutional to tax damages for emotional distress, loss of reputation and other non-physical personal injuries. The three-judge panel has since vacated its judgment and scheduled a rehearing for this spring. If reinstated, the ruling could alter the employment litigation landscape significantly.

Taxation unconstitutional?

Marrita Murphy sued the IRS to recover income taxes paid on compensatory damages she received for emotional distress and loss of reputation in an action against a former employer. Murphy argued that Internal Revenue Code Section 104(a)(2), which excludes from taxation damages received "on account of personal physical injuries or physical sickness," is unconstitutional.

She relied on the 16th Amendment, which states that government may "lay and collect taxes on incomes, from whatever source derived," and a U.S. Supreme Court holding that Congress can tax all gains or "accessions to wealth." Murphy asserted that her award was neither a gain nor an accession to wealth and thus not taxable as income.

Weighing "income"

The D.C. court weighed whether Murphy's award constituted "income." Applying the "in lieu of" test, it asked in lieu of what were damages awarded? The court found the damages weren't awarded in lieu of income but rather to make Murphy emotionally and reputationally whole.

It also considered whether Congress would have deemed compensatory damages for nonphysical injury "income" when drafting the 16th Amendment. It noted that emotional distress and loss of reputation

were actionable in tort at that time and concluded that Congress didn't regard compensation for nonphysical injuries as different from compensation for physical injuries.

Benefit employers *and* employees

The D.C. court therefore held that Sec. 104(a)(2) is unconstitutional to the extent it allows taxation of an award of damages for nonphysical personal injury unrelated to lost wages or earnings. If reinstated, this decision could benefit employers as well as employees: Plaintiffs may be more amenable to smaller settlements knowing the award won't be taxed.

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