



# *The* Expert

Perspectives **L** on Litigation Services

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Summer 2007

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# Don't gamble with ESOP valuations

Approximately 11,000 employee stock ownership plans (ESOPs) currently exist in the United States, according to the ESOP Association. Under federal law, every one of these must be valued on an annual basis — usually the last day of the plan year.



Valuations also are essential because plan fiduciaries are required to ensure their ESOPs pay no more than fair market value (FMV) for shares of their requisite companies. Failure to comply with the valuation requirements could result in costly, time-consuming litigation, as well as substantial excise taxes.

## Relevant factors

FMV isn't solely the amount an owner could obtain for the company if forced to sell, the price a competitor would pay for it, or a predetermined formula set forth in a shareholder agreement. Those factors may be relevant, but valuing a company for FMV requires a thorough examination of it and its industry.

This involves on-site visits, interviews with key employees and a review of the company's financial statements. A valuator will weigh the company's:

- Operations history,
- Financial strength,

- Economic outlook,
- Historical earnings and projected future earnings capacity,
- Dividend-paying capacity,
- Goodwill and other intangible value,
- Recent stock sales,
- Share value, and
- Amount of debt.

In addition, the valuator will consider the industry's history and economic forecast and the market price of publicly traded companies in the same business or similar ones. Other factors also may warrant consideration, depending on the specific company and industry.

## Valuation methods

Based on the facts and circumstances, experts determine which method or methods of valuing an ESOP's shares are appropriate. The three major methods are market, income and asset, though the asset method generally isn't applicable.

*A discount for lack of control is applied to the shares of minority shareholders who lack influence over the company's direction.*

One common market approach is the guideline public company method, in which value is derived from the prices and financial data of comparable publicly traded company stocks. Another market approach is the transaction, or merger and acquisition, method, in which value is derived from prices and financial data of private companies that have been sold. And with the industry, or rules of thumb, approach a valuator might take common industry formulas to estimate value. Industry multiples, however, are used with considerable care and generally not relied on as the primary appraisal method. Valuators further may use a company's past transactions or buy-sell agreements to determine value.

The most common income method is the discounted cash flow approach. A valuator using this approach calculates the present value of all of the company's expected future net cash flows by applying a discount rate of return that reflects risk.

## Discounts diminish value

Discounts for lack of marketability and lack of control can affect the value of ESOP stock significantly. Where no ready market exists for the ESOP shares, valuers often apply a discount for lack of marketability.

The discount can be reduced if the company has set aside assets or otherwise ensured adequate funding will be available to cover its future repurchase obligations. The valuator may further decrease the discount for private companies. Such companies must provide put options, which require them to simulate a market for the shares by buying back company stock at the current FMV during specified periods. Put

options, however, may be subject to a deferral of 15 or more years, resulting in discounts of at least 5% to 15%.

A discount for lack of control is applied to the shares of minority shareholders who lack influence over the company's direction. But ESOPs with as little as 34% of the employer's stock can, at times, block certain decisions. And some shareholders may be contractually obligated to sell additional shares to an ESOP to shift it to a position of control, shaving or eliminating the discount.

## Expertise essential

The law insists on accurate valuations of ESOP shares at least once a year. Your clients, therefore, need to understand the importance of retaining a qualified valuator to perform a comprehensive valuation. With the potentially dramatic effect of discounts, determining the value of ESOP shares is rarely as straightforward as they might assume. ■

# Getting relief

## A primer on calculating copyright damages

The 1976 Copyright Act made major revisions to copyright law, but litigation over infringement has continued to thrive since then. Technological advances and the related Digital Millennium Copyright Act of 1998 (DMCA) have only increased opportunities for infringement allegations. In cases of prohibited infringement, the remedies sought often include damages that can be extremely difficult to calculate.

## Variety of theories

Calculating actual damages requires financial experts to consider far more than simple accounting profits.

Courts have entertained a number of theories in assessing lost profits (the most common measure of actual damages), including:

**The infringer's sales.** The copyright holder may allege that, if not for the infringement, its sales of the protected work would have grown in an amount equal to the infringer's sales. Courts usually reject this approach unless the plaintiff can satisfy the

comparability standard — that the plaintiff's and infringer's products must be comparable in terms of price, customers, distribution, packaging and advertising.

**Overlapping customers/diverted sales.** A plaintiff might assert that it lost some of its former customers to the infringer and, if not for the infringer, those customers would have purchased from the plaintiff again. Comparability — especially in the customer base — again must be established. Other factors bearing on the customers' decisions also must be considered, making it difficult to produce a precise measure of lost sales.

**Sales projections.** Where the plaintiff has maintained records of its projected and actual sales from previous financial periods, it may be possible to establish a historical correlation between the figures. The correlation could support the use of sales projections as a basis for measuring lost sales. As long as the relationship between the projections and the actual past sales remained stable over time, the inaccuracy of past projections would be irrelevant.

**Product mix.** Sales of different products also may reflect lost sales. Analysis of the sales of these products during periods of infringement and noninfringement — as well as in both



infringed and noninfringed market segments — could establish benchmarks for projecting the mix of relationships in the absence of the infringement.

Courts also may give weight to changes in the size of the market, sales of alternative products and related market trends. By offering multiple approaches that result in similar amounts, plaintiffs can increase their likelihood of recovering commensurate damages.

### Additional factors considered

Several other factors can affect actual damages, too. For example, once the amount of lost sales is determined, an expert deducts the costs and expenses that would have been incurred to generate those sales.

The Copyright Act also allows recovery of the infringer's profits that were attributable to the infringement but not already accounted for in the actual damages formula.

The infringer's sales may be linked to factors other than the infringement. In some cases, it may be necessary to determine the percentage of the product's value provided by the infringed work. In others, the infringed work may be so closely intertwined with other product elements that detailed analysis and multiple regression models become necessary.



## Technology can make damage assessments tricky

Today's technology can complicate the computation of statutory damages in copyright infringement cases. Last year, for example, a federal appellate court in *WB Music Corp. v. RTV Communication Group* considered the calculation of statutory damages for copyright violations involving music compilations.

The seven infringing CD compilations at issue used 13 separate works owned by the plaintiffs. The plaintiffs sought statutory damages under Section 504(c) of the Copyright Act, which allows "an award of statutory damages for all infringements involved in the action, with respect to any one work .... For the purposes of this subsection, all the parts of a compilation or derivative work constitute one work."

The Second Circuit acknowledged that the last sentence of Sec. 504(c) is "facially ambiguous" as to whether a compilation that infringes multiple separate copyrights constitutes "one work." But it found that an unauthorized compilation of multiple separate copyrights didn't implicate the ambiguous sentence in Sec. 504. Thus, the court remanded the case for the calculation of 13 awards of statutory damages.

### Statutory damages

Copyright holders may elect statutory damages in lieu of actual damages under either the Copyright Act or the DMCA. These damages, however, carry statutory caps — \$30,000 per infringement under the Copyright Act and \$2,500 per violation under the DMCA. When a court finds the infringement was committed willfully, it may increase the award of statutory damages to a sum not exceeding \$150,000.

Conversely, a court can reduce a statutory damages award. If the infringer wasn't aware, and had no reason to believe, that his or her acts constituted an infringement of copyright, the court may reduce the award to a sum not less than \$200.

### Know your options

In addition to damages, copyright holders can pursue equitable relief, including injunctions and impoundment of infringing articles. An expert can help you decide the appropriate remedy depending on your client's circumstances. ■

# Neutral CPAs can reduce time and stress for divorcing spouses

The divorce rate in the United States shows no signs of abating, and the division of couples' finances remains a common issue for many attorneys. It can be a time-consuming and stressful process — and possibly lead to litigation — but relief may be available. Rather than retaining separate CPAs to assess and value assets, some divorcing spouses are hiring a single neutral one.

## The neutral's job

A neutral CPA may begin an engagement by meeting with the spouses and attorneys to discuss their goals and expectations. After that, the expert's duties closely mirror those of separately retained CPAs. He or she requests information from the spouses — including business financial statements, personal credit card, bank and investment statements, and tax returns — and values any assets. With that information, the neutral CPA establishes the spouses' income, expenses, and schedules of assets and liabilities.

The expert then proposes a preliminary equitable distribution of assets and liabilities and an amount for spousal support that will serve as a platform for negotiation between the parties. The neutral CPA likely will provide the spouses with additional proposed ranges built from different assumptions and circumstances so the spouses can consider a range of settlements.

The most obvious benefit of hiring a neutral CPA is cost; a single expert can slice accounting fees in half. Using a neutral CPA also may reduce the need for extensive, protracted discovery. The expert streamlines discovery by coordinating the exchange of necessary information and documentation, sometimes obtaining such materials directly from the spouses, rather than working through the attorneys (but generally only if all parties have agreed that this is permissible).

## A cooperative couple

A single neutral CPA isn't suitable for every situation. The individuals involved and the nature of their relationship can greatly affect whether it will succeed or fail. Highly antagonistic spouses, for example, are best off hiring separate CPAs.

A neutral CPA, on the other hand, is better suited for cases where some respect remains between the spouses and they are willing to disclose all of the requested information — and trust the other to do so. The spouses also must agree to ground rules



that will maximize the expert's flexibility. Everyone, including the attorneys, must consent to these in advance to preempt complaints or problems down the road.

## Right person for the job

If you're working on a divorce case that is likely to benefit from a neutral CPA, look for a professional who boasts:

- Strong negotiating and interpersonal skills,
- The ability to take an objective stance,
- Credibility that can translate to persuasiveness when necessary, and
- An understanding of any jurisdictional requirements.

The engagement letter should include not only the attorneys and neutral CPA, but also the spouses. Neutral CPAs typically require an upfront retainer and a provision in the engagement letter specifying that both spouses are jointly and severally liable for the fees and costs.

## Consider the option

There will always be divorce cases where the spouses need to retain their own experts, but you should remain on the lookout for those situations amenable to a neutral CPA. Your clients will thank you for the savings in time, cost and emotional stress. ■

# How to recognize early revenue recognition

According to the American Institute of Certified Public Accountants, improper revenue recognition accounts for approximately half of all financial statement fraud. Such recognition often is accomplished by recording revenue early, thereby creating the illusion of greater-than-actual profits. Here's what you and your clients need to know about spotting this type of fraud.

## Signs of trouble

Financial pressures or greed may make some companies seek to recognize revenue earlier than allowed. Early revenue recognition can occur in a number of forms, including:

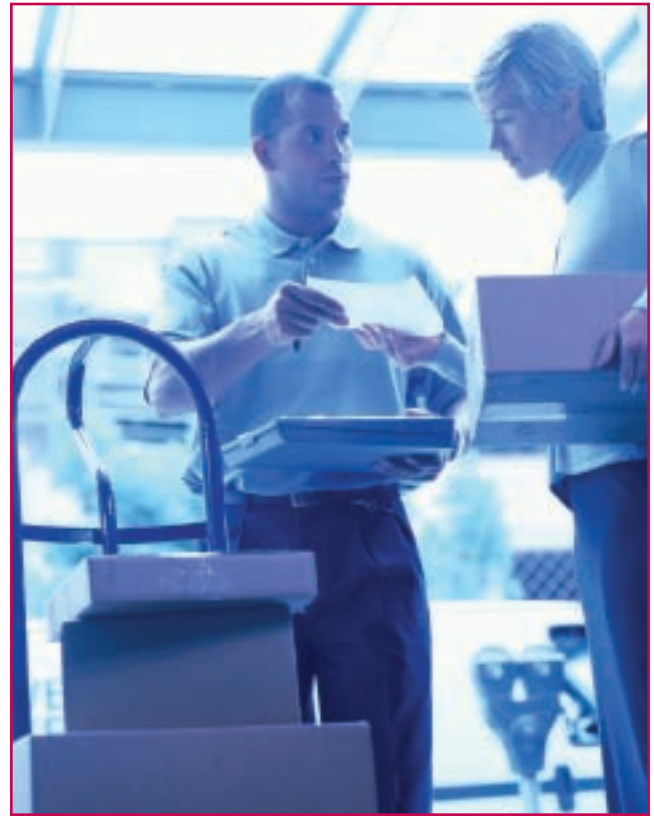
- Books kept open past the end of the accounting period to record more sales,
- Early product delivery,
- Revenue recorded before the full performance of a contract,
- Backdated agreements,
- Bill-and-hold arrangements, where the customer agrees to purchase merchandise, but the company holds the goods until shipment is requested,
- Revenue recorded from installment sales before the appropriate period, and
- Merchandise shipped to undisclosed warehouses and recording the shipments as sales.

Generally, your suspicions should be roused when a company records a large percentage of its revenue toward the end of the period. Look also for significant transactions with unusual payment terms, such as a large time gap between delivery and payment.

*Experts look for unusual pressure to achieve certain financial benchmarks — possibly to qualify for a loan.*

## An expert eye for trouble

When these or other warning signs are uncovered, reconciliation becomes key to detecting real problems. In cases



where companies are suspected of billing merchandise before shipment, financial experts look for discrepancies between the quantity of goods shipped and the quantity billed. They examine details on sales orders, shipping documents and sales invoices, and compare prices on invoices with published prices, noting any extensions.

When an expert suspects merchandise was shipped prematurely, he or she will compare the period's shipping costs with those in earlier periods. Unreasonably higher costs could signal improper revenue recognition. The expert also may sample sales invoices for the end of the period and the beginning of the next to confirm the associated revenues are recorded in the proper period. If false sales are suspected, experts look for reversed sales in subsequent periods and increased costs for off-site storage.

## Beyond the data

Suspicious financial statements aren't the only indicators that fraud is afoot. Companies in desperate straits sometimes resort to early revenue recognition because of pressure to reduce losses or produce high earnings. Individual employees may have personal financial problems that lead them to cook the books.

Experts, therefore, look for unusual pressure to achieve certain financial benchmarks — possibly to qualify for a loan or to look more attractive to a potential acquirer. They may scrutinize the finances of employees for signs that they need performance-related bonuses desperately enough to cheat.

Experts also consider if the company is generating revenue in the same way as in the past. Earnings tied to new and untested products, for example, may be less reliable than

those associated with the company's long-time bread and butter. It's important to consider where the revenue comes from, not just the amount.

### Catch it early

Revenue recognition has been at the heart of many recent — and devastating — financial scandals. But its early detection can minimize the harm to your clients. ■

## You have e-mail: An evidence challenge

Congressional investigations into Justice Department activities this spring have illustrated the increasingly critical role e-mail can play as evidence. Nevertheless, many companies continue to take a haphazard approach to handling e-mail. Now more than ever, it's important that your clients understand how these types of communications can be used as evidence in a litigation context.

### Risky business

In addition to their express messages and attachments, e-mails can reveal a wealth of information. They might provide evidence on matters ranging from intent, offer and acceptance, and relationships to infringement, prohibited disclosures, privacy violations, and security breaches. Users tend to treat e-mail more casually than formal correspondence, and innocuous remarks can seem incriminating.

The very nature of e-mail makes it troublesome. In particular, it is:

- Easily duplicated,
- Long-lived — often enduring longer than expected or intended,
- Vulnerable both to intentional and unintentional alteration,
- Packed with metadata, and
- Searchable by software.

Perhaps most dangerous, e-mail proliferates in ways not visible to the naked eye. Copies appear in the sender's Sent folder and recipient's Inbox and Deleted folders. They also might appear on hard drives, network backup systems and the systems' backup tapes. If sent or received via Web mail, such as Yahoo! Mail or Hotmail, copies may exist on the service provider's servers. And if a PDA was used as part of the communication, a copy probably resides there, too.



### Effect of litigation

Many companies don't have a formal e-mail retention policy, but litigation — or its threat — kicks the matter into overdrive. You can help your clients understand and comply with their duties to preserve e-mail evidence.

The scope of discovery requests will dictate their retention duties. But, at the very least, all employees should be alerted to the need to preserve evidence and trained on how to treat existing and future e-mails. Qualified forensic experts can help to copy hard drives of company computers, along with drives on PDAs and cell phones. Backup tapes from the tape rotation also will need to be pulled, so they won't be copied over unknowingly.

Don't make the mistake of relying on a client's internal IT staff to deal with e-mail evidentiary issues. Get computer forensics experts involved from the beginning of litigation to help protect, collect and analyze the necessary data.