



The Expert

Perspectives on Litigation Services

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More than just a paycheck: Calculating lost earnings

Plaintiffs seek damages for lost earnings in a range of cases, from wrongful termination to wrongful death. Calculations rarely are straightforward and must account for multiple components, including base earnings, pensions and fringe benefits. Understanding how experts calculate lost earnings can help you better represent your client — whether plaintiff or defendant.

Establishing base earnings

The initial focus in a lost earnings claim typically rests on the employee's "base earnings," which represent the earnings rate for a specific year from which lost earnings will be extrapolated. The facts of the case will determine whether the base earnings will use the actual earnings in the year before the injury, the projected earnings for the year the injury occurred or the expected rate of earnings for a year in the future.

A financial expert requires several types of data to reach a figure for base earnings, such as employer records, employee pay stubs, income tax records, Social Security records, census information, and the earnings of comparable employees in the industry or company. Information related to an employee's seniority, health history or productivity declines can provide additional insight if the employee's earnings record doesn't reflect regular annual increases.

An expert also may need to make adjustments for seasonal variations and sick pay. One-off, nonrecurring payments, such as a nonperformance-based bonus, can skew base earnings, as well.



Lost pension benefits

The proper amount of compensation for lost pension benefits depends on the type of pension plan involved. Calculations for defined contribution plans tend to be fairly straightforward.

To determine compensation for fringe benefits, experts compare the benefits received before the alleged wrong to those received after.

Employer contributions are considered as a portion of lost earnings in the years the contributions would have been made. Rather than projecting the postretirement benefits to be paid, the expert calculates the sum of the but-for employer contributions to the but-for earnings.

Calculations for defined benefit plans, on the other hand, may require projection of the actual benefit stream following the employee's retirement. Relevant factors include years of service, salary levels, retirement date and life expectancy.

The "expected life approach" to life expectancy, which uses an average life expectancy to project the full benefits up to the estimated time of death, is often applied. An alternative approach, known as the probabilistic method, multiplies the annual pension benefit by the probability that the plaintiff will survive from the current date until each future age up to the theoretical maximum age, and totals the products of all the ages.

Fringe benefits

To determine compensation for fringe benefits, experts compare the benefits received before the alleged wrong to those received after, possibly taking into account the replacement cost of the lost benefits. Individual insurance rates, for example, may be higher than those paid under a

group plan. Experts distinguish between those benefits that depend on the recipient's level of income and those that depend merely on being employed.

They also closely scrutinize those benefits to which both the employer and the employee contribute. The employee's contribution would be deducted from his or her lost wages, so the employee would be doubly compensated if damages were paid for the contribution *and* lost wages. Double recovery also could happen if vacation and sick pay are included in cash earnings.

Points of contention

Lost earnings claims can trigger several areas of dispute between parties, such as the effect of variable components of compensation. Commissions, overtime and performance bonuses must be clarified for the factfinder.

The employee's duty to mitigate his or her damages can raise questions, too. Defendants may argue that the employee took an unreasonable amount of time to land a new job or accepted a position at an unreasonably low rate of pay.

Arguments may further arise over how to handle the plaintiff's future compensation increases, retirement age and mortality. The availability of specialized data that accounts for lifestyle choices, such as smoking or motorcycle riding,

Don't overlook personal consumption

Courts considering wrongful death claims may agree to offset lost earnings awards based on the victim's personal consumption — the amount of money that wouldn't have been available to family members even if the individual hadn't suffered injury. Personal consumption covers the individual's separate food, health care, clothing and entertainment expenses, but not income taxes or savings.

Courts generally won't offset for indivisible or shared expenses like rent or insurance. Factors such as marriage and dependent children can reduce a person's personal consumption rate.

While past spending provides the strongest evidence for personal consumption rates, this data can be difficult to gather. Most experts rely on government studies — particularly those compiled by the U.S. Bureau of Labor Statistics — that identify the average percentages and dollar amounts of household income consumed by each family member. Experts adjust as necessary for unusual consumption patterns.

makes even the selection of work-life expectancy tables and statistics subject to debate.

The bottom line

Lost earnings claims frequently call for complicated and far-reaching calculations. You and your financial experts need to meet early in a case to discuss the various issues to ensure the availability of critical data and the development of appropriate arguments. ■

Tax Court reinforces importance of regular stock valuations

In the recent U.S. Tax Court case *Huber v. Comm'r*, the court found that a company's annual valuations, and reliance on those valuations for multiple purposes, supported its gift tax returns. This decision demonstrates the wisdom of obtaining regular valuations of company stock.

Case background

Shares in the privately held J.M. Huber Corporation (Huber) were owned by Huber family members, the Huber

Foundation and various independent nonprofit organizations. Most of the board of directors weren't family members.

Beginning in 1993, Huber hired an independent appraisal firm to annually value its stock. Huber's audit committee reviewed and adopted the valuation reports for various purposes, including using them to measure the company's financial performance and set compensation for board members.

Between 1994 and 2000, about 90 transactions involving Huber stock occurred among and between shareholders — all conducted at the then-applicable appraised value. Five family members transferred stock to heirs at different times between 1997 and 2000, using the appraised value on the relevant tax returns. The IRS, however, challenged the values on those returns, arguing that various sales transactions did not qualify as arm’s-length sales.

Family ties?

The Tax Court chided the IRS for focusing on “isolated sales that took place between closely related family members as if they were the only sales.” The court pointed out that the 90 transactions between 1994 and 2000 involved an “amalgam” of relationships.

It concluded that the existence of close family relationships between parties in some of the transactions was neutralized because many of the transactions took place between parties that either were hardly related or completely unrelated. In addition, transactions occurred between parties who held fiduciary duties to obtain the best prices. The court deemed this variety of relationships “a positive indicator of the existence of arm’s-length sales.”

The IRS also argued that two particular sales — involving shares from an estate of a third-generation Huber descendant and a trust of another deceased third-generation descendant — were conducted under compulsion and, therefore, not representative of arm’s-length sales. The court found no compulsion. The estate had sold the shares to pay estate tax but not under any immediate time constraint. The trust sold shares to pay budgeted obligations, but the sale was only one of several options considered for raising money.

Reliance on the appraiser’s report

The IRS attacked the appraiser’s valuation reports from several angles. It argued that the parties to the transactions weren’t reasonably informed about the company’s worth and thus not motivated to secure fair market value for their stock. It stressed that the reports used in the estate and trust transactions were 11 and 8 months old, respectively. The IRS claimed the time lapse caused the sellers to lose out on some increased profit.

The IRS alleged that the shareholders didn’t realize the optimum price because they failed to offer shares to the public.

But the Tax Court disagreed. It noted that no party who testified believed the company’s finances had significantly changed since the previous valuation. The court also didn’t find the time lapse unreasonable.

The IRS also argued that the parties weren’t reasonably informed because they didn’t see the appraiser’s report. The court rejected this claim as well. It determined that the parties were well informed because “the modus operandi of Huber gave plenty of opportunity for shareholders to educate themselves about the company and the [appraiser’s] methodology,” and many did so.



The IRS further argued that the lack of negotiation in the transactions indicated a lack of intent to realize the best price. The court observed that the IRS failed to cite any case law holding that negotiation is a necessary element for arm's-length transactions.

Finally, the IRS alleged that the shareholders didn't realize the optimum price because they failed to offer shares to the public. The court dismissed the notion that a company must take itself public to sell shares at a fair price. And testimony

illustrated bona fide business purposes for remaining private, including the ability to take a long-term view of the business.

Get an annual checkup

The *Huber* case provides several reasons for companies to obtain regular stock valuations, including building a foundation for gift and estate tax values. Keep shareholders educated about the business and the appraisal process also can help head off trouble. ■

Casting a wide net

Trademark damages recover actual damages *and* infringer profits

When a trademark is infringed, the most common remedy is injunctive relief under the Lanham Act, which is granted when a likelihood of consumer confusion is shown. But when a trademark is infringed in a manner that causes actual consumer confusion, the owner may be entitled both to its own actual damages *and* the infringer's profits.

Trademark owner's damages

If plaintiff trademark owners can establish actual consumer confusion resulting from the defendant's infringement, they usually can recover their past and anticipated future profits. Relevant factors in determining the amount of lost profits include the presence and conduct of other competitors; general economic conditions; and the plaintiff's sales before, during and after the infringement.

The plaintiff's sales are especially critical. Lost profits could be based on a comparison of plaintiff's actual sales after the infringement to its projections for that period. A court also could award damages on an estimate of the sales the plaintiff would have made but for the infringement, based on market share. To recover future profits, a plaintiff needs to cite reliable sales projections that have been prepared during the ordinary course of business — not for litigation.

Damages for price erosion may be available, too, if the erosion can be linked directly to the presence of the infringer in the marketplace. Without the infringer's presence, the plaintiff could have sold its product for a higher price. If the plaintiff was forced to engage in corrective advertising to combat the effects of the infringement, the costs also may be



recoverable. Note that such damages generally are awarded only in cases involving false advertising.

Bear in mind that profits on lost sales must be offset by variable and semivariable expenses the plaintiff avoided. Variable expenses include parts and materials; semivariable might include expenses such as sales commissions.

Award-winning theories

Courts award a defendant's profits to the plaintiff based on three theories:

1. Unjust enrichment. The award will block the infringer from enjoying profits it wouldn't have earned but for its wrongful conduct and restore the profits to the trademark owner.

2. Deterrence. The award will dissuade future infringement by removing the profit element.

3. Substituting for plaintiff's damages. The award will compensate a plaintiff who can't provide sufficient evidence to calculate its lost sales.

Regardless of the theory, the Lanham Act requires that the plaintiff establish only the defendant's sales. The defendant must prove any costs or other deductions it claims.

A court might apportion the defendant's profits in recognition of factors other than infringement that influence consumers' purchasing decisions. The court also will watch

for double-dipping, which can occur if the plaintiff recovers damages for lost profits on sales diverted to the defendant *and* the profits the defendant generated on those sales.

Beyond profits

The Lanham Act allows a court to "enter judgment, according to the circumstances of the case, for any sum above the amount found as actual damages, not exceeding three times such amount." If a court finds the amount of recovery based on profits inadequate or excessive, it can enter judgment for the sum it finds just. The act also permits prejudgment interest and, in "exceptional cases," attorneys' fees. ■

Avoid tax traps when splitting pensions in divorce

Pension plan benefits can represent a divorcing couple's most valuable asset, and the division is rarely simple. To avoid committing costly tax mistakes, it helps to understand some of the issues related to qualified domestic relations orders (QDROs), the timing of transfers and community property laws.

Consider QDROs

Under Internal Revenue Code Section 1041, transfers between spouses as part of divorce typically are tax-free. But, under the assignment-of-income doctrine, the IRS taxes the spouse making a transfer of unpaid

income, such as pension benefits. Further, the recipient spouse's separate property interest in unpaid income (as arises in community property law states) can result in taxation on the amount received.

QDROs can help your client avoid an application of the assignment-of-income doctrine to IRS-qualified pension plans. They create or recognize the existence of an alternate payee's right to receive — or assigns to an alternate payee the right to receive — all or part of the benefits payable to a pension plan participant. An alternate payee who is a spouse or former spouse is taxed as a "distributee" of the plan, and the employee isn't taxed for the spouse's share of the benefits.

When using QDROs, it's essential to discern whether the pension plan is defined benefit or defined contribution. The order can't qualify as a QDRO unless its assignment of rights or division of benefits complies with the terms of the plan.

Matter of timing

The timing of the transfer of benefits is critical. If a spouse transfers pension benefits before the court issues a QDRO, negative tax effects can result. The employee will be taxed on the premature distribution and become subject to a penalty. The recipient is considered to have received a tax-free transfer under Sec. 1041.

However, if the recipient rolls over the entire distribution to an IRA, a penalty for an excess contribution may be triggered, depending on the amount and the maximum contribution allowed by law. And rolling over the entire amount to an IRS-ineligible plan, such as a tax-sheltered annuity, renders the distribution taxable to the recipient.



ACFE fraud report suggests businesses are at risk

The Association of Certified Fraud Examiners (ACFE) has released its latest *Report to the Nation on Occupational Fraud and Abuse*. The report provides insights on the types of schemes common to certain industries, the types and sizes of organizations victimized, and the risks for businesses with fewer than 100 employees.

Targeted organizations

The ACFE study covers a cross-section of organization types — including private, public, government and nonprofit. Private companies are the most heavily hit by fraud and suffer the largest median losses.

The report also breaks down the fraud schemes by the size of the organizations, according to the number of employees. Those with fewer than 100 “tend to suffer disproportionately large fraud losses.” Such small organizations make up 36% of all frauds in the study.

The most common schemes suffered by small businesses involve check tampering. The report observes that check tampering can happen when a company fails to segregate duties. ACFE suggests basic countermeasures such as requiring the owner’s signature on every check and requesting that the bank send a copy of the company bank statement to the owner’s residence, instead of the office, for review.

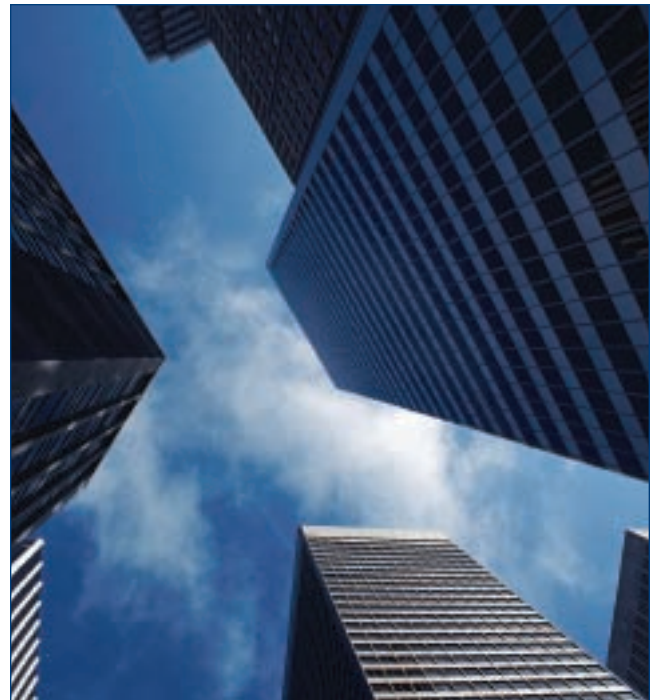
Fraud by industry

The report specifically discusses the most common types of asset misappropriation schemes in certain industries:

Banking and financial services. Cash larceny and skimming are among the most common schemes in this sector, generally through the theft of incoming cash and cash on hand. Noncash schemes in the industry most often involve the theft of proprietary information about customers.

Manufacturing. About one-third of these cases entail fraudulent billing. Expense reimbursement fraud and non-cash schemes also occur frequently.

Health care. Fraudulent billings account for most health care schemes, appearing in about one-quarter of the cases. The schemes range from submitting false claims to buying personal items with employer funds.



Insurance. Fraudulent billing appears in nearly 30% of insurance cases — almost twice as many as check tampering, the next most common scheme.

Retail. Noncash theft, usually of merchandise, is the most frequently reported retail fraud. Skimming and cash larceny occur in more than 20% of cases.

General services. Skimming is the most often reported scheme in general services businesses. This includes theft of unrecorded sales — particularly common in businesses such as restaurants and bars.

Professional, scientific and technical services. Billing fraud, check tampering, expense reimbursement fraud and payroll fraud are each identified in more than 20% of such cases.

Use information wisely

ACFE advises that its data isn’t intended to indicate whether certain types of organizations are more vulnerable to fraud than others. Fraud risk depends on many factors, including those inherent to the specific business. Nevertheless, companies can use the report information to better arm themselves against occupational fraud. ■