

FVCPAs Litigation Support



January/February 2012

Power of three

Court endorses triangular valuation approach

E-discovery pilot program

Survey suggests Seventh Circuit is on the right track

Do your clients know the facts about fraud?

IRS easing restrictions on innocent spouse relief

Power of three

Court endorses triangular valuation approach

The Delaware Chancery Court recently urged the use of a more robust approach to business valuation that applies multiple techniques to “triangulate” a value range. The court noted in its decision for *S. Muoio & Co., LLC v. Hallmark Entertainment Investments* that all three methodologies have their own limitations. So, it recommended using a discounted cash flow (DCF) analysis, a comparable transactions analysis *and* a comparable companies analysis.

DISPUTE AT HAND

The case involved the recapitalization of Crown Media Holdings, Inc. by its controlling stockholder and primary debt holder, Hallmark. When the recapitalization was first proposed, Crown’s cash flows were insufficient to service its debt. After the recapitalization agreement was announced, a shareholder, Muoio, filed suit to stop it. The suit alleged that the agreement significantly undervalued Crown and therefore improperly transferred wealth and voting power from Crown’s minority shareholders to Hallmark.

At trial, Muoio’s expert relied solely on a DCF analysis to calculate his \$2.9 billion valuation of Crown — almost three times higher than any of the other valuations presented by Hallmark’s experts and advisors. Although Muoio’s expert conducted two other valuations, a comparable companies analysis (which produced a value of \$803 million) and a comparable transactions analysis (\$1.3 billion), the expert rejected those conclusions as “absurdly low” in comparison to his DCF analysis.

WILDLY DIVERGENT RESULTS

In its opinion, the court included a chart to visually demonstrate “just how far off [the plaintiff’s expert’s] single methodology valuation was as compared to the multiple valuations of Crown,” which were performed by financial advisors engaged for the transaction and others that had previously considered acquiring Crown. The court also noted that the plaintiff’s valuation was “wildly divergent” from other valuations that had used multiple methodologies.



The court went on to credit the defense expert for recognizing the economic reality that real-world valuations conducted by potential buyers are often the best source of information about a company’s value. It agreed with the defense expert that a DCF analysis is more reliable when it can be verified by alternative valuation methods — especially valuations performed by potential third-party buyers. According to the court, the plaintiff’s expert’s failure to incorporate other methods in his analysis made his valuation far less credible.

GETTING SPECIFIC

The Chancery Court also listed several specific reasons for rejecting the plaintiff's expert's value. These include the facts that:

- ▶ The expert's DCF analysis ignored Crown management's contemporaneous projections and used his own hypothetical and overly optimistic set of projections.
- ▶ He unreasonably extended his optimistic projections to 2024, despite the fact that management considered it problematic to project more than five years and consistently used three- to five-year forecast periods.
- ▶ His valuation disregarded all of the contemporaneous evidence of Crown's value (including at least 18 valuations that were nowhere close to his own) and the company's economic reality (including its debt load).
- ▶ He rejected his own market-based valuations "because he was not satisfied with the results."

The court ultimately found that, because the expert failed to clearly and persuasively provide any acceptable reasons for his outlier result, his methodology left it with little confidence in his valuation.

The court agreed that a DCF analysis is more reliable when it can be verified by alternative valuation methods.

DEATH OF DCF?

Does the *Muoio* court's decision signal the end of the DCF method? Hardly. As the court observed, a DCF valuation is a dependable and commonly used methodology that merits the greatest confidence in the financial community. But the court also emphasized that it gives more credit and weight to the opinions of experts who apply *multiple* valuation techniques that can cross-check and reinforce one another's conclusions. ▶

E-discovery pilot program

Survey suggests Seventh Circuit is on the right track

Almost three years ago, the Seventh Circuit Court of Appeals launched its multiphase Electronic Discovery Pilot Program. The program is intended to develop, evaluate and improve pretrial litigation procedures that ensure fairness and justice for all parties while reducing the rising cost and burden of electronic discovery.



The program is now in its second phase and its oversight committee has released a full report on the first phase and an interim report on the second. Both reports suggest that some potentially significant changes to the discovery process are on the horizon.

PROGRAM PRINCIPLES

The Seventh Circuit's E-Discovery Committee — composed of government, plaintiffs', and defense and in-house attorneys, as well as technology experts — developed a set of initial principles related to the discovery of electronically stored information (ESI). The principles are designed to provide incentives for early and informal information exchanges about common issues related to evidence preservation and discovery, both paper and electronic.

HOW E-DISCOVERY LIAISONS HELP RESOLVE DISPUTES

The Seventh Circuit's E-Discovery pilot program principles (see main article) impose on counsel a duty to meet and confer on discovery and to identify disputes for early resolution before the initial status conference with the court. In the event of a dispute over preservation or production of electronically stored information, the principles require each party to designate an e-discovery liaison to meet, confer and attend court hearings on the subject.

The liaison may be an attorney, third-party consultant or employee of the party. He or she must:

1. Be prepared to participate in e-discovery dispute resolution,
2. Be knowledgeable about the party's e-discovery effort,
3. Be sufficiently familiar with the party's electronic systems and capabilities to explain those systems and answer relevant questions, or have reasonable access to those who are familiar with such systems, and
4. Be knowledgeable about the technical aspects of e-discovery or have reasonable access to those who have such knowledge.

The committee's principles provide guidance on how to streamline the discovery process and resolve disputes regarding e-discovery. They require that such issues be addressed early on, either by agreement or by raising them promptly with the court.

Other organizations have provided similar guidance, but the Seventh Circuit's principles underwent actual testing during Phase One of the pilot program and continue to undergo testing in Phase Two. During the first period, 13 judges from federal district courts in the Northern District of Illinois implemented the initial principles in 93 civil cases.

RESULTS ARE IN

In April 2010, judges and attorneys for the parties in the Phase One cases were surveyed. According to the report, the judges felt "overwhelmingly" that the principles positively affected attorneys' cooperation with opposing counsel and their knowledge of the procedures to be followed when addressing e-discovery issues. In particular, the judges believed that involving designated e-discovery liaisons for each party, as required by the principles, contributed to a more efficient and cost-effective discovery process.



On the other hand, many of the participating attorneys reported little impact on their cases. (The report's authors attributed the attorneys' response to the limited duration of Phase One.) Attorneys who did perceive an effect from the principles claimed "overwhelmingly" that the effect was positive in terms of promoting fairness, fostering more amicable dispute resolution and facilitating their advocacy on behalf of their clients.

MAKING MINOR CHANGES

Based on the survey's results, the E-Discovery Committee made only minor changes to the Phase Two principles. For example, the principles now *require*, rather than recommend, that attorneys for each party review and understand how their client's data is stored and retrieved before the mandatory "meet and confer" process. This enables attorneys to determine in advance which issues must be addressed during those discussions.

The committee originally planned for Phase Two to run for one year, from May 2010 to May 2011. Early on in the second phase, however, it determined

that a two-year period would better allow for a full evaluation of the principles. During the first half of Phase Two, the committee added more than 30 experts from across the country as members, and the program has grown to more than three dozen judges and hundreds of cases.

WHAT'S NEXT?

The E-Discovery Committee intends to present its final report on Phase Two in May 2012 at the Seventh Circuit Bar Association Meeting. Although the committee hasn't revealed any details about further changes, it will then move on to Phase Three. ▀

Do your clients know the facts about fraud?

Employee fraud remains a persistent concern for American companies, yet too many owners believe that it can't happen to them. Small businesses, in particular, foster environments of trust, and their owners might not even recognize criminal activities — until the company suffers big financial losses.

Help your clients prevent fraud by reminding them of the problem, as well as the solutions, such as strong internal controls, surprise audits, confidential tiplines and employee education. The following provides some basic facts about fraud that every owner or manager needs to know.

IDENTIFY THE ENEMY

For the past decade, the Association of Certified Fraud Examiners' (ACFE's) biennial survey of fraud experts has provided the best information on fraud schemes and their perpetrators. The latest *Report to the Nations on Occupational Fraud and Abuse* estimates that organizations lose about 5% of their annual revenues to fraud, and victimized businesses suffer a median loss of \$160,000.

To help companies understand, identify and prevent fraud, the ACFE breaks these crimes into three main categories:

Asset misappropriation is the most commonly reported type of occupational fraud. In these cases, perpetrators steal or misuse an organization's resources. Asset misappropriation is the least costly category, with a median loss of \$135,000.

Approximately 85% of asset misappropriation cases involve theft or misuse of cash.

The second is *corruption*, which occurs when employees use their influence to obtain a benefit for themselves or another party in a way that violates their duties to their employers. Examples include offering or accepting bribes and extorting funds from third parties. Corruption occurs in almost 33% of cases, with a median loss of \$250,000.

The third, and most costly, is *financial statement fraud*. These types of fraud involve the intentional misstatement or omission of material information on an organization's financial statements. An employee may report fictitious revenues or conceal expenses or liabilities. Financial statement fraud is the least common type of scheme, but because it's most often perpetrated by senior executives and owners, it's the most costly, with a median loss of \$4.1 million.



COSTLY MISAPPROPRIATION

Because 90% of occupational fraud can be categorized as asset misappropriation, most businesses should focus on detecting and preventing these schemes. The ACFE identifies nine distinct categories of asset misappropriation:

- ▶ Skimming,
- ▶ Cash larceny,
- ▶ Cash register disbursements,
- ▶ Cash-on-hand misappropriations,
- ▶ Check tampering,
- ▶ Expense reimbursements,
- ▶ Billing schemes,
- ▶ Payroll schemes, and
- ▶ Noncash misappropriations.

This last scheme involves the theft or misuse of physical assets, such as inventory or equipment, and misappropriation of proprietary information.

Approximately 85% of asset misappropriation cases involve theft or misuse of cash, with fraudulent disbursements being the most common cash schemes. Check tampering has the highest median loss of asset misappropriation cases: \$131,000. Billing schemes and cash larceny also cost their victims median losses of at least \$100,000. Noncash misappropriation, such as stealing inventory from warehouses or misusing customer financial data, comes in at \$90,000.

Of course, some schemes are more prevalent in certain industries. For example, fraudulent billing is a major concern in the insurance and health care sectors, and financial services organizations need to look for cash larceny and skimming. Retailers, on the other hand, are most likely to fall victim to noncash theft — mainly of merchandise.

ACT FAST ON SUSPICIONS

When owners and managers suspect that asset misappropriation or other types of fraud are occurring, they need to act fast. The longer fraud lasts, the more costly it becomes. The median fraud scheme runs for 18 months, but the most damaging — fraudulent financial statements — runs for 27. The least expensive scheme, cash register disbursement, is typically detected after 12 months.

To help deter fraud, businesses should contact their attorneys, who can, in turn, call in forensic accountants. These fraud experts know how to collect evidence, interview suspects and build a case that will hold up in court. Even if companies don't want to prosecute the thief, fraud experts can help them prevent employee theft from happening in the future.

BE BETTER INFORMED

Businesses have enough challenges these days without occupational fraud adding to the load. A little knowledge can help your clients head off costly scams, or at least limit the duration of fraud schemes. ▶

IRS easing restrictions on innocent spouse relief

Years after a divorce decree has been signed and entered, an innocent former spouse could end up on the hook for the misstatement of taxes on a couple's joint tax return. Even if the decree stated that one spouse would be responsible for any amounts due on previously filed tax returns, the nonresponsible spouse must request innocent spouse relief from the IRS.



Until recently, though, the innocent spouse ran the risk of exceeding the IRS time limit on certain relief requests. That limit was expanded recently and many spouses — divorced or not — who previously were denied relief because of the limit may now qualify.

NECESSARY CHANGE

Since 2002, regulations required that innocent spouse requests seeking equitable relief be filed within two years after the IRS first takes collection against the requesting spouse. But the IRS determined last year that changes were necessary to help innocent spouses who didn't know and didn't have reason to know that their spouses understated or underpaid an income tax liability.

It announced that it will no longer apply the two-year limit to new equitable relief requests or requests currently under consideration. A taxpayer whose equitable relief request was previously denied based solely on the two-year limit can reapply if the collection statute of limitations for the tax years involved hasn't expired. The IRS won't apply the two-year limit in any pending litigation involving equitable relief. Where litigation is final, it will suspend collection action under certain circumstances.

NONEQUITABLE RELIEF

Taxpayers seek equitable relief because they don't qualify for the two other primary types of relief — both of which are considered nonequitable. These are:

Innocent spouse. This relief may be available from understated tax, interest and penalties due to erroneous items such as unreported income or an improper deduction. The taxpayer must show that 1) he or she signed the joint return without actual knowledge or reason to know of the understated tax, and 2) it would be unfair to hold the taxpayer liable.

Separation of liability. Here, the understated tax, plus penalties and interest, is allocated between the taxpayer and the spouse. The taxpayer must establish the basis for allocating the erroneous items. Relief doesn't apply to understated tax for erroneous items of which the taxpayer had actual knowledge.

SOME CAVEATS

Even with these changes, the IRS's two-year election period for seeking nonequitable innocent spouse relief continues to apply. The normal refund statute of limitations also continues to apply to tax years covered by any innocent spouse request. ▀

Litigation and Valuation Consulting Services

- Litigation and Arbitration
- Lost Profit Analysis
- Mergers & Acquisitions
- Business Valuations
- Contract Disputes
- Forensic Accounting
- Family Law
- Wrongful Employment Termination
- Business Damages
- Lost Earnings
- Due Diligence
- Wrongful Franchise Termination
- Fraud & Embezzlement Investigation
- Expert Witness Testimony

The Partners of Frankeberger Vausher + Company, CPAs and Litigation Consultants, have in excess of 35 years professional litigation and expert witness experience. We consult with clients, their attorneys and or accountants on the matters listed above in support of confrontational issues requiring settlement and or potential equitable adjustments. We have the technical expertise to analyze complex situations, assist with discovery, and render independent, professional opinions.

Frankeberger Vausher + Company includes CPAs, Forensic Accountants, Certified Fraud Examiners, and includes an expert with a Masters Degree in Taxation. Dennis Frankeberger – Managing Partner, is also the Chairman of the Board of Advisors to The Leventhal School of Accounting at the University of Southern California. He has lectured extensively regarding matters of Internal Control, Discovery, Fraud, Ethics and Taxation.

For more information, please contact:

Dennis Frankeberger, CPA/CFE, CFE
909-597-1100
FV@FVCPAs.com
www.FVCPAs.com