

Willamette Management Associates

Insights

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Autumn 2019

Business Valuation, Forensic Analysis, and Financial Opinion Insights



THOUGHT LEADERSHIP IN FORENSIC ACCOUNTING,
SPECIAL INVESTIGATIONS, AND ECONOMIC DAMAGES



Willamette Management Associates

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Insights

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Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

Insights is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted with regard to such matters. Due to the wide range of the topics presented herein, the *Insights* thought leadership discussions are intended to be general in nature. These discussions are not intended to address the specific facts and circumstances of any particular client situation.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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THOUGHT LEADERSHIP IN
FORENSIC ACCOUNTING, SPECIAL INVESTIGATIONS, AND ECONOMIC DAMAGES
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Forethoughts

The Willamette Management Associates 50th anniversary celebration continues in this Autumn 2019 edition of *Insights*. We thank our clients for their continued support. We also thank our contributing authors, and especially the authors from King & Spalding, Tucker Ellis, and TI-Trust, for their time, talents, and contributions to the *Insights* thought leadership.

This *Insights* issue focuses on forensic accounting, special investigations, litigation services, and economic damages analysis. The discussions in this *Insights* issue provide litigation counsel, general counsel, boards of directors, C-suite personnel, and financial professionals and testifying experts with an understanding of current topics related to the legal, finance, and accounting professions.

We are pleased to include two discussions from King & Spalding attorneys. Tish McDonald, Emily Newton, and James Graessle present a discussion outlining the provisions for, and the pros and cons of, domestic self-settled asset protection trusts. Jessica Corley and Peter Starr describe the primary types of shareholder tort litigation and discuss the current trends in securities and derivative litigation.

This *Insights* issue includes a topical discussion of financial projection due diligence issues in ESOP litigation presented by Chelsae Mikula of Tucker Ellis, Chip Brown of TI-Trust, Kyle Wishing, and Khatija Sajid. The issue also includes a discussion on ESOP feasibility analyses by Robert Reilly.

Other thought leadership discussions consider the analysis of the reasonableness of financial projections by Scott Miller and the use of experts in litigation by Lerry Suarez and Jason Bolt. Other discussions consider the use of reasonable royalty calculations in patent infringement litigation by Andrew Fisher and the measurement of lost profits under the modern new business rule by Brandon McFarland, John Kirkland, and Kristine Taylor.

This *Insights* issue summarizes the judicial decision in *Floyd Landis v. Talkwind Sports Corp. et al.* as it pertains to the measurement of economic damages in a *qui tam* case by Thomas Eichenblatt.

Finally, Dean Driskell provides discussions of the analysis of fraudulent conveyance actions and best practices (along with a few war stories) for conducting forensic accounting and internal investigations.

About the Editor

F. Dean Driskell III, CPA

F. Dean Driskell III, CPA/CFF, CFE, is a managing director and office director in the firm's Atlanta office.

Dean's practice includes financial consulting services for clients involved in various types of accounting, economic, and commercial disputes as well as fraud and forensic accounting matters. He has significant experience as a testifying expert. During Dean's career, he has

provided expert testimony in the United States District Courts, United States Bankruptcy Courts, and various State Superior Courts. Dean has also assisted clients in arbitrations (both as an arbitrator and expert) and as a special master.

He has led fraud and forensic investigations across a variety of industries and business types. These engagements included bank fraud, employee theft, phishing schemes, accounting misconduct, vendor fraud, asset misappropriation, financial statement fraud, and corporate integrity agreements.

Dean earned a BS in business administration from Auburn University and an MBA from Georgia State

University. Dean is an active member of the American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, American Society of Appraisers, and the American Bar Association.

He is an adjunct professor of accounting at Georgia State University where he primarily teaches principles of accounting, forensic accounting, and graduate level financial analysis classes. He previously served on the board of directors for the Synchronicity Theater Group as finance chairman and Safe Kids Georgia as finance and vice chairman.

In 2018, Dean testified as the financial expert in the nationally televised trial *Georgia v. Claud Lee "Tex" McIver III*. McIver was accused of shooting his wife in the back as they were driving near Piedmont Park in Atlanta. Dean's testimony was covered in the *Atlanta Journal Constitution*, the *Daily Report*, and the TV shows *48 Hours* and *Dateline NBC*. McIver was convicted of felony murder and three lesser charges and will likely spend the rest of his life in prison.

Finally, but not least importantly, Dean has been married to the lovely Megan Kristi (Quinn) Driskell for 12 years. They have two beautiful girls, Quinn Ashlyn (10) and Kathryn Rose (8), who are the apples of their daddy's eye.



Conducting Forensic Accounting and Internal Investigations

F. Dean Driskell III, CPA

Performing forensic analyses can be some of the most rewarding, but also the most challenging, work for a professional accountant. This discussion provides a practical guide to conducting forensic accounting and internal investigations. This discussion summarizes some of the real-world experiences of a seasoned forensic accountant.

INTRODUCTION

The term “forensic accounting” is often misused and misunderstood. When I tell someone that I am a forensic accountant, the response I typically get is, “So, like *CSI*¹ on television!” And then I say, “Yeah, sort of. But I investigate numbers instead of murders and dead bodies.” Then their excited facial expression fades away and they change the subject.

The practice of forensic accounting can be fascinating. In my 20-plus years of experience in the field, I have traced assets belonging to Holocaust victims, testified in litigation matters where the continuance of the company was at stake, worked as a special master,² investigated Ponzi schemes,³ managed teams involved in billion dollar litigations, analyzed large bank frauds, worked with the FBI and the Department of Justice in white-collar criminal matters, and testified in a televised murder trial.

The American Institute of Certified Public Accountants (“AICPA”) (the governing body of professional accountancy in the United States) defines forensic accounting as “the application of specialized knowledge and investigative skills possessed by CPAs to collect, analyze, and evaluate evidential matter, and to interpret and communicate findings in the courtroom, boardroom or other legal or administrative venue.”⁴

Professional accountants, mostly CPAs, conduct forensic accounting engagements. A subcategory

of forensic accounting is fraud examination. Fraud examinations may be conducted by either accountants or nonaccountants (collectively referred to as “analysts” throughout this discussion). When forensic accountants investigate allegations of misconduct or fraud within businesses, those investigations are often referred to as *internal investigations*.

This discussion provides summary information related to a variety of forensic accounting and internal investigation engagements.

Sometime earlier than 400 BC, Sophocles, the Greek tragedian, said that he would “rather fail with honor than succeed by fraud.” Unfortunately, in today’s time, that sentiment is becoming less common—especially in the corporate world.

A quick look at the business press over the past year produces numerous articles on financial statement frauds, corporate investigations, asset misappropriations, public corruption, and a host of other occupational frauds.⁵

In fact, the Association of Certified Fraud Examiners (“ACFE”) reported in its 2018 *Report to the Nations: Global Study on Occupational Fraud and Abuse*, that the total global fraud loss could be as high as \$4 trillion U.S. dollars (or roughly 5 percent of gross world product) per year.⁶ And these numbers do not appear to be decreasing even with the allocation of additional resources at the corporate level and the passing of 17 years since the Sarbanes-Oxley Act (“SOX”)⁷ became law.

This discussion makes no attempt to solve the problems of corporate fraud and abuse. Rather, this discussion addresses what to do once you discover an issue (or are retained to investigate an issue) from the perspective of the forensic analyst.

This discussion identifies the best practices for conducting forensic accounting investigations, including the following:

- Beginning the engagement
- Planning and communications during the engagement
- Executing the engagement
- Reporting findings

When executed properly, a forensic accounting investigation can accomplish several important tasks. It may assist triers of fact along with financial victims. It may also root out corruption in governmental and business organizations. And, finally, it may bring criminals to justice.

WHERE TO START

In most forensic engagements, an interested party wants an answer to two principal questions:

- What happened?
- Who is responsible?

And in many cases, the party looks to a forensic specialist to assist in answering those questions. In my experience, forensic accounting assignments generally begin in one of two ways.

First, there is an issue in litigation that requires analysis. Examples of these types of assignment include the following:

- Measurement of economic damages and lost profits
- Valuation of business interests, intellectual property, real estate, intangible assets, or other assets
- Transfer pricing
- Intellectual property infringement

Second, a governmental agency or business has a suspicion (or in some cases a confirmation) that some type of fraud has occurred in the organization. Forensic accountants or analysts are frequently retained to assist in the investigation of such frauds. In some instances, the analyst will be retained directly by the organization, while in other instances outside legal counsel retains the specialists.⁸

Examples of fraud examinations include the following:

- Corruption, including conflicts of interest, bribery, illegal gratuities, and economic extortion
- Asset misappropriation, including theft, fraudulent disbursements, inventory, and other assets
- Financial statement fraud⁹

According to the ACFE, fraud examinations can also address other organizational objectives, such as the following:¹⁰

- Identifying improper conduct
- Identifying the persons responsible for improper conduct
- Stopping fraud
- Sending a message throughout the organization that fraud will not be tolerated
- Determining the extent of political liabilities of losses that might exist
- Helping to facilitate the recovery of losses
- Stopping future losses
- Mitigating other potential consequences
- Strengthening internal control weaknesses

TYPES OF ENGAGEMENTS

There are infinite types of forensic accounting engagements. These assignments are primarily classified as:

1. accounting or nonaccounting,
2. litigation or nonlitigation, or
3. fraud or nonfraud.

While there is certainly overlap within the groups, the primary reason for the classification system is to make certain that the assembled professional team is both qualified and has the specialized knowledge to complete the assignment.

For example, if the assignment relates to financial statement fraud, the team is going to require accounting expertise. And because of the fraud component, the team will also require someone with experience interviewing financial personnel.

Finally, the analyst should assume that any assignment may end in litigation and, therefore, should consider whether he would make a credible witness in the case. If the answer to that question is no, the analyst should either reject the assignment or add someone to the team who would serve as a potential expert witness.

PROFESSIONAL STANDARDS

The analyst should also consider which (if any) professional standards may apply to the assignment. Credentialed accountants, valuation analysts, and fraud professionals may belong to different professional organizations with different sets of professional standards. CPAs should consider the following professional standards:

- AICPA *Code of Professional Conduct*
- AICPA *Statement on Standards of Consulting Services*
- AICPA *Statement on Standards for Attestation Services*
- AICPA *Statement on Standards for Forensic Services No. 1*¹¹

The valuation profession often follows the *Uniform Standards of Professional Appraisal Practice*, which includes both ethical and development/reporting standards for various valuation disciplines. Certified Fraud Examiners comply with the Association of Certified Fraud Examiners Code of Professional Ethics and Code of Professional Standards. It is the analyst's responsibility to know which standards apply to any assignment.

OTHER CONSIDERATIONS¹²

Prior to accepting any assignment, the analyst should make certain that he (or his firm) has no conflicts of interest. Generally, the analyst should examine the company, key executives, and any potential targets for conflicts.

The AICPA provides guidance on conflicts in the Forensic and Valuation Services Section Special Report 08-1: "Independence and Integrity and Objectivity in Performing Forensic and Valuation Services."

It is always a best practice to have an engagement letter with the client (preferably with the outside legal counsel representing the organization). It is also important, in general terms, to outline the nature and professional standards governing the assignment. If these issues are not addressed, the client may incorrectly assume that the forensic accountant is providing some type of assurance (such as an "audit" or a "review"). Unless such assurances are being provided, the analyst (even if a nonaccountant) should avoid using attestation terms like audit and review in engagement letters, working papers, and client correspondence.

The AICPA provides additional guidance on engagement letters in the Forensic and Valuation

Services Practice Aid 04-1: "Engagement Letters for Litigation Services."

As soon as practicable, the analyst should develop a scope of work for the assignment. At the beginning of the assignment, a high-level work plan should suffice. This plan may be expanded and refined as additional facts are discovered and analyses performed.

It is important to keep outside legal counsel apprised (assuming the client heeded your advice to hire outside counsel) of the progress of your work and informed of any changes in scope. This communication should help create a team environment and ease tensions when the invoices for your services arrive.

Finally, the analyst should not allow the client or outside counsel to control the scope of the assignment and at the same time request a report of "no findings." If you find yourself in this predicament, you should consider resigning from the assignment.

Taking the time to understand the appropriate professional standards, properly staff the assignment, investigate potential conflicts, prepare effective engagement letters, develop efficient work plans, and communicate with outside counsel will greatly increase the chances of conducting a successful forensic accounting assignment.

Practical Procedures

More often than not, one of the first questions out of the client's mouth is going to be, "How much is this going to cost?" And while estimating that number is very difficult in litigation settings, it is virtually impossible in fraud investigations. Why? A couple of reasons.

First, you do not know how deep the rabbit hole goes. What starts with an anonymous tip¹³ from one employee about another employee may turn into collusion with multiple employees. All of which will then need to be investigated. And collusion creates other more significant problems. It overrides internal controls, systems access, and ordinarily solid process and procedures.

Additionally, if the assignment is with a public company and the fraud involves an employee that the outside auditors relied upon in conducting the audit or internal control review, the independent auditors are likely going to be concerned about the reliability of their audit and wish to conduct some type of shadow investigation. Such an investigation is going to require periodic reporting, and additional time, from the forensic accountant.

I once investigated a large manufacturing conglomerate related to a financial statement fraud.

Ultimately, I determined that the CFO conspired with the division heads to falsify account records in order to maximize bonus pools. Collusion between senior employees makes fraud investigations difficult to solve and costly to complete.

Second, people are going to lie to you and that will slow you down. I led investigations where employees lied to cover up office affairs, where assistants lied to cover for their bosses, and controllers lied to cover for their business units. The most effective way to combat this lying is to analyze the evidence and the data and to effectively interview employees. This is because putting a piece of paper in front of someone that refutes their lie is the quickest way to get to the truth. Once the interviewee realizes you have done your due diligence, you will receive much more truthful answers.

Several years ago, I interviewed the corporate controller for a major division of a Fortune 500 company. The company received a whistle-blower complaint from their internal fraud hotline stating that the division was fraudulently overstating its operating results.

On the morning of day one of the investigation, the controller sat in the conference room with me, lined with the leather-bound volumes of internal controls and process and procedures documents required under SOX, and told me his books were perfectly clean and accurate.

On the afternoon of day three, after several interviews, the analysis of several hundred transactions, and a list of 30 or so written questions about certain end of the month journal entries, the same controller walked into the same conference room and confessed to the fraud. Because of his title and his longevity in the organization, he was able to override any of the existing internal controls. The SOX documents were worthless.

When I asked him why he was confessing, he confided to me that he knew once I started asking the right questions and not accepting his first answers, that I was going to eventually find the fraud—it was only a matter of how long it would take. And he said he could not sleep at night. Be consistent and skeptical and you will eventually find the answers.

Finally, electronic record keeping has made fraud investigations infinitely more complicated. Twenty years ago, analysts might look through the file cabinets located in an executive's office or the office of his secretary. Today, analysts have file servers, email systems, shared drives, text messages, and chat rooms.

And many businesses retain everything—forever! So, all of it should be analyzed for relevancy.

And even with computer tools, SQL databases, and structured data and computer analytics professionals doing the work, this analysis takes time and is expensive.

I once interviewed a woman who we believed was skimming money from her employer. She denied the allegations. I then reviewed her company emails along with her voice mail messages, text messages, and group chats from her company server. She obviously did not know that the company saved the metadata from the instant messages she sent through her work computer. Those messages not only showed how she was skimming the money, but also showed she was spending a good bit of it on her boss, with whom she was also having an affair. The company terminated both employees and referred the case to local law enforcement for prosecution.

My best recommendation to manage the client's expectations and engagement costs is to utilize a phased approach. I generally create an approach memorandum (or work plan) at the beginning of each forensic investigation. At a high level, the memorandum outlines the steps of the investigation and the estimated cost of each step. At the end of every week, I revise the memorandum, update the estimates, and circulate the updates to counsel and/or the client. This process keeps everyone on the same page and minimizes any "sticker shock" for your billings.

WHAT'S NEXT?

Preliminary Assessment

It is generally appropriate to conduct some type of preliminary assessment at the beginning of any forensics investigation. This assessment may include the following:

1. Gaining an understanding of internal controls and processes
2. Performing an analysis of records
3. Conducting some preliminary discussions with executives who are not a target¹⁴ of the investigation¹⁵

In many instances, the assessment requires the interaction of the forensic analyst with employees of the accounting and finance department of the company. Care should be taken during these interactions as the accounting and finance departments are often the targets of the investigation—and news travels fast even in very large organizations. In this type of environment, I will often introduce myself as a member of the independent audit team (with prior notification of counsel, of course).

The AICPA provides the following questions that may assist with the assessment:¹⁶

- What data are available? Understanding (1) the type of financial information that is available and (2) the related time periods covered will help the analyst assess the level of work and the cost required to gather and analyze the information.
- Are the data available in electronic format? Electronic data will make analysis more efficient and will provide for more comprehensible procedures. It is also helpful to request data that are in a proper format and compatible with any tools that the forensic accountant will use to perform an analysis. Including a specimen document request letter may facilitate the accurate collection of electronic data.
- Will the information be complete? Incomplete information will limit the practitioner's ability to produce accurate conclusions. The time spent to fill in incomplete data will also affect the cost of the investigation.
- Are there nonfinancial types of information that could help with the investigation? Other types of information, such as phone records, email, and building access logs could assist the forensic accountant with the assignment. It is important to inquire about what types of nonfinancial information are available.

Subsequent to the preliminary assessment, I will update the approach memorandum and consider any necessary changes to the team structure. Team changes are generally because of complex accounting issues, specific industry expertise requirements, and electronic data issues.

Working Papers

It is imperative that the analyst retain a complete set of working papers prepared during the investigation. That is not to say that all notes, schedules, and other documents should be retained. The analyst should determine whether notes or other materials are relevant to the investigation. If so, the notes should be formed into a memorandum or other document. If not, the materials should be discarded.

This is especially important for interview memorandums. The purpose of the interview memorandum is not to transcribe everything said during the interview, but rather to summarize the relevant



content. It is permissible to quote the interviewee for particularly important details.

In the event the analyst takes possession of original documents, it is important that the proper chain of custody be maintained to ensure preservation of the evidence.¹⁷ This is particularly important for documents with original signatures or items like cancelled checks, computer hard drives, and the like.

Communications

Communication should be directed to your client, be that outside legal counsel or company management. In some cases, the client may be the company's board of directors or audit committee. As noted above, it is always preferable for the client in forensic investigations to be legal counsel. That way if the analyst determines there is collusion or management involvement in the fraud, the analyst has an unbiased communication partner. If company management is the client, it is advisable to have management involve the board of directors or audit committee early in the assignment for the same reasons.

Finally, at some point in the investigation, the analyst and the client will need to determine how to communicate the conclusions from the assignment. This generally takes the form of a written report or an oral presentation. There are pros and cons to each method. Written reports take time and are expensive to write but provide high levels of detail.

Clients usually prefer written reports if they wish to refer the case to law enforcement or plan to seek reimbursement of costs from their insurance carrier. Oral reports can be prepared quickly, but only offer summary information. Clients generally prefer oral reports if they are concerned with legal privilege and discovery issues—if there is no report, no report can be produced. I have clients that requested oral presentations, but written reports for recommendations for internal controls as they wished to share the latter with their outside auditors.

Executing the Engagement

Subsequent to the approval of the work plans by the client, the analyst should begin executing the plan. While every forensic accounting assignment will vary, there are a couple of execution categories that should remain the same.

First, you will gather the relevant hard copy and electronic documents. In some cases, the hard copy documents may be voluminous. If so, the engagement team should either keep the copies of the documents off site or work with the client to obtain means to limit access to employees. Electronic documents (emails, spreadsheets, shared drives, etc.) are generally processed and loaded into a review environment tool. The processing of documents is complex and outside the scope of this discussion.

Second, depending on the type of assignment, the next step may involve the use of analytical procedures. These procedures may identify trends or unusual transactions that would assist the analyst. Some examples of analytical procedures include the following:¹⁸

- Comparison of company financial data versus operational data, such as production levels, number of employees, and square footage
- Comparison of current company data versus historical periods
- Comparison of actual financial results versus company budgets, forecasts, or projections
- Comparison of company data versus industry and competitor data
- Comparison of financial statement information with income tax returns
- Comparison of financial statements submitted to different parties or regulators
- Comparison of subsets of company data versus other subsets of company data (i.e., comparison of data on a disaggregated basis such as by division, product, location, or employee)
- Analyses of financial data in the context of external events (i.e., economic, political, etc.) or circumstances
- Vertical, horizontal, financial statement, and financial ratio analyses

Third, the analyst should begin scheduling interviews as quickly as practicable. Prior to any interview, the analyst should consider the following issues:

- Will outside legal counsel (for the company) attend the interview? If so, will they provide *Upjohn*¹⁹ warnings, background of the investigation, and or other privilege instructions? If not, will the analyst perform this task?
- The order of the interviews. Generally, you should interview the whistle-blower first (if applicable) and the subject of the investigation last. It is also a best practice to interview lower-level employees first. This should provide a solid base of knowledge for the interview of senior personnel.
- Site of the interviews. If you are interviewing an internal whistle-blower, it is better to conduct the interview at an off-site location. If on site, you will need a quiet and private location to conduct interviews so that the interviewee will feel comfortable.
- What if the interviewee requests legal counsel? Generally, this means an immediate halt to the interview until such time that interviewee can discuss options with his or her counsel.

Generally, the interviewer should have one additional person in attendance to take notes during the interview. I find it best to place the person taking notes slightly out of the direct eyesight of the interviewee. This keeps the interviewee's focus on the interviewer and not the notes that are being taken.

Interview memorandums should be prepared as quickly as possible after the interviews. This keeps the details of the interview fresh in your mind and significantly improves the quality of the memorandums. I have on occasion been asked by an interviewee for a copy of the interview memorandum. I have always refused this request on the basis the document is legally privileged and a work product of the investigation.

Practical Procedures

Conducting interviews is, by far, the most fun part of forensic investigations. But to be fun, the interview must be successful and the only way to a successful interview is through preparation. You need to walk into the interview knowing more than the interviewee thinks you know. Do your homework and prepare an outline. But perhaps more importantly, listen to what the interviewee is telling you.

I have seen interviews where the interviewer was so intent on his next question that he did not hear the response to the previous question. Be flexible enough to deviate from your outline when

the interviewee takes you in a fruitful direction, but return if you are not getting anywhere.

If you feel like the interviewee is not being truthful, ask the question again and again but in slightly different ways. Return to topics and see if you get slightly different responses. Many times your persistence will pay off and you will get to the truth. And your last question should always be, “Is there anything else you would like to tell me?” You may be surprised at some of the responses you get.

I once interviewed a woman who was the office manager of a large construction company. An internal whistle-blower alleged that several construction executives at the company were paying political contributions to select local politicians and then receiving reimbursements for those payments from company funds. The reimbursements were alleged to have been categorized as travel and other expenses in the company’s accounting system.

When I interviewed the whistle-blower, she told me that the office manager knew “everything that happened in this company” and that she was “close friends” with the executives in question. So, I spent several days going through the expense reports and pulled every expense for the past three years categorized as “travel” or “other” and without supporting documentation.

I then scheduled the interview with the office manager. I explained to her why I was there and outlined the whistle-blower’s allegations. She denied any knowledge of the allegations. I spent the next several hours going through the expense reports—I would cover 10 and then ask, “Do you know anything about these.” She would deny knowledge. I would cover 10 more then add, “Someone from an earlier interview said you were knowledgeable about this process.” She would deny knowledge.

At some point, she stopped me and said, “How long are we going to be here?” and I responded, “Until we find the truth.” After several more examples, she paused and explained how the fraud worked. She did not participate, but knew the details. She was tired of answering questions and just wanted someone to know that she was not responsible for the fraud. In this case, persistence paid off.

Finally, the analyst may perform additional substantive procedures as necessary. These procedures may include things like observations of internal control systems, asset tracing, analysis of access logs, examination of metadata from electronic media, selection of journal entries from the general ledger, and analysis of unusual or related party transactions. It is wise to seek consensus with the client



before undertaking these procedures (especially if the procedures were not part of your original work plan).

Reporting Findings

Documenting your findings is important and may be done in a variety of ways—both written and oral reports directly to the client are common. Additionally, the analyst may be asked to submit a report to a court or a law enforcement agency. Any investigative report should contain the following basic elements:²⁰

- Identify the client
- Include the analyst’s qualifications and background
- Describe the predication²¹
- State in broad terms what the analyst was asked to do
- Describe the engagement scope, including the time period examined
- Include mention of any restriction as to distribution and use of the report
- Identify the professional standards under which the work was conducted
- Identify exclusions in the reliance on the analyst’s report
- State that the work should not be relied on to detect fraud
- Include a list of the documents reviewed and relied upon during the investigation
- Include the names, titles/organizations, and dates of interviewees
- Include the procedures performed and the technical pronouncements relied upon
- Describe the observations and identify the findings

Finally, the analyst should not state definitive conclusions of fraud. You may conclude there were indications of fraud and you may even state that the subject of the investigation confessed to certain allegations, but the act of fraud is a legal conclusion and should be reserved for courts, judges, arbitrators, and juries.

SUMMARY AND CONCLUSION

Taking the time to properly plan and organize a forensic investigation will produce more efficient investigations and cost savings to your clients. This process involves communicating initial cost estimates, changes in scope, and tentative findings with the client.

Other issues, especially the pros and cons of the various types of reports, should be discussed early in the engagement. If the client either intends to seek reimbursement for the costs of the fraud and investigation for its insurance carrier or wishes to refer the matter to a law enforcement agency for prosecution, the analyst should prepare a written report. If these issues are not important to the client, but there are concerns about confidentiality or legal privilege, an oral presentation may suffice.

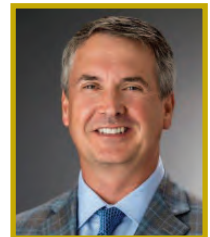
Finally, the success to the investigation very well may depend on the forensic interviews. Analysts should thoroughly prepare for the interviews and walk in knowing more than the interviewee expects. Clients should expect that the analyst has experience with effective interview techniques and can handle deceptive or confrontational interviewees.

Notes:

1. *CSI: Crime Scene Investigation* is a procedural forensics crime drama television series which ran on CBS from October 2000 through September 2015.
2. A special master is appointed by a court to carry out some sort of action on its behalf. Found at https://www.law.cornell.edu/wex/special_master.
3. A Ponzi scheme is a fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for early investors by acquiring new investors. Found at <https://www.investopedia.com/terms/p/ponzischeme.asp>.
4. AICPA Practice Aid 10-1, "Serving as an Expert Witness or Consultant."
5. The Association of Certified Fraud Examiners defines occupational fraud as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.
6. *ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse*, 8. The report may be downloaded for free at <https://www.acfe.com/report-to-the-nations/2018/>.

7. SOX required corporate executives to certify the financial statements under penalty of prosecution. Additionally, companies were required to publish details of their internal accounting controls. The thought at the time was that these processes would significantly decrease corporate fraud events. As of this writing, the success of SOX is debatable.
8. I always recommend the retention of outside legal counsel in fraud examinations and that outside legal counsel retain the specialist. This arrangement allows for confidentiality and legal privilege of the investigation until such time the company wishes to disclose any findings to governmental or other regulatory agencies.
9. *ACFE Report to the Nations*, 11. Summarized from Occupational Fraud and Abuse Classification System (the Fraud Tree).
10. *ACFE 2016 Fraud Examiners Manual*, 3.101.
11. In June 2019, the AICPA issued SSFS 1, which provides authoritative guidance for AICPA members providing litigation and investigative services. The statement defines litigation and investigation for accounting purposes, outlines key considerations for client and provider relationships, and establishes boundaries on the services members can provide. The new standards take effect for new engagements accepted on or after January 1, 2020. Early adoption is permitted.
12. Summarized from AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation."
13. According to the *ACFE 2014 Report to the Nations*, more than 40 percent of all internal investigations originate with a tip from an employee, customer, or vendor.
14. Keep in mind potential collusion issues as discussed above.
15. AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation," 6.
16. *Ibid.*
17. *Ibid.*, 7.
18. *Ibid.*, 13.
19. Informally known as a corporate *Miranda* warning. Notifies an employee being interviewed that the legal counsel for the investigation represents the company and NOT the employee.
20. AICPA Forensic and Valuation Section, "How to Organize a Forensic Accounting Investigation," 17.
21. "Predication" is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a fraud has occurred, is occurring, and/or will occur. *ACFE 2016 Fraud Examiners Manual*, 3.105.

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The State of Domestic Self-Settled Asset Protection Trusts

Tish McDonald, Esq.; Emily Newton, Esq.; and James Graessle, Esq.

This discussion sets out the general provisions of self-settled asset protection trusts, such as the requirement for a spendthrift provision. Additionally, this discussion demonstrates the differences of law between the states that allow for such trusts (most notably the allowance of revocable self-settled asset protection trusts in Oklahoma). Finally this discussion addresses the potential upside and downside of specific provisions in such trusts, such as (1) the potential asset protection from creditors and (2) the grantor/beneficiary losing control over his or her assets.

INTRODUCTION

This discussion sets out the general provisions of self-settled asset protection trusts, the variations of law between the 17 states that allow such trusts, and the potential pros and cons of the specific built-in provisions in such trusts.

Under typical norms of trust creation, the grantor and the sole beneficiary could not be the same person. Otherwise a grantor could move her assets into a trust for her own benefit and possibly prevent creditors from accessing such assets in satisfaction of claims.

However, since 1999, 17 states have enacted legislation permitting self-settled asset protection trusts, which allow the grantor to create a spendthrift trust where the grantor is also a beneficiary. The states that allow for these types of trusts are Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.¹

The creation of such trusts has caused controversy and legal challenges with regard to a myriad of issues, including jurisdictional matters as well as debtor-creditor relations. Certain states that allow self-settled asset protection trusts have built-in

statutory provisions to provide protection to creditors. Most states, for example, require that these self-settled asset protection trusts be irrevocable, which means that the grantor cannot modify or revoke the trust.

In addition, all states that have recognized such trusts prohibit fraudulent conveyances to these trusts—that is, transfers that are intended to defeat the reach of known or future creditors. And some courts in the states that bar such trusts have refused to enforce self-settled trusts formed in one of the 17 states that recognize such trusts on public policy grounds.

SELF-SETTLED ASSET PROTECTION TRUSTS

A self-settled asset protection trust allows for a grantor to convey her own assets into a trust where she is also the sole beneficiary. This differs from a typical trust where the grantor conveys her own assets into a trust for the benefit of others—often her family members or charitable organizations.

The trustee of such a trust can be a corporate trustee or even a family member. However, the trust must contain a few provisions to make it

“Typically, state laws have prevented a grantor from creating a trust for her own benefit where the trust contains a spendthrift clause applicable to existing and future creditors.”

enforceable. The trust must contain a “spendthrift” provision, which prevents the beneficiary from spending or borrowing against trust funds (a voluntary transfer), and, more importantly, prevents creditors from accessing the trust assets (an involuntary transfer).

Therefore, the trust must only allow for permissive distributions—that is, the trust must not have an ascertainable standard forcing specific distributions to the beneficiaries.² Having required distributions would allow creditors to access the distributed assets.

In states that allow these types of trusts, the self-settled asset protection trust must, in fact, be self-settled. That is, the grantor/beneficiary must have funded the assets of the trust.

STATES THAT ALLOW SELF-SETTLED ASSET PROTECTION TRUSTS

Typically, state laws have prevented a grantor from creating a trust for her own benefit where the trust contains a spendthrift clause applicable to existing and future creditors.³

These typical trusts allow creditors to access the assets the grantor transferred to the trust, which is the position still held by the majority of states and the Restatement (Third) of Trusts and the Uniform Trust Code.⁴

The typical rule is that spendthrift clauses can be used to insulate *other beneficiaries* from creditors, but they cannot be used to protect the grantor as the beneficiary from her own creditors.

This all changed with the creation of the domestic self-settled asset protection trust in the state of Alaska in 1997.⁵ South Dakota enacted a similar statute next, and 15 other states followed behind, most notably Nevada and Delaware.⁶ These new statutes allow a grantor to utilize a spendthrift clause in a trust for herself.⁷

Importantly, these new laws allow residents of any state to establish self-settled asset protection trusts in those states.⁸ For example, a resident of Georgia could create a self-settled asset protection trust in Alaska, South Dakota, Nevada, or a host of other states that have amended their trust laws to allow these types of trusts.⁹

There are, of course, risks associated with such actions by nonresidents, as will be discussed below.

While the aim of the legislation is similar, different states have varying provisions to effectively create these new trusts. With the exception of Oklahoma, every state allowing for such trusts requires that the grantor establish an irrevocable trust.¹⁰

In Oklahoma, the grantor can create a revocable trust, and a court cannot force the revocation of the trust.¹¹ No state allows for fraudulent conveyances into the trust, but some states, such as Alaska, require a showing of actual fraud to establish such a conveyance.¹²

Nevada is also a popular state for the creation of self-settled asset protection trusts because of the short statute of limitations: “The assets are secure from the claims of creditors after the statute of limitations of two years from the date of transfer, or for an existing creditor, six months after the creditor discovers or reasonably should have discovered the transfer, whichever is the latter.”¹³

Additionally, some states allow certain creditors to pierce the trust as a matter of public policy. In Delaware, for example, the spendthrift provision is not enforceable as to the payment of alimony or support for a former spouse, child support, property distribution because of a dissolution of marriage, or a tort committed on or before the date of the creation of the trust.¹⁴

Oklahoma exempts child support payments from the spendthrift provision,¹⁵ and Alaska bars the creation of these trusts if the grantor is in default by 30 or more days of payment for child support.¹⁶

Universal provisions also exist. All of the states that allow self-settled asset protection trusts require that:

1. some assets are settled within the state,
2. the trust be administered by at least one resident trustee or trust company in that state, and
3. the trust be governed under the trust law of that state.¹⁷

This last provision, discussed below, has come under scrutiny by certain courts.¹⁸

STATES THAT DISFAVOR SELF-SETTLED ASSET PROTECTION TRUSTS

Thirty-three states do not have a statute allowing self-settled asset protection trusts.¹⁹ Simply because

the state does not have an explicit statute allowing these trusts to be created within the state does not mean that the courts in the state will not recognize these trusts formed in one of the 17 states that explicitly allow these trusts. Whether courts within one of the states that does not allow self-settled asset protection trusts will recognize these trusts is no guarantee.

As an illustration, in 2013, a Washington U.S. bankruptcy court faced the issue of deciding whether to uphold an Alaskan-created self-settled asset protection trust where the trust “designat[ed] the law of Alaska to govern the Trust.”²⁰

In order to determine if the grantor created the trust based upon fraudulent intent, the court looked to Ninth Circuit precedent:

[a]mong the more common circumstantial indicia of fraudulent intent at the time of the transfer are: (1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor’s property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and, after the transfer, (5) retention by the debtor of the property involved in the putative transfer.²¹

These so-called “badges of fraud” assisted the court in ruling in favor of the creditors on summary judgment, despite the insistence of the debtor that there was a material fact if he actually intended to defraud his creditors.²²

Noting that the presence of one badge of fraud would not necessarily prove fraudulent conveyance, the court went through each badge of fraud and determined that “the timing of the Trust’s creation, the facts surrounding its creation, and timing of the asset transfers support a finding of a motive other than estate planning, that of asset protection at the expense of his creditors.”²³

From this posture, the court found that the trust violated the Washington “strong public policy against self-settled asset protection trusts . . . [and the court held that] transfers made to self-settled trusts are void as against existing or future creditors.”²⁴

While self-settled asset protection trusts can protect the grantor/beneficiary against certain credi-



tors, the grantor/beneficiary must be careful to keep herself adequately capitalized and to avoid the appearance of fraud. In piercing the trust, the bankruptcy court in Washington noted, “Based on the evidence before the Court, the only reasonable conclusion is that the Debtor continued to use and enjoy the Trust assets just as he did before the transfers.”²⁵

While the law is developing on this issue, a bankruptcy court in New York also considered the public policy of New York when dealing with foreign self-settled asset protection trusts and held that the grantor “may not unilaterally remove the characterization of property as his simply by incorporating a favorable choice of law provision into a self-settled trust of which he is the primary beneficiary. Equity would not countenance such a practice.”²⁶

A risk remains that courts in states that do not explicitly recognize self-settled asset protection trusts will pierce the trusts because of issues regarding choice of law provisions and considerations of the fundamental fairness to creditors.

IMPORTANT PROVISIONS IN SELF-SETTLED ASSET PROTECTION TRUSTS

Some Assets Must Be Settled Within the State

The requirement that some assets must be settled within the state is rarely an issue for residents of

“Besides Oklahoma, every state that has adopted self-settled asset protection trusts has a requirement that the trust be irrevocable.”

the 17 states that have provisions allowing self-settled asset protection trusts. But for the majority of the population, residents must transfer property to the state in which they create the trust. And jurisdictional issues can arise from transferring property into a self-settled asset protection trust in a different state.

For example, suppose a grantor living in Washington (a state that does not have its own self-settled asset protection statute) created a trust in and under Nevada law (a state that does have its own self-settled asset protection statute), funded the trust with assets in Nevada, appointed a Nevada trustee, and a creditor in Washington sought to access the assets of that trust.

If the creditor sued in Washington, the court may have personal jurisdiction over the defendant. However, the court likely would not be able to exercise jurisdiction over the trust property if the Nevada trustee did not have sufficient contacts with Washington. Likewise, if the creditor sued in Nevada, the court likely would have jurisdiction over the trust, but the law in Nevada protects the trust assets. Such trust planning strategy may protect the grantor in this instance.

If, however, the Washington grantor created a Nevada self-settled asset protection trust, but funded the trust with assets in Washington, the Washington court likely would have jurisdiction over the trust assets. While this result could create complicated conflict of law questions, there is a possibility that a Washington court may decide that self-settled asset protection trusts are in direct conflict with Washington law—and thus refuse to recognize the protective aspect of the trust on public policy grounds.

Irrevocability

Besides Oklahoma, every state that has adopted self-settled asset protection trusts has a requirement that the trust be irrevocable.²⁷ Once created, irrevocable trusts cannot be modified or revoked.

While still a beneficiary, the grantor of the self-settled asset protection trust loses all control over the assets that she used to fund the trust. These assets could be managed by a trustee who, for example, makes financial decisions of which the grantor disagrees. Or the grantor's financial circumstances

could change, and the grantor may desire complete control over the assets in the future. The irrevocable trust prevents the grantor from revoking or modifying the trust to regain control over the assets in these scenarios.

The Oklahoma statute addressing irrevocability for a self-settled asset protection trust differs from all the other domestic provisions. Like some foreign self-settled asset protection trust laws, Oklahoma allows the trust to be revocable, and “[n]o court or other judicial body shall have the authority to compel a person holding a power of revocation or amendment over a preservation trust to exercise the power of revocation or amendment.”²⁸

Oklahoma prevents courts from ordering the trustee from revoking or amending a revocable self-settled asset protection trust. “Hence, in effect, grantors can impress a self-settled trust in Oklahoma with a restraint on involuntary alienation without simultaneously restraining voluntary alienation. By exercising a reserved right of revocation, wholly personal to themselves, grantors can recover the corpus at will, but creditors cannot touch it.”²⁹

Spendthrift Provisions

Additionally, states that recognize self-settled asset protection trusts require that the trust contain a spendthrift provision to provide an effective protection against potential creditors. The spendthrift provision gives the trustee discretion over how the assets are distributed to the beneficiaries.

For example, some trusts provide that a trustee may make distributions to beneficiaries for specific reasons, such as educational, medical, or other living needs. Such provisions prevent creditors from attaching assets and making claims against the trustee of the trust.

On the flip side, a beneficiary who seeks to borrow against a spendthrift self-settled asset protection trust is out of luck. And while the trustee of a self-settled asset protection trust owes fiduciary duties to the beneficiaries, those fiduciary duties do not necessarily require the trustee to distribute as much assets as desired by the beneficiaries. Rather, they must make such distributions based on the terms of the trust agreement. While the trustee has the potential to protect against creditors, the grantor/beneficiary must be willing to part with ownership and control over her assets.

Fraudulent Conveyances

Committing fraud upon creditors is against the public policy of every state.³⁰ Like any other trust,

the self-settled asset protection trusts are subject to similar fraudulent conveyance rules. These trusts can be set aside if it is shown that the trust is used as an instrument to commit fraud to present and future creditors.

States that allow for self-settled asset protection trusts contain similar (if not more stringent) language in their relevant statutes to the language in the Alaska statute, which states that the trust will not be valid if “the creditor establishes by clear and convincing evidence that the grantor’s transfer of property in trust was made with the intent to defraud that creditor. . . .”³¹

To void such trusts in Delaware, it requires a showing of an “actual intent to defraud [a] creditor,”³² and Nevada’s statute requires a showing of an intent “to hinder, delay or defraud known creditors.”³³

According to most states, “[i]f a fraud is shown, the trust is void, and a creditor of the beneficiary may reach its assets to satisfy the creditor’s judgment claim.”³⁴ Self-settled asset protection trusts created to defraud creditors, former spouses, or to avoid child support are disfavored by states and courts.³⁵

For example, courts would likely disfavor those in a high-risk profession for tort liability—such as doctors—from refusing to carry liability insurance, making themselves insolvent, and conveying all of their assets to a self-settled asset protection trust, because it would appear that the trust was solely created to delay, hinder, or defraud potential creditors.³⁶

SUMMARY AND CONCLUSION

Self-settled asset protection trusts remain controversial because of the possibility of a grantor protecting her own assets from recovery by legitimate creditors. Despite the controversy, 17 states have passed laws allowing the creation of such trusts, and more states are actively considering allowing the creation of such trusts.³⁷

And while the states that allow such trusts have been steadily increasing, only one-third of the 50 states allow such trusts—even though it has been over 20 years since Alaska created the first statute allowing such trusts. The law is still developing on this issue and potentially difficult choice of law questions and creditor rights concerns remain unsettled.³⁸



Notes:

1. <https://www.aeapa.com/2019/01/domestic-asset-protection-trusts>.
2. An example of a mandatory distribution requirement would be: “The trustee shall pay the beneficiary the income of the Trust each quarter.”
3. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).
4. *Id.*; see also, RESTATEMENT (THIRD) OF TRUSTS § 58(2) (2003) (“A restraint on the voluntary and involuntary alienation of a beneficial interest retained by the [grantor] of a trust is invalid.”); UNIF. TRUST CODE § 505(a)(2) (follows the Restatement (Third) of Trusts and traditional doctrine that a grantor “may not use the trust as a shield against the grantor’s creditors”).
5. Alaska Stat. § 34.40.110 (2018).
6. <https://www.assetprotectionplanners.com/asset-protection-trust/domestic>.
7. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).
8. *Id.*
9. For more information regarding specific state law summaries, see Summary of State Laws That Authorize Self-settled Asset Protection Trusts, Fraudulent Transfers, Prebankruptcy Planning and Exemptions Appendix B.
10. Okla. Stat. tit. 31, § 13 (2019).
11. Okla. Stat. tit. 31, § 16 (2019) (“No court or other judicial body shall have the authority to compel a person holding a power of revocation or amendment over a preservation trust to exercise the power of revocation or amendment. The provisions of this act shall be considered restrictions on the transferability of the grantor’s beneficial interest in the preservation trust that is enforceable under applicable nonbankruptcy law within

- the meaning of Section 541(c)(2) of the United States Bankruptcy Code or any successor provisions.”) (internal footnotes omitted).
12. Alaska Stat. § 34.40.110 (2019) (“the creditor establishes by clear and convincing evidence that the grantor’s transfer of property in trust was made with the intent to defraud that creditor . . .”).
 13. <https://alliancetrustcompany.com/services/trustee-services/asset-protection-trusts>.
 14. Del. Code tit. 12, § 3573 (2019).
 15. Okla. Stat. tit. 31, § 13 (2019).
 16. Alaska Stat. § 34.40.110 (2018).
 17. Bogert, *Trusts and Trustees*, 2d ed. § 223, pp. 438, 439 (Grantor creates spendthrift trust for self).
 18. See, e.g., *Toni 1 Tr., by Tangwall v. Wacker*, 413 P.3d 1199 (Alaska 2018).
 19. <https://www.aaepa.com/2019/01/domestic-asset-protection-trusts>.
 20. *In re Huber*, 493 B.R. 798, 807 (Bankr. W.D. Wash. 2013).
 21. *Id.* at 811.
 22. *Id.*
 23. *Id.* at 813.
 24. *Id.* at 809.
 25. *Id.* at 813.
 26. *In re Portnoy*, 201 B.R. 685, 701 (Bankr. S.D.N.Y. 1996).
 27. Okla. Stat. tit. 31, § 16 (2019).
 28. *Id.*
 29. Adam J. Hirsch, *Fear Not the Asset Protection Trust*, 27 CARDOZO L. REV. 2685, 2687 (2006). Professor Hirsch contends that the motivation behind the revocability provision in Oklahoma’s statute is straightforward: “The driving force behind these legislative initiatives is clear enough. States are vying for trust business.”
 30. See, e.g., *Erickson v. Bank of California, N. A.*, 97 Wash. 2d 246, 254, 643 P.2d 670, 675 (1982) (“To hold otherwise would be to hand spendthrift trust beneficiaries an active sword for defrauding creditors against the public policy of this state.”); *Whitelock v. Geiger*, 368 So. 2d 372, 374 (Fla. 3d DCA 1979) (“[A] scheme to defraud creditors is against public policy.”); *Vezina v. Kannen*, No. CV 960557344S, 1996 WL 493228, at *2 (Conn. Super. Ct. July 31, 1996) (“the public policy against defrauding creditors . . . clearly outweighs any interspousal privilege that might otherwise exist.”).
 31. Alaska Stat. § 34.40.110 (2018); see also, *Kulp v. Timmons*, 944 A.2d 1023, 1029 (Del. Ch. 2002) (noting that the relevant Delaware statute states: “If such beneficiary has transferred property to the trust in defraud of the beneficiary’s creditors the foregoing shall in no way limit the rights of such creditors with respect to the property so transferred.”).
 32. Del. Code tit. 12, § 3572 (2019).
 33. Nev. Rev. Stat. § 166.040 (2019).
 34. *Kulp v. Timmons*, 944 A.2d 1023, 1030 (Del. Ch. 2002).
 35. § 211. Trusts for unlawful purposes, *The Law Of Trusts And Trustees* § 211 (“Many states have enacted either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, each of which describes transfers or dispositions that are deemed fraudulent. Both Acts provide that a transfer made with actual intent to hinder, delay, or defraud creditors is fraudulent and can be set aside or disregarded by creditors of the transferor or grantor.”) (internal footnote omitted).
 36. *Id.*
 37. See, e.g., Georgia Bill 497 during the 2019-2020 session.
 38. See, e.g., *Toni 1 Tr., by Tangwall v. Wacker*, 413 P.3d 1199 (Alaska 2018).

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Thought Leadership Discussion

Reasonable Certainty of Lost Profits in a New Business or Venture

Brandon L. McFarland, John C. Kirkland, and Kristine D. Taylor

The controversy over the existence of lost profits related to new businesses has long been debated among legal counsel and forensic analysts. Regarding this issue, the view of most federal and state courts has shifted from a rule of law to a rule of evidence. Whereas the concept of lost profits for unestablished businesses was previously dismissed, the Modern New Business Rule grants new businesses potential credibility in recovering damages. This discussion (1) reviews the Modern New Business Rule along with its endorsement of reasonable certainty and (2) summarizes judicial decisions in which the standard of reasonable certainty is used in the measurement of lost profits damages.

INTRODUCTION

One of the challenges of measuring economic damages in a case that involves a new enterprise is deriving a reasonable estimate of profits lost due to the wrongful actions of another party. Due to lack of historical performance for the new enterprises, certain state and federal courts formerly abided by the New Business Rule, which dismissed any action by a new enterprise to claim lost profits. However, recent judicial decisions in damages cases where a new business or venture claimed lost profits have revealed a new standard that many courts now observe—the Modern New Business Rule.

Whether assuming a role in the plaintiff's or the defendant's damages case, it is important that the damages analyst ("analyst") and the legal counsel ("counsel") understand the standards by which courts assess damages and have knowledge of relevant court decisions. This discussion summarizes the following:

1. The shift in standards applied by both federal and state courts to address lost profits in damages cases involving new enterprises

2. The application of reasonable certainty in federal and state judicial decisions

NEW BUSINESS RULE

The New Business Rule ("NBR") traces its roots to 19th century American common law. At the time, courts sought to protect businesses and create an environment in which the nascent, industrializing American economy could grow.

The NBR originally held that "lost profits for a new business were not recoverable" for a new or recently formed business as future profits were too "uncertain, speculative, and contingent."¹

The foundation on which the NBR is premised precludes a number of newly formed businesses from claiming lost profits in damages cases. This view provided an opportunity for one party to potentially breach a contract before the other party began to conduct its business operations.

Under the NBR, the nonbreaching party had little to no recourse against the breaching party. However, as time passed, most courts began to realize the inequities created by this interpretation and application of the NBR.

THE SHIFT FROM A RULE OF LAW TO A RULE OF EVIDENCE

More recently there has been a shift in the judicial interpretation of the NBR. The majority of state and federal courts now reject the application of the NBR as a per se rule in favor of a new interpretation and standard. “The development of the law has been to find damages for lost profits of an unestablished business recoverable when they can be adequately proved with reasonable certainty.”²

This distinction between absolute certainty and reasonable certainty by the court is an important element of the new interpretation that allows new businesses to claim, and in some cases recover, lost profits. “What was once a rule of law has been converted to a rule of evidence.”³

This shift in interpretations came about gradually and eventually resulted in what is commonly known as the Modern New Business Rule (“MNBR”). The MNBR holds that profits of a recently formed business are in fact recoverable, so long as the amount of lost profits can be “adequately proven with reasonable certainty.”⁴

An important distinction between the NBR and the MNBR is that the NBR is a rule of law, whereas the MNBR is an evidentiary rule.

There are several scenarios in which the MNBR may be applied:⁵

1. **Post-Breach Profits for an Injured Business.** In this situation, a damaged business may eventually return to the projected growth curve that existed prior to the alleged wrongful act. For example, if a supplier breached its contract to provide a certain product or service, the business damaged by the breach may need time to find a replacement supplier. This may ultimately lead to lost profits.

If the injured business is able to find a replacement supplier and return to its prior level of sales, the lost profits may only apply during the time needed to find a new supplier and return to previous growth. In this instance, a comparison of projected and actual profits during the time of recuperation may be used to calculate lost profits.
2. **Post-Breach Profits by Successor Business.** In some instances, a wrongful act may cause the injured business to vacate its location and a competitor business may take its place. Provided all other market factors remain the same, the profits generated by the successor business may be used as a substitute for calculating the lost profits of the damaged business.

3. **Business Enterprise Ceases.** In some situations, the damaged business may cease all operations. In such a case, to meet the reasonable certainty standard, the elements that are necessary for the success of a particular business must be identified. These critical success factors are business-specific and should be determined by the nature, industry, and market of each enterprise.
4. **Short-Term Pre-Breach Operations.** It is possible for a new business to have only operated for a short period of time before being affected by an alleged wrongful act. “Even if the business operated for less than one year, sufficient information may exist to extrapolate lost profits as a result of the breach.”⁶

Data gathered for even a few months may be comparable to industry statistics. A new business may demonstrate reasonable certainty by comparing its data with similar new business trends.

Although courts have started to acknowledge scenarios in which unestablished businesses may recover lost profits, the requirement of reasonable certainty is often strictly followed.

REASONABLE CERTAINTY

In determining the validity of a calculation of lost profits, courts consider the establishment of reasonable certainty in an analyst’s measurement of lost profits.

In *Morris Concrete, Inc. v. Warrick*, the court describes reasonable certainty as follows: “In order that it may be a recoverable element of damage, the loss of profits must be the natural and proximate, or direct, result of the breach complained of and they must also be capable of ascertainment with reasonable, or sufficient, certainty . . . absolute certainty is not called for or required.”⁷

While there is no law or single measure for reasonable certainty, section 352 of the Restatement (Second) of Contracts states, “Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.”⁸

Although federal and state courts provide varying case-specific decisions, they generally agree on certain guidelines:

1. The conduct of the defendant upon which the claim is based directly caused the damages to the plaintiff.

2. The plaintiff can estimate the amount of damages, and the estimation employs a reliable method of measurement.
3. The length of the damage period is reasonable.
4. The plaintiff based its assumptions upon the best available evidence, and both internal and external factors were considered within the measurement of damages.

For well-established companies, damages measurements should acknowledge past performance as reliable predictors of the future. For a new or speculative business, parties may measure damages with reasonable certainty by the use of expert testimony, business records, economic and financial data, and other verifiable data. However, new businesses face significant challenges in proving lost profits due to the lack of or limited historical record of performance.

Some of those challenges include the following:⁹

1. Reliability of expected profits projections
2. Selection of guideline companies to apply a yardstick method¹⁰
3. Determination of the length of the damages period
4. Demonstration of specific business risk, cost of capital, and discount rates as applicable to future lost profits
5. Verification of existence of a market and probable acceptance of the product/service
6. Capacity to scale operations and meet expected projections
7. Confirmation of management expertise

The inherent challenges of proving lost profits in a damages case where the plaintiff is a new business result in increased scrutiny by both federal and state courts as evidenced by the judicial decisions summarized below.

ENERGY CAPITAL CORP. v. UNITED STATES

In *Energy Capital Corp. v. United States* (“Energy”), Energy Capital Corporation (“Energy Capital”) brought a breach of contract action against the Department of Housing and Urban Development (“HUD”) in the Court of Federal Claims (the “Claims Court”) and was awarded lost profit damages. This judicial decision was subsequently appealed by the U.S. government.

Upon review, the United States Court of Appeals for the Federal Circuit (“Appeals Court”), affirmed the decision by the Claims Court to award Energy Capital lost profits.

Background¹¹

Formed in 1994, Energy Capital Corp. was established to provide financing that would allow institutions and businesses to optimize their energy consumption. One opportunity that Energy Capital identified was the affordability and lack of financing available for energy improvements in HUD housing.

A major hurdle to the development of an affordable financing program was the regulatory restrictions on HUD housing already in place. Mortgages for HUD housing were provided mainly by the Federal National Mortgage Association (“Fannie Mae”) and were insured by the Federal Housing Authority (“FHA”). The restrictions imposed by Fannie Mae and the FHA would not allow the homeowners of HUD housing to place additional mortgages on their properties.

Over time, Energy Capital was able to come to an agreement with HUD and eliminate the financing restrictions put on HUD housing. This agreement was known as the Affordable Housing Energy Loan Program (“AHELP”). The AHELP agreement allowed Energy Capital to originate \$200 million in loans to owners of HUD properties over three years.

These loans would include provisions referred to as a “spring subordinated lien” and a “cross-default provision.” This means that if a property owner defaulted on the energy efficiency loan originated under AHELP, the first mortgage on the property would also go into default.

At the same time, the energy efficiency loan would “spring” into the senior mortgage position. In turn, Energy Capital would structure the loans so that the anticipated savings of the energy improvements would be 110 percent of the loan payments annually. These loans would bear an interest rate of 3.87 percent above the Treasury rate.

Fannie Mae would fund the loan and be paid back at an interest rate equal to the Treasury rate plus 1.87 percent—Energy Capital would keep the other 2 percent. As part of its agreement to fund up to \$200 million in loans, Fannie Mae agreed to buy back the loans from Energy Capital in the future.

On February 7, 1997, an article in the *Wall Street Journal* stated that Energy Capital had received the AHELP contract in exchange for fund raising for President Clinton. HUD terminated the AHELP agreement on February 10, 1997.

The Court's Decision

The Claims Court started from the premise that in order to demonstrate entitlement to lost profits, Energy Capital was required to establish (1) causation, (2) foreseeability, and (3) reasonable certainty.¹²

In addition, the court took the position that because AHELP was a new venture, Energy Capital would have a difficult burden establishing that its claim for lost profits was reasonably certain.

During the appeals process, the government argued that because the agreement with Energy Capital was a new venture, the court should adopt a per se rule that lost profits may never be recovered from a new business venture that was not performed.¹³

The Appeals Court declined to adopt this rule for the following reasons, among others:

- The benefits that were expected from the contract, “expectancy damages,” are often equated with lost profits, although they can include other damage elements as well.¹⁴
- To recover lost profits for the breach of contract, the plaintiff should establish by a preponderance of evidence that (1) the loss was the proximate result of the breach, (2) the loss of profits caused by the breach was within the contemplation of the parties because the loss was foreseeable or because the defaulting party had knowledge of special circumstances at the time of contracting, and (3) a sufficient basis existed for measuring the amount of lost profits with reasonable certainty.¹⁵

In addition, the Appeals Court did not agree with the government’s argument that because AHELP was a new venture, there was no evidence of a track record and it would be impossible to measure lost profits.

To support its decision, the Appeals Court cited the following statement by the Alabama Supreme Court:

The weight of modern authority does not predicate recovery of lost profits upon the artificial categorization of a business as “unestablished,” “existing,” or “new” particularly where the defendant itself has wrongfully prevented the business from coming into existence and generating a track record of profits. Instead the courts



focus on whether the plaintiff has adduced evidence that provides a basis from which the jury could with “reasonable certainty” calculate the amount of lost profits. . . . The risk of uncertainty must fall on the defendant whose wrongful conduct caused the damages.¹⁶

Ultimately, the Appeals Court upheld the opinion of the Claims Court that “while the evidentiary hurdles to recovering lost profits for a new venture are high, such profits may be recovered if the hurdles are overcome.”¹⁷

Commentary

In *Energy Capital Corp. v. United States*, the Claims Court and the Appeals Court rejected the per se NBR that lost profits cannot be determined for a new business or venture because future profits are too speculative and uncertain. Instead, both courts expressed support for the MNBR and applied the standard of reasonable certainty.

In *Energy*, the court was provided a business plan and the fees that were agreed to by all parties involved. The capital to finance the project was also in place. The only matter that was left to speculation was the extent to which Energy Capital could execute on the \$200 million loan program.

The Appeals Court addressed this in its opinion by commenting that the Claims Court “drew reasonable inferences based upon the evidence” and that this “was not a case in which the trial court engaged in unsupported speculation.”¹⁸

In comparison to *Energy*, the trial court in *Neely v. United States* (“*Neely*”) awarded the plaintiff lost

profits after it determined that the profits earned by a third party were sufficient to prove reasonable certainty.

In *Neely*, the company F.S. Neely brought action against the government for breach of a land lease to mine coal. Approximately four or five years after the breach, the leased lands were actually strip-mined by a third party.

In its decision, the Claims Court stated “that almost always, in the case of a new venture, the fact that there would have been a profit, had there been no breach, is too shrouded in uncertainty for loss of anticipated profits to form a reliable measure of the damages suffered.”¹⁹

However, the court went on to conclude that since a third party had actually mined the land, “the profit realized from these operations, if, indeed, there were profits, would furnish some basis for a fairly reliable estimate of what plaintiffs profits would have been.”²⁰

In both cases, the court was clear that proving the reasonable certainty of lost profit claims is a difficult hurdle to overcome in a new business or new venture damages case. In addition, the court does not accept a per se rule and does not exclude a new business or venture from receiving lost profits. However, the plaintiff should prove that the analyst’s measurement of lost profits is reasonably certain.

MANSOUR BIN ABDULLAH AL-SAUD V. YOUTOO MEDIA, L.P.

In *Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P., and Christopher Wyatt* (“*Youtoo*”), Mr. Al-Saud (the “plaintiff”) brought a breach of contract claim against Youtoo Media, L.P. (“Youtoo Media”) and its chief executive officer Christopher Wyatt (collectively, the “defendants”). The breach of contract claim was related to a failure by the defendants to reimburse the plaintiff.

The defendants filed counterclaims. The U.S. Court for the Northern District of Texas (the “District Court”) granted Mr. Al-Saud’s motion for entry of judgment on jury verdict in his favor.

The District Court also rejected the defendants’ counterclaims on the basis that the testimony of the Youtoo Media damages expert was too speculative. The parties appealed to the U.S. Court of Appeals for the Fifth Circuit (the “Fifth Circuit Court”).

Background²¹

Mr. Al-Saud invested \$3 million in the form of a reimbursable down payment to Youtoo Media while he contemplated whether to purchase an interest

in it. Youtoo Media was a technology company that combined elements of social media and television in a way that allowed viewers to participate in broadcasts through their mobile device by sending pictures, videos, or texts.

The ultimate goal of Youtoo Media was to have its platform purchased by American broadcasters. In order to reach this goal, Youtoo Media believed it should demonstrate success in other markets. Youtoo Media felt that capital would be required to enable it to reach those markets. The search for additional funding brought Mr. Al-Saud and Youtoo Media together and led the parties to enter into a letter of intent in 2013.

Mr. Al-Saud made the \$3 million reimbursable down payment as an initial investment in Youtoo Media that provided him with a three-month option to contemplate the purchase of an interest in Youtoo Media. However, Youtoo Media encountered financial difficulty and was forced by a lender to sell its intellectual property and assets to pay outstanding obligations.

After learning of the Youtoo Media troubles, Mr. Al-Saud requested that Youtoo Media reimburse the \$3 million down payment. Youtoo Media refused and Mr. Al-Saud sued Youtoo Media for breach of contract. Youtoo Media filed a counterclaim for breach of fiduciary duty in order to seek lost profits attributable to the actions of Mr. Al-Saud.

The Court’s Decision

The District Court rejected the Youtoo Media counterclaims on the premise that the testimony of the Youtoo Media damages expert was too speculative.

The Fifth Circuit Court upheld the District Court ruling for the following reasons, among others: (1) Youtoo Media lacked a history of profitability and (2) Youtoo Media had few signed agreements with potential customers. Therefore, the defendants’ expert relied largely on “hoped for” partnerships and the earnings those partnerships might create.

Commentary

Both the District Court and the Fifth Circuit Court considered the fact that Youtoo Media was a newly established business and determined that this status did not preclude a reliable lost profits number. However, upon hearing and analyzing the testimony of the defendants’ damages expert, both courts determined that the measurement of lost profits was too speculative to be deemed reliable.

Although the courts involved in the *Youtoo* decision reached a different conclusion than the courts involved in *Energy* and *Neely*, the decisions

were premised on the modern interpretation of the NBR—that is, that a newly formed business or enterprise may be entitled to damages for lost profits if it can prove with reasonable certainty that such profits would have been earned but-for the breach.

SUMMARY AND CONCLUSION

Although new businesses face significant challenges in validating a claim of lost profits, the MNBR allows recently formed businesses and ventures to recover economic damages as long as the business provides adequate reasonable certainty.

In *Energy*, *Neely*, and *Youtoo*, the courts did not dismiss the cases based on the new nature of the involved ventures. Instead, the courts determined a verdict founded upon the reliability of evidence as a basis to measure lost profits.

Energy Capital provided thorough documents such as its business plan and contracted fees of all parties involved, which left little for the court to speculate, and as a result received a favorable court decision.

While also a new venture, Youtoo Media on the other hand lacked a history of profitability and could not supply objective confirmation of future profit which resulted in the rejection of their counterclaims. In reviewing cases such as these, analysts may better understand the role of reasonable certainty in supporting lost profits claims.

New businesses now have the ability to contest inequities caused by harmful conduct against them, however, the responsibility lies with analysts and counsel to thoroughly understand the implications of reasonable certainty.

An understanding of these judicial decisions can assist an analyst to:

1. better understand the judicial application of reasonable certainty in light of the shift toward the MNBR,
2. identify the hurdles in proving reasonable certainty in a lost profits analysis involving a new business or venture, and
3. recognize supportable scenarios where federal and state courts have awarded lost profit damages.

Notes:

1. Robert L. Dunn, *Recovery of Damages for Lost Profits* (Westport, CT: Lawpress Corporation, 2005), vol. 1, 376.
2. *Ibid.*, 378.
3. *Ibid.*
4. *Ibid.*

5. Mark Gauthier, “Recovering Lost Profits for Start-Up Companies,” *Business Law Today* (December 14, 2017), found at <https://businesslawtoday.org/2017/12/recovering-lost-profits-for-start-up-companies/>.
6. *Ibid.*
7. *Morris Concrete, Inc. v. Warrick*, 868 So. 2d 429, 440 (Ala. Civ. App. 2003).
8. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, *Litigation Services Handbook*, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), 4.9.
9. Scott A. Barnes, “Lost Profits and Lost Value in Litigation Involving Startups, New Ventures, Emerging Companies and New Technologies” found at (<https://docplayer.net/90185629-Lost-profits-and-lost-value-in-litigation-involving-startups-new-ventures-emerging-companies-and-new-technologies.html>).
10. “The yardstick method involves using a benchmark to estimate what would have occurred if the damages event had not taken place. Common benchmarks used in a yardstick method damages analysis include other companies in the same or a similar industry as the owner/operator or industry data for the industry that the owner/operator participates in.” Source: Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, 2014), 200.
11. *Energy Capital Corp. v. U.S.*, 302 F.3d 1314, 1317 (Fed. Cir. 2002).
12. *Id.* at 1320.
13. *Id.* at 1324.
14. *Id.*
15. *Id.* at 1325.
16. *Id.* at 1327.
17. *Id.* at 1328.
18. *Id.* at 1329.
19. *Neely v. U.S.*, 285 F.2d 438, 152 Ct.Cl. 137 (1961).
20. *Id.* at 147.
21. *Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P.*, 754 Fed.Appx. 246 (5th Cir. 2018).

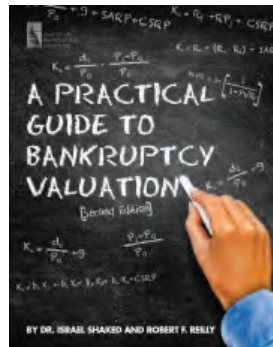
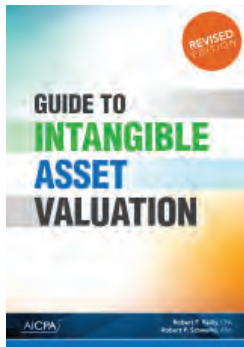
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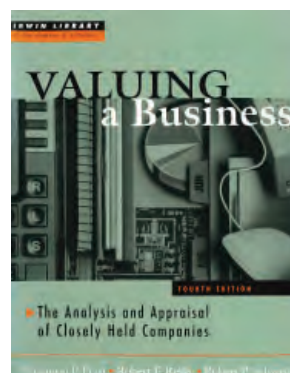
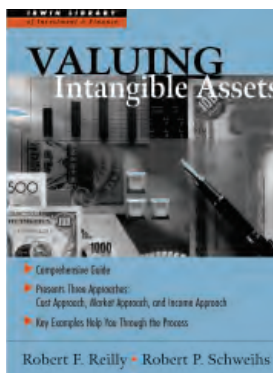
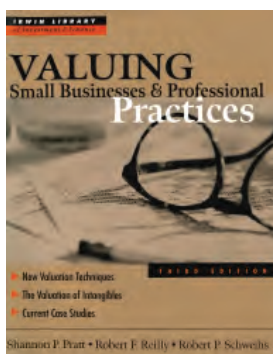
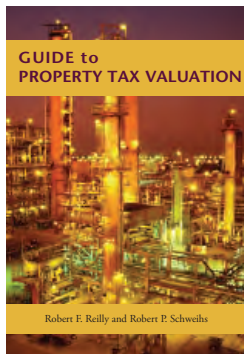
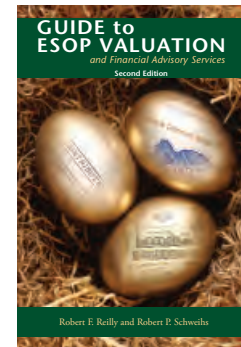
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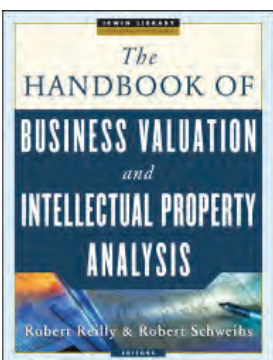
Valuation Textbooks Authored by Robert Reilly and Robert Schweih

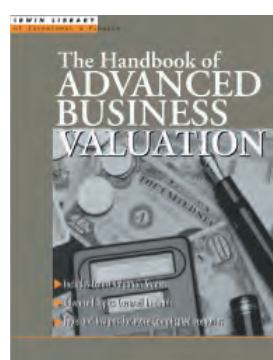


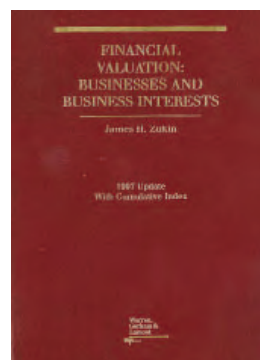
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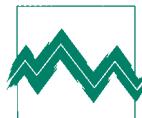




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Willamette Management Associates

Best Practices Discussion

Understanding Your Projections in a Lost Profits Damages Analysis

Scott R. Miller

Financial projections are one of the (if not the) most important inputs when measuring lost profits in an economic damages measurement analysis. Often, the damages analyst (“analyst”) is confronted with multiple conflicting sets of financial projections, financial projections with questionable credibility, or, in some cases, no financial projections at all. This discussion addresses some of the typical projection-related issues that the analyst is confronted with when conducting damages measurement analyses. This discussion also summarizes damages-related judicial decisions where the analyst successfully implemented and scrutinized financial projections in the damages analysis—and where the analyst was unsuccessful in doing so.

INTRODUCTION

A damages analyst (“analyst”) may regularly rely on financial projections in damages measurements. These financial projections may have been prepared by a company’s management team, by an industry expert, or (when necessary) by the analyst himself. When confronted with a damages measurement analysis involving financial projections, the analyst too often relies on projections at face value.

That is, the analyst may not sufficiently question the reasonableness, credibility, reliability, or applicability of the management-prepared financial projections.

Regardless of how well the remainder of a damages measurement analysis is performed, if the projections relied on lack of credibility to the finder of fact, the damages measurement analysis may be ruled inadmissible. For this reason, an analyst should adequately vet the financial projections that he or she relies on.

This discussion addresses analyst considerations when deciding which set of financial projections to

rely on in a damages analysis. This discussion considers the questions the analyst should ask when provided with financial projections in a damages measurement, including (1) why the projections were prepared, (2) when the projections were prepared, and (3) whether the projections are sufficiently supported.

This discussion summarizes two damages-related judicial decisions where one party moved to have the opposing expert’s testimony excluded based primarily on the underlying projections. One decision summarizes the actions the analyst took to successfully overcome a *Daubert* motion. The other decision illustrates how a lack of projection scrutiny led to an analyst’s expert testimony and expert report being deemed inadmissible.

BACKGROUND ON LOST PROFITS MEASUREMENT METHOD

One generally accepted damages measurement method is the lost profits method. The lost profits

method measures the additional profits that the plaintiff would have realized but for the wrongful act of the defendant.

Four generally accepted methods applied to measure damages in a lost profit's analysis are as follows:

1. The before-and-after method
2. The yardstick method
3. The market model
4. The sales projections method

Before-and-After Method

A before-and-after method analysis seeks to measure damages by comparing the performance of a business before the wrongful act occurred and after the wrongful act occurred. In applying this method, credible projections prepared prior to the wrongful act may help to establish that a business anticipated achieving significantly different results than those realized after the wrongful act.

Alternatively, financial projections may help to establish that the results anticipated prior to the wrongful act did not deviate materially from the results realized after the wrongful act.

Yardstick Method

A yardstick method analysis relies on guideline company or guideline industry benchmarks to serve as a proxy for what results would have been achieved by a business but for the wrongful act.

When applying the yardstick method, the analyst should provide sufficient evidence that the selected guideline companies are reasonably similar to the subject business. Likewise, when relying on industry benchmarks, the analyst should prove that the industry data are both relevant and reliable.

Market Model

A market model analysis involves analyzing the plaintiff business's market share prior to the wrongful act, or what the plaintiff business's market share would have been but for the wrongful act. This information is then relied on to establish the lost profits that would have been realized but for the wrongful act.

Financial projections may be utilized to demonstrate what market share would have been realized but for the wrongful act. Additionally, financial projections are important in demonstrating the anticipated expansion or contraction of the relevant market.

Sales Projection Method

As the name implies, the sales projection method may require the greatest reliance on, and scrutiny of, financial projections. The sales projection method involves comparing company-specific projected results (based on circumstances that existed prior to the wrongful act, and, preferably, based on projections prepared prior to the litigation event) to the results realized or anticipated after the wrongful act.

Preferably, the financial projections relied on in the sales projection method were prepared in the ordinary course of business and for a purpose other than the subject litigation. Further, it is preferable that the financial projections relied on were prepared contemporaneously or closely prior to the wrongful act occurring.

When applying the sales projection method, the credibility of the analyst's damages measurement analysis may be closely correlated with the credibility of the financial projections relied on. For this reason, the analyst may take care to scrutinize the underlying financial projections.

Although financial projections may play an important role in each of these lost profits measurement methods, this discussion is particularly applicable to the sales projection method.

SELECTING DIFFERENT SCENARIO PROJECTIONS

During the regular course of business, a company's management team often prepares multiple sets of financial projections to incorporate differing levels of growth, profitability, and other factors. These financial projections may come in the form of worst-case scenario, best-case scenario, and base-case scenario.

However, multiple projections may also be prepared to incorporate different potential future events, with a similar likelihood of achieving each scenario.

The relevance of a certain set of financial projections may be dependent on a future outcome such as the approval of a drug or a decision to move forward with an acquisition or major capital project. In this case, if the event does not occur, an individual set of projections could be rendered irrelevant.

Generally, if one set of financial projections was prepared as the "most likely" or "base case," this set will be the most supportable in a litigation analysis. The base-case scenario set of projections may also provide the analyst with the most accurate picture

of what results the business anticipated achieving if business continued as usual, without the damages event occurring.

However, the base-case set of financial projections is not always the most applicable to the damages measurement analysis. Management may prepare a set of projections that are predicated on achieving some future result. This result may be directly related to the alleged wrongful act.

For example, management may prepare a set of financial projections that anticipate the successful implementation of a product. If the alleged wrongful act hindered the business' ability to successfully implement the product, it may be the most relevant set of financial projections for the damages analysis. This may be the case even if the projections do not represent the base-case scenario. The analyst should, however, consider the risk of achieving the projected results absent the alleged wrongful act.

The analyst may take care not to rely on a projection scenario that is predicated on circumstances unrelated to the alleged wrongful act. The case of *Exel Transportation Services, Inc. v. Aim High Logistics Services, LLC*,¹ provides an example of this scenario. In this litigation, Aim High Logistics Services, LLC ("Aim High" or "plaintiff"), alleged that Exel Transportation Services, Inc., breached their contract causing Aim High to suffer a loss of profits.

In conducting his lost profits measurement analysis, the plaintiff's analyst relied on financial projections that reflected a company-wide loss of profits. The most significant factor contributing to the loss of profits in the plaintiff analyst's financial projections was the Aim High loss of its largest customer (accounting for approximately two-thirds of company revenue).

However, the loss of this customer was not a result of the alleged wrongful act and, therefore, the financial projections were not applicable to determine the lost profits attributable to the wrongful act.

Based on this information, the Texas Court of Appeals held that the evidence was insufficient to support an award of lost profits damages and overturned a jury's previous damages award.

The analyst may be provided with a set of projections that are overly optimistic or dependent on an uncertain event occurring. This is often the case



when the subject company is a start-up business without historical proven results.

Generally, lost profits damages measurements should be proven with "reasonable certainty." When confronted with a start-up business, the only projections available may represent the best-case scenario. Management may have no reason for modeling a scenario where the business is not successful, in which case all available financial projections may have a lower likelihood of being realized.

In this scenario, the analyst may either decide to alter the projections to represent a more likely outcome, discount the cash flow based on a higher risk-adjusted discount rate, or reject the projections altogether.

Of these three options, discounting the projected cash flow using a higher risk-adjusted discount rate to account for the higher risk of achieving the level of cash flow present in the projections may be the most practical and supportable option.

WHY WERE THE PROJECTIONS PREPARED?

In the regular course of business, financial projections may be prepared for a variety of reasons. These reasons include the following:

1. Regular budgeting and planning purposes
2. Decision making regarding major capital investments
3. Decision making regarding potential acquisitions or divestitures

4. Bank decision making in relation to financing or covenant compliance
5. Attracting investors such as venture capital firms
6. Break-even analysis
7. Internal liquidity analysis

The reason for which a set of financial projections was prepared will largely determine if they are applicable for use in a damages measurement analysis.

Generally, financial projections prepared for actual decision-making purposes may carry more weight than those prepared in a “back of the envelope” manner. If company management prepares internal projections to decide whether to move forward with an actual capital investment, business acquisition, or business divestiture, it is more likely that the projections were made in good faith with significant research and analysis backing them up.

Alternatively, company management may prepare “back of the envelope” projections when tossing around ideas. These projections may have never been intended for actual decision-making purposes and may lack thorough research and analysis.

Financial projections prepared to attract investors may be overly optimistic or represent a best-case scenario. In the case of start-up firms, investors will likely take company management’s projections with a grain of salt, and potentially apply a high discount rate to the projections when making investment decisions.

If the analyst naively accepts this type of projection and applies a discount rate more appropriate for a base-case scenario, he or she may overestimate the damages amount and lose credibility in the eyes of the finder of fact.

Alternatively, financial projections prepared for bank loan purposes or internal liquidity analysis may be overly conservative and represent a worst-case scenario. The projections may not represent in any way what management expects future results to be, but rather may be used to determine how bad things can get without causing financial distress.

If the analyst relies on this type of projection without making appropriate adjustments, it may lead to a challenge by opposing counsel and cause the entire damages measurement analysis to be disregarded by the finder of fact.

Finally, financial projections may be prepared by company management specifically for damages litigation. This may be required when relevant projec-

tions prepared prior to the litigation event are not available. However, when projections are prepared exclusively for litigation purposes, they will come under increased scrutiny by the finder of fact.

When financial projections are prepared exclusively for litigation purposes, it is important that the analyst confirm that the projections are credible and reasonable through comparison to historical results, comparison to publicly available industry and market data, discussion with the person(s) who prepared the projections, and/or analysis of the underlying assumptions and information relied upon to prepare the financial projections.

WHEN WERE THE PROJECTIONS PREPARED?

Financial projections that are prepared prior to any litigation event are often viewed as more trustworthy than projections created subsequent to the litigation event. Whether or not it is true, the finder of fact may question whether projections prepared after the litigation event occurred are unbiased and reliable.

Alternatively, if company management prepared a set of internal projections prior to the anticipation of any litigation event, they would have no reason to bias the results one way or the other.

Even if the post-litigation projections are not created to purposely influence the damages measurement one way or the other, they may still unintentionally incorporate information that was not known or knowable prior to the litigation event.

In *Agranoff v. Miller*,² the Court of Chancery in the State of Delaware (the “Chancery Court”) gave a rebuke to the plaintiff expert’s projection adjustments based on information obtained after the valuation date. When provided with financial projections that the plaintiff expert and defendant expert agreed were overly optimistic, the plaintiff expert (Lee) “purported to base a DCF analysis on a substantial negative revision of those projections that he came up with after discussions with EMS managers after the valuation date. That is, Lee discussed the projections for the years following 1998 with managers who knew what the actual results of those later years were.”

The Chancery Court went on to state, “I refuse to give any weight to this technique and therefore to Lee’s DCF analysis. The possibility of hindsight bias and other cognitive distortions seems untenably high. . . . Suppose there was an interview with Sir George Martin from 1962 in which he opined as to how many number one songs he thought

would be released by his new proteges, the Beatles.” One can infer the direction that the rest of this analogy took.

Post-litigation financial projections are nevertheless commonly prepared by damages analysts and other parties. This may be necessary and helpful under certain circumstances. Analysts may examine the appropriateness of altering or creating projections after a litigation event has occurred, and only do so for valid reasons and with sufficient supporting information.

ARE THE PROJECTIONS SUFFICIENTLY SUPPORTED?

After receiving management projections, the analyst may vet the projections for reliability, credibility, and reasonableness. By conducting this vetting process, the analyst not only ensures that the analysis is more accurate and complete, but also is in a position to defend the use of the subject projections when questioned by opposing counsel or the finder of fact.

One way to consider the credibility of financial projections is to compare them to the subject company’s historical results. If a company’s past sales and profits are in line with the projected results, it will be much easier to substantiate the credibility of the projections.

Additionally, the analyst can review past financial projections prepared by the same management team to verify if the projections are reliable. If the subject management team has a history of consistently underperforming or overperforming the projections that they compile, the subject projections relied on in the damages measurement analysis may be less reliable, either in reality or perception.

Another way to consider if financial projections are reasonable is to compare them to industry and market data. The analyst will have a stronger case in supporting a set of projections if they have independently scrutinized the underlying data through comparison to publicly available information.

To achieve this objective, the analyst may consider the following data sources:

1. Information regarding competitor companies or other industry participants
2. Published research and analysis regarding industry growth expectations and trends
3. Discussions with third-party industry experts



4. Market share data for the industry

The analyst may also conduct the necessary research to understand the underlying assumptions and information relied on to prepare the financial projections. This may be achieved by conducting interviews with the person(s) who prepared the projections, as well as requesting and reviewing the information that the person(s) relied on to prepare the projections.

Additionally, the analyst may consider the appropriateness and credibility of the person(s) who prepared the subject financial projections. This can be achieved through direct interviews with relevant members of the company management team or industry experts, and research into the credentials of those who prepared the financial projections.

It may be important to verify that the person(s) who prepared the subject financial projections had extensive knowledge regarding the relevant business or product line.

OVERCOMING A *DAUBERT* CHALLENGE

In the case of *Aetna, Inc. v. Blue Cross Blue Shield of Michigan*,³ Aetna, Inc. (“Aetna”), alleged that Blue Cross Blue Shield of Michigan (“Blue Cross”) engaged in anticompetitive practices that caused financial damages to Aetna. Blue Cross was seeking to exclude the Aetna damages analyst on the basis of reliability.

Blue Cross alleged that the analyst based his conclusions on (1) projections that were fundamentally flawed and inconsistent with actual data, (2)

damages that were unreliable and speculative based on the number of years projected, and (3) incorrect assumptions regarding the damages actually caused.

In defending its damages analyst and the projections that his lost profits measurement was based on, Aetna argued that the projections were prepared in the ordinary course of business. Further, Aetna argued that the projections were based on analysis by business experts in each relevant business unit who used extensive information from various sources, including third-party data and consultant's reports.

Additionally, Aetna noted that the financial projections were created prior to the damages event and that they were validated through multiple acquisitions.

Aetna argued that its analyst did not naively rely on the ordinary course of business projections, but rather conducted a thorough investigation of the processes and methodology underlying the projections, including a detailed review of relevant documents and numerous conversations with the individuals who developed the projections.

Aetna claimed that its analyst checked the reliability of the financial projections and found that Aetna met and exceeded its projections prior to the damages event.

Blue Cross argued that the most relevant financial projections were those prepared after the alleged damages event occurred based on a change in circumstances. Aetna countered that projections prepared before the alleged damages event are more relevant because the revised projections incorporated the decreased profit resulting from the alleged damages event.

Blue Cross argued that the Aetna analyst's use of financial projections nine years into the future were not relevant because Aetna did not prepare projections for a period greater than three years. Aetna responded that case law does not support the argument that damages should be capped at the duration of financial projections.

Aetna also asserted that the extended projections were not just made up by the analyst, but rather based on assumptions he made from available information after analyzing relevant data.

After considering the arguments put forth by Blue Cross and Aetna, the U.S. District Court (the "District Court"), found that the Aetna analyst's model was reliable.

The District Court stated that damages need not be determined with mathematical certainty, and that the level of detail in the projections does not

exclude the reliability of the model used. Therefore, the District Court denied the Blue Cross motions to exclude the Aetna expert's testimony.

This decision touches on a number of the financial projection considerations discussed above. This decision highlights the importance of relying on financial projections that were prepared:

1. in the regular course of business,
2. in the appropriate time period (i.e., prior to the damages event),
3. via a rigorous process by qualified experts including third-party data, and
4. for a relevant purpose (i.e., for actual acquisition decision making purposes).

This decision further highlights the importance of the analyst vetting projections, including:

1. understanding the underlying methodology,
2. reviewing relevant documents and information,
3. interviewing the people who prepared the projections, and
4. comparing the projections to actual results that occurred prior to the damages event.

SUCCUMBING TO A *DAUBERT* CHALLENGE

In the case of *Bruno v. Bozzuto's, Inc.*,⁴ the owner of a supermarket ("Bruno" or "plaintiff") brought action against a wholesale supplier ("Bozzuto" or "defendant") for breach of contract. The defendant challenged that the plaintiff's expert report was based entirely on unverified data and, therefore, not admissible.

In contrast to the prior decision discussion, the motion was granted and the U.S. District Court (the "District Court") granted in full the defendant's *Daubert* motion to exclude the plaintiff's expert reports and expert testimony.

The defendant alleged, and the District Court agreed, that the plaintiff expert's analysis was based entirely on unverified data and thus was unrealizable and not admissible to establish damages.

The initial iteration of the plaintiff's expert report lacked the benefit of historical financial information. This was due to the fact that the plaintiff destroyed all historical financial information related to the subject supermarket shortly before filing the litigation. This lack of historical data hindered the damages expert's ability to verify and scrutinize the projected results based on a comparison to actual results.

The plaintiff's analyst relied on unverified secondhand data. These data were from a pro forma sales projection created internally by the defendant.

The defendant argued that the pro forma grossly overstated the sales that were actually realized by the plaintiff's supermarket and, therefore, the defendant had internally rejected the pro forma figures as unreliable prior to the litigation event.

Further, the defendant contended that the pro forma was created to conduct a break-even loan analysis, and not to project actual sales or potential contract damages.

The plaintiff's analyst relied on the pro forma without making any revisions or conducting any independent verification of the numbers. The plaintiff's expert admitted that he did not speak with anyone at Bozzuto's and did not conduct any independent review of Bruno's books and records.

The plaintiff's analyst also admitted that he did not know the exact methodology used to create the projections. Rather, the plaintiff's analyst naively relied on Buzzuto's management (who had prepared the projections) as being experts in the field, and the analyst performed no further verification of the financial projection accuracy, reliability, or relevance.

After completing the initial expert report, documents surfaced that provided historical financial information for the supermarket. This information showed that the actual sales realized by the supermarket shortly prior to the alleged damages event were significantly less than the base for the pro forma.

However, the plaintiff's analyst ignored this new information and continued to rely on the inflated numbers from the pro forma in his revised expert report. The pro forma utilized a constant growth rate applied to a base level of sales. By relying on a base level of sales that clearly did not reflect reality, the defendant alleged that the resulting damages measurement was significantly overstated.

Based on these factors, the District Court granted the defendant's *Daubert* motion to exclude the plaintiff's expert reports and expert testimony.

This decision touches on a number of financial projection considerations discussed above. This decision highlights the importance of:

1. comparing projections to historical results,
2. verifying projections through market data and trends,
3. analyzing the documents relied on to prepare projections,
4. discussing projections with the people who prepared them,

5. understanding the underlying methodology used to create projections,
6. understanding the purpose for which projections were created,
7. assessing the reasonableness of projections, and
8. revising analyses based on the introduction of new relevant information.

SUMMARY AND CONCLUSION

The difference between a credible damages measurement analysis and an inadmissible analysis can hinge entirely on the underlying projections. When applying the lost profits measurement method, the analyst may take care when deciding (1) which set of projections to rely on, (2) whether to alter a set of projections, and (3) whether to create their own set of projections.

The analyst should conduct sufficient due diligence in order to assess whether the subject financial projections are:

1. reasonable,
2. credible,
3. reliable, and
4. appropriate for the subject damages measurement analysis.

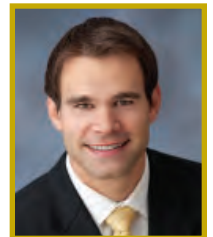
The analyst should understand the projections that they rely on in a damages measurement analysis, and vet the underlying assumptions and information appropriately. This procedure includes understanding:

1. the differences between conflicting scenario projections,
2. why the projections were prepared, and
3. when the projections were prepared.

Notes:

1. Exel Transportation Services, Inc. v. Aim High Logistics Services, LLC, 323 S.W.3d 224 (Tex. App. 2010).
2. Agranoff v. Miller, 791 A.2d 880 (Del. Ch. 2001).
3. Aetna, Inc. v. Blue Cross Blue Shield of Michigan, No. 11-15346, 2015 WL 1497826 (E.D. Mich. Mar. 31, 2015).
4. Bruno v. Bozzuto's, Inc., 311 F.R.D. 124 (M.D. Pa. 2015).

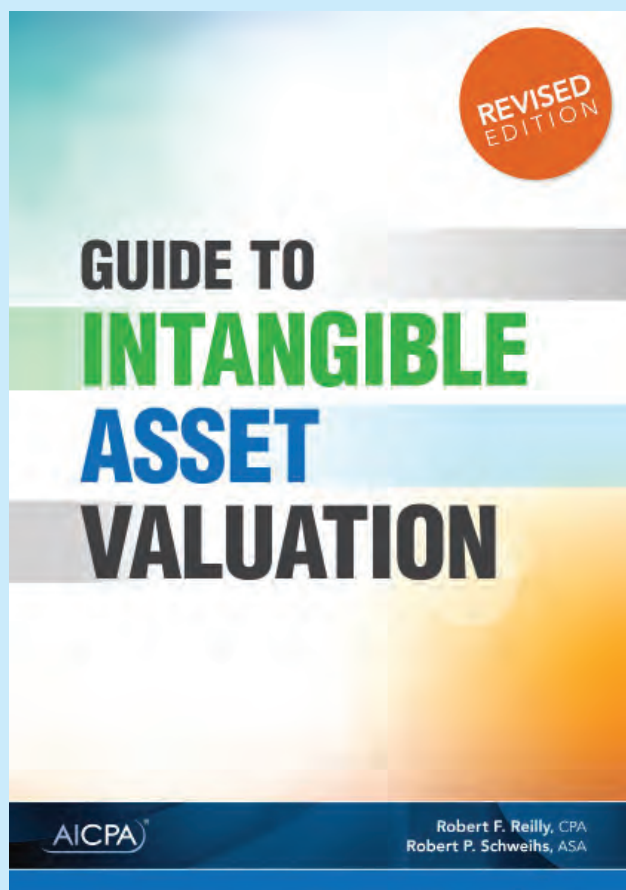
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We are pleased to announce the Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweih



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweih, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

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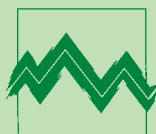
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Guide to Intangible Asset Valuation

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Trends in Securities and Derivative Litigation: Record Filings and Novel Theories

Jessica Corley, Esq., and Peter Starr, Esq.

When a company's stock price decreases, shareholder litigation often ensues. That is nothing new. However, in recent years, there has been a significant uptick in the number of cases filed and a corresponding expansion in the types of claims pursued by plaintiffs. This discussion analyzes this increase in judicial claims, providing an overview of the types of cases being filed, the corporate defendants being sued, and the amounts claimed in damages. Finally, this discussion examines the trends in securities and derivative litigation that underlie those statistics.

INTRODUCTION

As a general matter, investors are more likely to file suit during times of economic turbulence than in times of economic prosperity. That trend is unsurprising—shareholders whose investments are generating healthy returns are less likely to find fault with management than those who are losing money.

To cite one example, when the U.S. economy came to a standstill in the grip of the 2008 financial crisis, the number of securities filings soared.¹

In light of this general trend, it is surprising that shareholder filings are presently approaching record levels, even while the U.S. capital markets have performed fairly well.

This discussion addresses the common categories of shareholder litigation and delves beyond the statistics to provide a glimpse into:

1. the types of cases being filed,
2. the types of companies being sued, and
3. the potential drivers of the higher rate of filings.

CLASSIFYING SHAREHOLDER LITIGATION

Federal Securities Litigation

Although technically any claim brought under the securities laws satisfies the definition of “securities litigation,” this discussion focuses on federal class actions—that is, cases brought under Federal Rule of Civil Procedure 23 on behalf of a group of persons or entities who purchased a company's securities during a specified period of time and which allege that a company and/or its officers and directors violated the federal securities laws.

As its name suggests, a securities class action is a form of representative litigation in which a lead plaintiff (also called a “class representative,” once a class has been certified) pursues claims ostensibly for the benefit of all shareholders.

By far the most frequent claim asserted in such cases is for securities fraud pursuant to Section

10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 promulgated thereunder. These provisions impose liability on persons and companies who make material misrepresentations or omissions—often in their financial statements—that affect secondary market trading in such a way as to injure shareholders.

However, public companies also routinely defend against claims arising from the Securities Act of 1933, particularly Section 11 of that Act. Section 11 imposes liability for material misrepresentations and omissions in a registration statement.

One can distinguish claims arising under the Exchange Act from claims arising under the Securities Act by looking to the type of purchaser alleged to be injured: if the plaintiff purchased securities in the secondary market, then he or she is suing under the Exchange Act, but if the plaintiff purchased shares that were issued pursuant to a registration statement—such as in an IPO—then the Securities Act provides the right of action.

Shareholder Derivative Litigation

Shareholder derivative suits are another type of representative litigation. Whereas the plaintiff in a securities class action represents other members of the class, the plaintiff in a shareholder derivative action asserts claims on behalf of the corporation itself.

A shareholder suit is properly classified as derivative “when it is based on an injury to the corporation, such as a claim for monetary damages based on corporate mismanagement.”² Although derivative suits can span a wide variety of subject matters, common fact patterns include allegations of self-dealing by corporate executives, mismanagement or waste of corporate assets, and shareholder objections to specific corporate transactions.³

Because a shareholder’s ability to bring a derivative claim is governed by the law of the state in which the company is incorporated,⁴ legal standards vary, and cases can be harder to monitor. However, the law of Delaware controls in many



cases, owing to the large number of companies incorporated there.

Filing Trends in Federal Securities Litigation

As discussed above, the number of securities class actions filed in recent years has been on the rise. In its annual report on securities class action litigation, NERA Economic Consulting, Inc. (“NERA”), noted that “the pace of securities class action filings was the highest since the aftermath of the 2000 dot-com crash, with 441 new cases.”⁵

Another market observer, Cornerstone Research (“Cornerstone”), described the recent shift in stark terms:

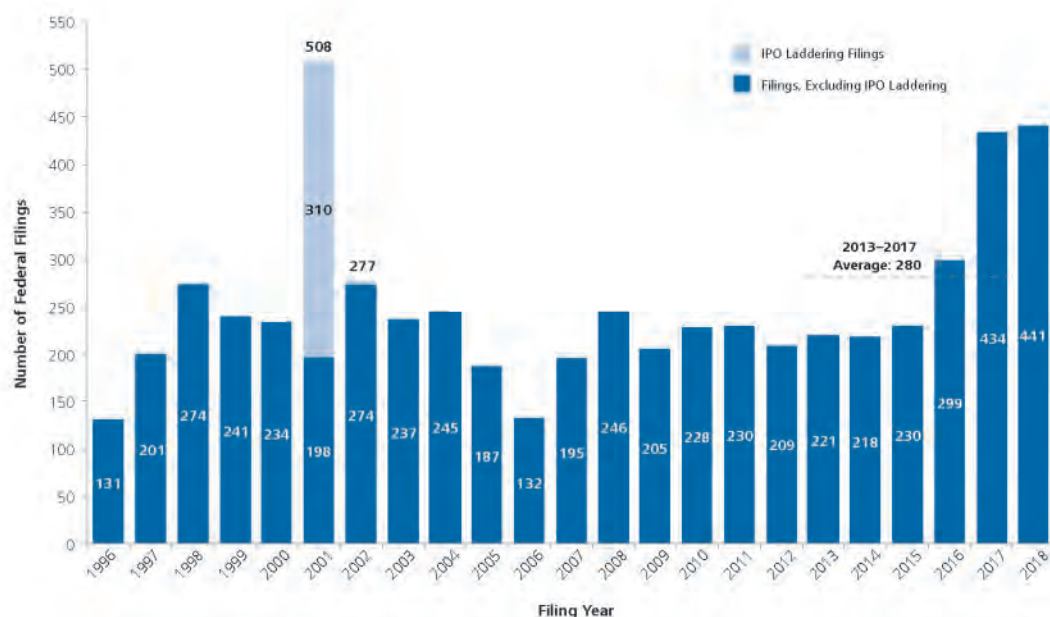
On several dimensions, the last three years—particularly 2017 and 2018—have been more active than any previous year. . . . The total number of filings in 2018 was the second-highest on record after 2017. Filings against companies with large market capitalizations surged to near record highs.⁶

In terms of “filing intensity,” Cornerstone noted that the likelihood of U.S. exchange-listed companies getting hit with traditional securities litigation “was greater [in 2018] than in any previous year.”⁷

For context, the average number of securities class actions filed between 1996 and 2016 was 193⁸—meaning that there were around 225 percent more filings in 2018 than the annual average for that 10-year period.

These trends are best illustrated in Figure 1, generated by NERA.

Figure 1
Federal Filings
January 1996–December 2018



Source: Stefan Boettlich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review* (New York NERA Economic Consulting, January 29, 2019).

What's Driving the Increase in Filings?

This increase has occurred despite the absence of significant market turbulence, which begs the question—why? There are several potential explanations.

One clear driver of the recent growth in securities class action filings is the migration of merger objection cases from Delaware state court to the federal courts. By Cornerstone's count, in 2018 alone there were 182 M&A filings, which accounts for 45 percent of the total number of filings (403 securities class action filings total, again according to Cornerstone).⁹

These cases migrated from Delaware state court to the federal courts because of the Delaware Chancery Court decision in *In re Trulia Inc. Stockholders Litigation*.¹⁰

The *Trulia* case involved the online real estate company Zillow's proposed acquisition of Trulia, another real estate website. After the proposed merger was announced, several Trulia stockholders filed complaints alleging that Trulia's directors had breached their fiduciary duties, forcing Trulia to make additional disclosures regarding the deal. Several months later, the parties reached an agreement to settle.¹¹

As the Chancery Court observed, the "proposed settlement is of the type often referred to as a 'disclosure settlement,'" which has "become the most common method for quickly resolving stockholder lawsuits that are filed routinely in response to the announcement of virtually every transaction involving the acquisition of a public company."¹²

In such cases, plaintiffs often agree to drop their motion to enjoin the transaction and to provide a

release of behalf of a proposed class of shareholders in exchange for additional disclosures.

The *Trulia* Court considered such "disclosure settlements" to be frivolous; it noted that they do not provide "stockholders with any economic benefits," and that the "only money that . . . change[s] hands is the payment of a fee to plaintiffs' counsel."¹³

The Court, therefore, refused to certify the proposed settlement class and warned litigants that the Court would be "increasingly vigilant" in adjudicating such cases.¹⁴

Commentators correctly predicted that *Trulia* "spell[ed] the end of disclosure only settlements in Delaware,"¹⁵ and it appears that the majority of these cases have migrated to federal court. The likely reason for this shift is that "plaintiffs in other states could not establish personal jurisdiction in state court over the defendant corporation when it was neither incorporated nor had its principal place of business in that jurisdiction."¹⁶

This legal impediment would not have posed a problem in Delaware, where many companies are incorporated.

But even setting aside merger objection suits—and counting only what Cornerstone refers to as “core,” or traditional, securities class actions—filings in 2018 “were the highest since 2008.”¹⁷

The explanation for this increase in “core filings” may lie partially in the rise of what commentators call “event-driven” securities class actions. Whereas securities cases used to involve primarily the disclosure of financial information, a growing number of securities cases have been filed in the wake of catastrophic events that negatively impact a company’s stock price.

As Professor John Coffee of Columbia Law School puts it, in the old world of securities litigation, “the biggest disaster was an accounting restatement. Now, the biggest disaster may be a literal disaster.”¹⁸

For instance, Boeing was sued by investors after its newest jet, the 737 Max, crashed in Asia; Johnson & Johnson was sued in a securities class action alleging it had wrongfully concealed that its talcum powder products cause cancer; and the hotel chain Marriott was hit with a securities class action in the wake of a large data breach that compromised the personal data of up to 500 million guests.¹⁹

Although the types of events that trigger a securities suit of this ilk can differ widely, the basic fact pattern is the same: “Something goes wrong at the company, its share price declines, and the company gets hit with a securities suit.”²⁰

Types of Claims and Types of Defendants

Moving beyond the high numbers of filings, it is instructive to understand the types of claims and types of

defendants being sued. In 2018, as in years past, the majority of filings included claims for securities fraud under SEC Rule 10b-5. Specifically, 86 percent of filings asserted 10b-5 claims.²¹

Typical allegations included misrepresentations in financial statements (95 percent of filings), false forward-looking statements (48 percent of filings), and violations of Generally Accepted Accounting Principles (23 percent of filings).²²

Claims arising under Section 11 of the Securities Act decreased from 12 percent of filings in 2017 to 10 percent of filings in 2018. However, claims under Section 12(2) of the Securities Act increased to 10 percent of filings.²³

Figure 2, created by Cornerstone, provides a helpful overview of the types of claims made in securities class actions.

NERA breaks the types of claims asserted in securities cases into more detailed categories. According to NERA, in 2018, class actions alleging violations of Rule 10b-5, Section 11, and/or Section 12 (the most commonly asserted claims), related to the following subject matters:

- Accounting issues (26 percent of filings)

Figure 2
Allegations Box Score—Core Filings

	Percentage of Filings ¹				
	2014	2015	2016	2017	2018
Allegations in Core Filings²					
Rule 10b-5 Claims	93%	92%	94%	93%	86%
Section 11 Claims	15%	16%	12%	12%	10%
Section 12(2) Claims	7%	9%	6%	4%	10%
Misrepresentations in Financial Documents	95%	99%	99%	100%	95%
False Forward-Looking Statements	51%	53%	45%	46%	48%
Trading by Company Insiders	16%	16%	10%	3%	5%
GAAP Violations ³	39%	38%	30%	22%	23%
Announced Restatement ⁴	19%	12%	10%	6%	5%
Internal Control Weaknesses ⁵	26%	26%	21%	14%	18%
Announced Internal Control Weaknesses ⁶	11%	11%	7%	7%	7%
Underwriter Defendant	12%	12%	7%	8%	8%
Auditor Defendant	1%	1%	2%	0%	0%

Note:

1. The percentages do not add to 100 percent because complaints may include multiple allegations.

2. Core filings are all federal securities class actions excluding those defined as M&A filings.

3. First identified complaint (FIC) includes allegations of GAAP violations. In some cases, plaintiff(s) may not have expressly referenced GAAP; however, the allegations, if true, would represent GAAP violations.

4. FIC includes allegations of GAAP violations and refers to an announcement during or subsequent to the class period that the company will restate, may restate, or has unreliable financial statements.

5. FIC includes allegations of internal control weaknesses over financial reporting.

6. FIC includes allegations of internal control weaknesses and refers to an announcement during or subsequent to the class period that the company has internal control weaknesses over financial reporting.

Source: *Securities Class Action Filings: 2018 Year in Review* (San Francisco: Cornerstone Research and Stanford Law School Securities Class Action Clearinghouse, 2019).



- Missed earnings guidance (21 percent of filings)
- Regulatory issues (19 percent of filings)
- Misled future performance (18 percent of filings)²⁴

In terms of the types of corporate defendants being sued, corporations in the “consumer non-cyclical” sector, which includes biotechnology, pharmaceuticals, and health care, experienced the highest number of overall “core” securities filings in 2018, with 68 such complaints filed.²⁵

The next most frequently targeted industries were “consumer cyclical,” communications, and technology, which saw 29, 28, and 22 filings in 2018, respectively.²⁶

NERA applies a slightly different system to classify industries. Under the NERA approach, the industries that saw the highest number of traditional securities class action filings in 2018 were Health Technology and Services (25 percent of filings), Electronic Technology and Technology Services (21 percent of filings), and Finance (16 percent of filings).²⁷

Investor Losses and Settlements

Not only have the number of filings been on the rise, but the amount of potential losses has also jumped. NERA tracks a metric it refers to as “Aggregate

NERA-defined Investor Losses,” which refers to the “aggregate amount that investors lost from buying the defendant’s stock, rather than investing in the broader market during the alleged class period,” and which NERA uses as “a rough proxy for the relative size of investors’ potential claims.”²⁸

In 2018, NERA-defined Investor Losses reached “\$939 billion, more than double that of any prior year and nearly four times the preceding five-year average of \$245 billion.”²⁹

This increase can be partially explained by the magnitude of investor losses in litigation against General Electric; indeed, the GE case accounted for \$290 billion of that figure.³⁰ But even when the GE case is excluded from consideration, the dollar size of “filings in all but the smallest strata [of cases] grew,” suggesting a “systematic shift toward larger filings.”³¹

Cornerstone employs a similar metric—the “Maximum Dollar Loss Index” (the “MDL Index”)—to measure the “dollar value change in the defendant firm’s market capitalization from the trading day with the highest market capitalization during the class period to the trading day immediately following the end of the class period.”³²

The MDL Index also showed a significant increase in 2018, totaling \$1.3 trillion. As Cornerstone noted, “[t]he MDL Index reached over \$1.3 trillion in 2018, surpassing 2008 to become the third-largest year on record.”³³

Figure 3 illustrates annual losses on the MDL Index for the past 15 years.

One final measure that is relevant to the magnitude of potential losses in these cases is the amounts for which they are settled. Taking into account the 78 securities class actions settled in 2018, the total amount of settlement dollars was just over \$5 billion, which was “50 percent higher than the average for the prior nine years.”³⁴

The average settlement amount in 2018 was \$69 million, which also represented an increase in comparison to 2017.³⁵ This increase was largely driven by “mega settlements” of \$100 million or more, of which there were five, but also by an increase in mid-sized settlements (between \$10 million and \$50 million).³⁶

Of particular note was the \$3 billion settlement against *Petróleo Brasileiro* (“Petrobras”), which was the fifth-highest settlement ever.³⁷ The average time from filing to settlement in 2018 was 3.3 years.³⁸

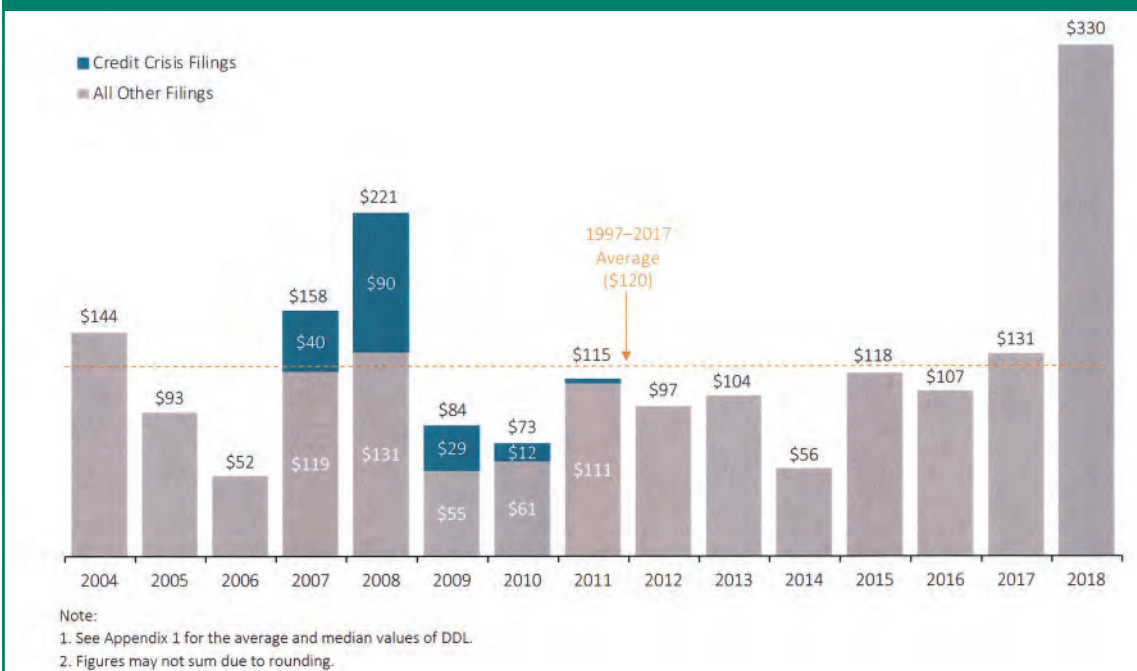
RECENT TRENDS IN SHAREHOLDER DERIVATIVE LITIGATION

There is less quantitative research available regarding shareholder derivative filings, which makes precise, statistical analysis difficult. This dearth of data can be largely attributed to the fact that derivative suits are often brought in state court rather than in federal court, which makes them more difficult to track. It may also be because there are fewer “mega-cases” in this field—damages in derivative cases do not reach the levels that they do in securities class actions—and they have therefore garnered less academic attention.

As a point of comparison, consider that when the derivative suit arising from Wells Fargo’s creation of fake bank accounts recently settled for \$320 million, it was arguably the “largest derivative settlement ever.”³⁹

Meanwhile, there have been five securities class action settlements in excess of \$3 billion since the passage of the Private Securities Litigation Reform Act in 1995.⁴⁰

Figure 3
Disclosure Dollar Loss Index® (DDL Index®)
2004–2018
(Dollars in Billions)



Source: *Securities Class Action Filings: 2018 Year in Review* (San Francisco: Cornerstone Research and Stanford Law School Securities Class Action Clearinghouse, 2019).

Given the absence of a comprehensive data set, this discussion will forgo the statistical analysis and focus instead on novel theories of liability animating derivative filings today.

The #MeToo Movement

Most people do not think of shareholder derivative litigation when the #MeToo movement is mentioned, but perhaps commercial litigators should—accusations of sexual misconduct have recently begun to surface as a theory of liability in shareholder derivative actions.⁴¹

As one commentator noted, plaintiffs first sought to file traditional federal securities class actions based on #MeToo-style revelations, but such cases proved difficult to maintain due to the “exacting pleading standards applied to federal securities class actions” and “the typical absence of actionable public statements” regarding sexual misconduct.⁴²

These impediments have opened the door to the expression of #MeToo allegations in shareholder derivative actions. Indeed, in the last 12 to 18 months, a growing number of companies have been sued in shareholder derivative actions based on

their boards' handling of sexual harassment allegations; the list of such companies includes Nike, CBS, the Weinstein Company, Twenty-First Century Fox, Wynn Resorts, Alphabet, Inc. (Google's parent corporation), Lululemon Athletica, and Liberty Tax.⁴³

Because these lawsuits often target misconduct involving upper management, plaintiffs are able to argue that "directors minimize or conceal this misconduct to protect influential executives."⁴⁴

However, these plaintiffs can have difficulty overcoming the business judgment rule, under which courts will not second-guess directors' business decisions unless a plaintiff makes a high evidentiary showing, such as demonstrating that the director had a conflicting interest.⁴⁵

Opioid Crisis Litigation

In the pharmaceutical space, litigation relating to the opioid crisis has dominated the headlines. Most attention has focused on the sprawling multidistrict litigation that involves more than 30 states and almost 1,500 municipalities,⁴⁶ but there is a possibility that shareholder derivative litigation will follow on its heels. In April, an investor sued major drug distributor AmerisourceBergen Corp. in Delaware, demanding access to records with a goal of, among other things, initiating derivative litigation.⁴⁷

And a month before that, the Delaware Chancery Court stayed a derivative suit against opioid marketer Insys Therapeutics, pending the verdict in an ongoing criminal trial.⁴⁸

Whether drug manufacturers, distributors, and marketers are inundated with a major wave of shareholder derivative litigation remains to be seen, but such companies would do well to anticipate derivative litigation.

SUMMARY AND CONCLUSION

If the first two quarters of 2019 are any indication, the increased rate of securities filings will continue. From January to June 2019, 199 securities class actions were filed in federal court, which is "an extraordinary number of securities suit filings in just a six-month period."⁴⁹

The past few years suggest that these heightened filing rates are becoming the new normal, making it all the more important for companies to carefully consider their public disclosures and to be prepared for litigation when it comes.

Notes:

1. The 224 securities cases filed in 2008 represented a 30 percent increase over the number of such cases filed in 2007, and an 88 percent increase over the 119 securities claims filed in 2006. See Kevin LaCroix, *A Closer Look at the 2008 Securities Lawsuits*, The D&O Diary (Jan. 2, 2009), <https://www.dandodiary.com/2009/01/articles/securities-litigation/a-closer-look-at-the-2008-securities-lawsuits>.
2. Ann M. Scarlett, *Shareholder Derivative Litigation's Historical and Normative Foundations*, 61 Buff. L. Rev. (2013), 837, 841 (2013).
3. See R. Franklin Balotti and Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS*, § 13-10 (3d ed. 2019).
4. Robert J. Kopecky, *Derivative Litigation – A Primer*, 20 LITIGATION 38, 38 (1994).
5. Stefan Boettlich and Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2018 Full-Year Review*, 1, NERA ECONOMIC CONSULTING (Jan. 29, 2019), https://www.nera.com/content/dam/nera/publications/2019/PUB_Year_End_Trends_012819_Final.pdf.
6. *Securities Class Action Filings: 2018 Year in Review*, CORNERSTONE RESEARCH, 3, (2019), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2018-Year-in-Review>. Note that due to differences in classification, Cornerstone tallied a lower number of total securities class action filings than NERA. Cornerstone reported 403 securities class actions, and NERA's count was 441.
7. *Id.* at 1 (emphasis added).
8. John C. Coffee, Jr., *The Changing Character of Securities Litigation in 2019: Why It's Time to Draw Some Distinctions*, THE CLS BLUE SKY BLOG (January 22, 2019), <http://clsbluesky.law.columbia.edu/2019/01/22/the-changing-character-of-securities-litigation-in-2019-why-its-time-to-draw-some-distinctions/>.
9. Cornerstone Research, *supra* note 7, at 5.
10. *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).
11. *Id.* at 886-87.
12. *Id.* at 887.
13. *Id.*
14. *Id.*
15. *Delaware Insider: Trulia and the Demise of 'Disclosure Only' Settlements in Delaware*, AMERICAN BAR ASSOCIATION'S BUSINESS LAW TODAY (February 20, 2016), https://www.american-bar.org/groups/business_law/publications/blt/2016/02/delaware_insider/.
16. Coffee, *supra* note 9, at 1.
17. Cornerstone Research, *supra* note 7, at 5.

18. Coffee, *supra* note 9, at 1.
19. *Id.*; see also Kevin LaCroix, *Marriott Hit with Data Breach-Related Securities Lawsuit*, THE D&O DIARY (Dec. 3, 2018), <https://www.dandodiary.com/2018/12/articles/securities-litigation/marriott-hit-data-breach-related-securities-law-suit/>.
20. Kevin LaCroix, *Scrutinizing Event-Driven Securities Litigation*, THE D&O DIARY (March 27, 2018), <https://www.dandodiary.com/2018/03/articles/securities-litigation/scrutinizing-event-driven-securities-litigation/>; see also Kevin LaCroix, *Latest Brazilian Dam Disaster Leads to Event-Driven Securities Suit*, THE D&O DIARY (January 29, 2019) (“A big factor in the heightened levels of securities litigation filings in 2018 and one of the most important recent litigation trends has been the rise of event-driven securities litigation. These are securities lawsuits based not—as was the case in the past—on accounting misstatements or financial misrepresentations, but on setbacks in a company’s operations that affect a company’s share price.”), <https://www.dandodiary.com/2019/01/articles/securities-litigation/latest-brazilian-dam-disaster-leads-event-driven-securities-suit/>.
21. Cornerstone Research, *supra* note 7, at 10.
22. *Id.* All percentages are based on the allegations made in the first identified complaint. Because complaints may include multiple allegations, the percentages are not exclusive but overlapping.
23. Section 12(2) of the Securities Act gives buyers “an express cause of action for rescission against sellers who make material misstatements or omissions by means of a prospectus.” *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 564 (1995) (internal quotation marks omitted).
24. Boettrich and Starykh, *supra* note 6, at 17.
25. Cornerstone Research, *supra* note 7, at 33.
26. *Id.*
27. Boettrich and Starykh, *supra* note 6, at 15.
28. Boettrich and Starykh, *supra* note 6, at 11.
29. *Id.*
30. *Id.* at 11-12.
31. *Id.* at 11.
32. Cornerstone Research, *supra* note 7, at 8.
33. *Id.*
34. Laarni T. Bulan, Ellen M. Ryan, & Laura E. Simmons, *Securities Class Action Settlements: 2018 Review and Analysis*, CORNERSTONE RESEARCH, 1, (2019).
35. Boettrich and Starykh, *supra* note 6, at 27.
36. Bulan *et al.*, *supra* note 36, at 1.
37. Boettrich and Starykh, *supra* note 6, at 27.
38. Bulan *et al.*, *supra* note 36, at 14.
39. Kevin LaCroix, *Massive Settlement in Wells Fargo Bogus Account Scandal Derivative Suit*, THE D&O DIARY (March 3, 2019), <https://www.dandodiary.com/2019/03/articles/shareholders-derivative-litigation/massive-settlement-in-wells-fargo-bogus-account-scandal-derivative-suit/>.
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41. Scott Carlton, *The #MeToo Movement and the Shareholder Derivative Action*, AMERICAN BAR ASSOCIATION PRACTICE POINTS (April 24, 2019), <https://www.americanbar.org/groups/litigation/committees/class-actions/practice/2019/me-too-movement-lawsuits-shareholder-derivative-action/>.
42. *Id.*
43. *Id.*; see also Peter French & Tristan Fretwell, *Shareholder Derivative Suits in 2018 and Issues to Watch in 2019* (Feb. 1, 2019), <https://www.taftlaw.com/news-events/law-bulletins/shareholder-derivative-suits-in-2018-and-issues-to-watch-in-2019>.
44. Scott Carlton, *supra* note 43.
45. *Id.*
46. See generally Erin Quinn-Kong, *An Introduction to the Opioid Litigation*, JURIST (Feb. 4, 2019), <https://www.jurist.org/commentary/2019/02/an-introduction-to-the-opioid-litigation/>.
47. Jeff Montgomery, *Amerisource Bergen Investors Demand Opioid Crisis Records*, LAW360 (April 18, 2019), <https://www.law360.com/articles/1151479/amerisourcebergen-investors-demand-opioid-crisis-records>.
48. Jeff Montgomery, *Chancery Oks New Stay for ‘Dark’ Insys Derivative Claims*, LAW360 (March 26, 2019), <https://www.law360.com/articles/1143108/chancery-oks-new-stay-for-dark-insys-derivative-claims>.
49. Kevin LaCroix, *Securities Suit Filings Remain at Heightened Pace in Year’s First Half*, THE D&O DIARY (June 30, 2019), <https://www.dandodiary.com/2019/06/articles/securities-litigation/securities-suit-filings-remain-at-heightened-pace-in-years-first-half/>.

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United States ex rel. Landis v. Tailwind Sports Corp.—Lance Armstrong Pays \$5 Million Settlement to the USPS in Fraud Case

Thomas M. Eichenblatt

This discussion reviews the United States litigation against Tailwind Sports Corp. Specifically, the discussion (1) describes the facts of the case, (2) explains the damages measurement analyses and the corresponding challenges to the expert witnesses, and (3) concludes with commentary on damages measurement issues and still unanswered questions raised as a result of this litigation.

INTRODUCTION

It has been nearly seven years since former professional road racing cyclist Lance Armstrong (“Armstrong”) was stripped of all seven of his Tour de France titles—after it was revealed that he had relied on performance enhancing drugs (“PEDs”) during the entirety of his career.¹

After defeating cancer in 1996, Armstrong won the Tour de France seven consecutive times from 1999 to 2005, winning six of those titles while leading the United States Postal Service (“USPS”) Cycling Team.

Outside of cycling, Armstrong was a well-known philanthropist, mainly due to the non-profit he founded in 1997 known as the Livestrong Foundation, which focused on providing support for people affected by cancer.²

What we know today about Armstrong paints a different picture than that of the once cycling champion. In 2012, the United States Anti-Doping Agency (“USADA”) concluded its investigation and announced that Armstrong had used PEDs his entire professional cycling career. USADA claimed that Armstrong was the leader of “the most sophisticat-

ed, professionalized and successful doping program that sport has ever seen.”³

Armstrong continued to deny that he ever doped. However, he did not contest USADA’s findings, claiming fighting the charges would put too much of a toll on his family.⁴

In January of 2013, Armstrong finally admitted to doping during an interview with Oprah Winfrey.

Shortly after his admission, Armstrong found himself in a legal battle with the U.S. government (the “government”) over the sponsorship money he received during his time as the head of the USPS Cycling Team.

The lawsuit was originated by one of Armstrong’s ex-teammates, Floyd Landis (“Landis”), who filed a claim under the False Claims Act (“FCA”) on behalf of the government in 2010. Landis was a member of the USPS Cycling Team from 2002 to 2004.

Like Armstrong, Landis had his 2006 Tour de France title revoked due to the revelation that he was also doping.⁵ The government took over the case from Landis in 2013, for what would become a long and tedious legal battle with Armstrong.

This discussion presents the FCA, the context of the litigation, and the facts regarding how the government's expert witnesses created a nonspeculative framework to present to a jury for how to measure the damages the USPS incurred.

Due to the long and complex history of the relationship between USPS and the USPS Cycling Team, the damages measurement is not a straightforward task. The expert witnesses in the case reviewed both (1) the positive impact of the USPS sponsorship and (2) the negative impact of the news coverage the USPS received during the scandal. That coverage followed the revelation that the USPS Cycling Team was doping.

This discussion also presents the legal precedent set in *Daubert v. Merrell Dow Pharmaceuticals, Inc.* ("Daubert"), which outlines what is required for an individual to be considered an expert witness.

In this case, Armstrong challenged the government expert witnesses' ability to testify credibly on the relevant topics of the case. These challenges highlight the importance of having a qualified expert who can both present and defend credible testimony.

THE FALSE CLAIMS ACT

The FCA is a federal statute that can be filed to recover damages arising from defendants knowingly presenting, or causing to be presented, a false or fraudulent claim for payment or approval from the government. Any person who is found guilty of violating the FCA is liable to the government for a civil penalty between \$5,000 and \$10,000, plus three times the amount of damages that the government sustains because of the act of that person.⁶

According to 31 U.S.C. Section 3730, a person may bring a civil action for a violation of the FCA for the person and the government. The action is brought in the name of the government, and the government may elect to intervene and proceed with the action within 60 days, or within an allotted extension period, after it receives both the complaint and the material evidence and information.

If the government proceeds with the action, it has the primary responsibility of prosecuting the action and is not bound by any act of the person who filed the original complaint, although they remain a party to the action.

If the government is successful with the action, the person who filed the original complaint is entitled to receive at least 15 percent and no more than 25 percent of the proceeds of the action or settlement of the claim, depending on the extent

to which the person substantially contributed to the prosecution, along with an amount for reasonable expenses which the court finds to have been necessarily incurred, plus reasonable attorney's fees and costs.⁷

The FCA is often applied to reward whistle-blowers who bring cases forward where the government recovers funds lost due to fraudulent actions.

THE DEFENDANTS

The original defendants in the government's complaint were the following parties:⁸

- Tailwind Sports, LLC, and Tailwind Sports Corp. (collectively referred to as "Tailwind Sports")
- Johan Bruyneel ("Bruyneel")
- Armstrong

Tailwind Sports, LLC, was founded in 1999, and owned and operated the USPS Cycling Team from 1999 until 2002. In 2002, it merged with Tailwind Sports Corp. and transferred the ownership of the team to the new entity. Tailwind Sports was dissolved in 2007.⁹

Bruyneel was the managing director of the USPS Cycling Team from 1999 through 2004, and an employee of Tailwind Sports from 1999 to 2007. Bruyneel was originally from Belgium and did not respond to his summons for the complaint. Because of this, the court clerk entered a default judgment in favor of the government against Bruyneel.

Armstrong was the lead cyclist on the USPS cycling team from 1999 through 2004.

After Tailwind Sports was dissolved, and a default judgment was entered against Bruyneel, Armstrong was left as the only active defendant in the case.

The government asserted that the original defendants submitted or caused to be submitted false or fraudulent claims to the USPS during the time USPS sponsored the cycling team owned by Tailwind Sports.¹⁰

THE CONTEXT

In 1995 the USPS entered into an agreement ("the 1995 Agreement") with Montgomery Sports, LLC, the predecessor to Tailwind Sports, for the rights to sponsor the cycling team owned by the entity.

The 1995 Agreement automatically renewed on an annual basis and did so every year until 2000. The 1995 Agreement required that the performance of the obligations of the parties to

be subject to compliance with all applicable rules of the major governing bodies of professional cycling, which forbade the use of performance enhancing drugs and activities.¹¹

In 2000, the USPS entered into a four-year agreement for the 2001 through 2004 cycling seasons (“the 2000 Agreement”). This agreement also included clauses that required the USPS Cycling Team to adhere to the anti-doping regulations of the governing bodies of the sport.

From 1998 through 2004, the USPS paid Tailwind Sports and its predecessors approximately \$40 million. Defendant Armstrong received salaries of approximately \$17.9 million during that time period.¹²

Performance Enhancing Drugs and Doping

“Doping” is defined broadly as the use of prohibited substances or prohibited methods to increase athletic performance. Typical methods of doping in professional cycling include the use of erythropoietin (“EPO”), anabolic steroids, and blood transfusions.

EPO is a naturally occurring protein hormone that stimulates the production of red blood cells, which then carry oxygen to the muscles. Athletes use EPO to increase the red blood cell count in their bodies, which increases the flow of oxygen to the muscles, thus increasing their endurance during competition.

Anabolic steroids are man-made steroids that mimic the effects of testosterone by increasing the speed of muscle development, strength, and endurance. These drugs commonly come in the form of injections, patches, and gels. Anabolic steroids are classified as a Schedule III controlled substance, meaning it is illegal under federal law to distribute the drug without a prescription and a medical necessity.

Blood transfusions, also referred to as blood doping, like EPO, are used to increase the red blood cell count to increase the speed at which oxygen is delivered to the muscles. The process involves removing and storing a person’s blood, allowing that person to naturally regenerate the removed blood, and then re-injecting the stored blood back into the body to artificially increase that person’s red blood cell count prior to an athletic competition.¹³



THE COMPLAINT

The government’s complaint cited seven counts. Four counts were filed under the FCA, which requested an order for the defendants to pay an amount equal to three times the amount of damages the United States has sustained because of the defendant’s actions, plus a civil penalty between \$5,000 and \$10,000 for each count.

One count was of common law fraud, one count was for unjust enrichment, and one count was for a breach of contract.¹⁴

THE DAMAGES CLAIM

The government identified 41 payments totaling \$32.3 million paid to the defendants during the period the USPS was sponsoring the cycling team. The government was seeking almost \$100 million in damages, which is approximately three times the total amount of the USPS sponsorship payments.¹⁵

If successful, Landis would be entitled to up to 25 percent of the proceeds.

Armstrong argued that the government suffered no damages, stating that the USPS received benefits in excess of the \$32.3 million spent on sponsoring the cycling team.

Difficulties Determining the Market Value of the Services

Typically, FCA lawsuits measure damages by applying a “benefit of the bargain” method. This method states that the government’s actual damages are equal to the difference between:

1. the market value of the products or services it received and retained and

2. the market value that the products or services would have had if they had been of the specified quality.

Sometimes called “expectation damages,” benefit of the bargain damages compensate an aggrieved party for the loss of the bargain for which it negotiated.

Measuring the benefit of the bargain damages becomes difficult when the market value of the product or service is not readily ascertainable. Given the unique aspects of the case, accurately identifying the market value of the subject products or services applying generally accepted valuation methods may likely be challenging.

The unique aspects of the case made the application of damage measurement methodologies difficult. For example, a generally accepted damages measurement method known as the “yardstick” method involves using a benchmark to estimate what would have occurred if the damages event had not taken place.

In a yardstick analysis, the analyst typically selects a guideline company or industry data as a benchmark for comparison.¹⁶ Because the USPS is an entity of the government, its operations are fundamentally different than comparable companies in the parcel delivery industry. The lack of reasonable guideline companies made the application of market-based damages measurement methods such as the yardstick method difficult in this case.

Another generally accepted damages measurement method is the “but for” method. This method attempts to replicate what would have occurred but for the actions of one of the parties to the litigation. This analysis looks at any factors that would have been different absent the alleged damages event.

In other instances, this measurement method would compare sales projections for a product that were produced prior to the damages event, to the actual sales results of the damaged product.¹⁷

Because of the nature of the damages in this case, income-based damages measurement methods such as the “but for” method were difficult to apply. The USPS did not have projections for the revenue generated from their sponsorship of the USPS Cycling Team, therefore, they could not compare projected results to actual results.

Even if those projections existed, the damages continued to occur over a number of years after the sponsorship ended, meaning the damages period is much longer than the period that would have been projected.

Further, preparing projections for the USPS assuming a clean cycling team versus projections

for the USPS assuming a PED-tainted cycling team may be considered speculative. Therefore, the government took a different method to measuring FCA damages.

The government cited a 2010 court case, *United States v. Science Applications International Corporation* (“SAIC”), where FCA damages were measured for services received.¹⁸

USA v. SAIC

In *USA v. SAIC*, the Nuclear Regulatory Commission (“NRC”) hired SAIC to provide technical assistance and expertise to assist in researching and implementing regulations on the handling of radioactive material waste. The contract between the NRC and SAIC included conflict-of-interest provisions which required SAIC to certify that it would not conduct business with organizations regulated by the NRC to preserve the impartiality of its consulting services.

It was revealed that SAIC had violated the conflict-of-interest provisions and, therefore, the government claimed that SAIC had violated the FCA by continuing to submit invoices for payment after conflicting relationships occurred. The government requested damages equal to triple the amount that they had paid to SAIC.

Similarly to the Tailwind Sports case, the government claimed that it had received no value from the SAIC contract because, “had the NRC known about SAIC’s organizational conflicts, it would have made no payments whatsoever for the consulting advice and technical assistance it received.”

The jury found SAIC liable and awarded the government the full amount of the payments it made under the contract, which the court tripled.

The D.C. Circuit Court overturned the verdict on appeal. The D.C. Circuit Court stated that in order to measure FCA damages, “the fact-finder seeks to set an award that puts the government in the same position as it would have been if the defendant’s claims had not been false.”

The Circuit Court opined, “Where the value that conforming goods or services would have had is impossible to determine, then the fact-finder bases damages on the amount the government actually paid minus the value of the goods or services the government received or used.”¹⁹

The Government Argument

The government applied this framework to the measurement of the damages that the USPS incurred, stating the market value of the “PED-tainted” promotional service is similarly impossible

to determine like the market value of the “conflict-tainted” consulting services of SAIC.

Therefore, instead of determining the market value of a “clean” cycling team versus the market value of a “tainted” cycling team, the precedent required the government to measure the damages by subtracting the value the government received from the total price paid to the defendants over the sponsorship period.

The government approached the issue by arguing that the positive benefits received from sponsoring the USPS cycling team were reduced or eliminated altogether by the negative publicity that accompanied the investigation and disclosure of the team’s doping; therefore, the damages the USPS incurred were equal to the price it paid.²⁰

The Defendant’s Argument

Armstrong argued that there were no damages—because the USPS received value in excess of the \$32 million paid in sponsorship fees. Armstrong claimed that the USPS saw increased revenue, among other benefits, due to the sponsorship.

The first support Armstrong cited were sales figures from a USPS presentation made in 2000, stating that the sponsorship generated \$24.4 million in new revenue from 1998 to 2000.

The government argued this point by highlighting the fact that Armstrong was citing gross revenue figures, which does not account for the cost of sales associated with the increased revenue. Furthermore, the vice president of sales of the USPS released a clarifying statement that said the cycling team was “only one of many factors” that contributed to the USPS concluding any new sales.

The government further defended this stance by citing a 2003 USPS Inspector General audit which found that only \$698,000 of the \$18 million in revenue that the USPS itself attributed to the sponsorship from 2000 to 2004 could be verified.

The second benefit that Armstrong suggested the USPS received from the cycling team was positive media exposure.

During the time it was sponsoring the cycling team, the USPS commissioned reports from two sports marketing firms to estimate the dollar value of the press coverage that the USPS received due to the sponsorship. The two sports marketing firms attempted to assign a dollar value to the press coverage by identifying all positive impressions (i.e., unique viewers) of the team in the media.

Then the two firms discounted each piece of media coverage relative to the cost it would have incurred to place a paid advertisement or com-

mercial with the same media outlet. The report concluded that the USPS received \$103.5 million in media coverage from 2001 to 2004.

Armstrong then supported these valuations by pointing to times where the USPS used these reports to justify the costs of sponsoring the USPS Cycling Team in public forums and in internal emails.²¹

Therefore, Armstrong argued that the benefits the government received from the PED-tainted cycling team far exceeded the costs the government incurred to retain the sponsorship.

However, the sports marketing reports themselves acknowledged that their estimated figures were strictly estimates, and that there was no industry standard for calculating the value of the positive media the USPS received. Even one of the authors of the valuation reports admitted in a deposition that, “at that time no one was going to pay that amount for a cycling sponsorship even if it was Lance Armstrong.”

The valuation reports in question also did not account for the negative media impressions that the USPS incurred when it was revealed that the USPS Cycling Team had used PEDs and participated in doping.

The court decided against any summary judgments after both sides had made their case. Instead, the court followed the precedent set by the *SAIC* case and allowed both sides to present their case to a jury.

EXPERT TESTIMONY

The next step in the process was to have expert witnesses present their testimony to the jury. Before this occurs, both sides have an opportunity to discuss and challenge each other’s experts.

In order for an expert witness to testify, he or she should first pass the two-part test laid out in *Daubert*. *Daubert* states that the court must determine “whether the expert is proposing to testify to (1) scientific knowledge that (2) will assist the trier of fact to understand or determine a fact in issue.” Simply, *Daubert* states that expert testimony should be both reliable and relevant.²²

The government was represented by three expert witnesses: Larry Gerbrandt (“Gerbrandt”), Dr. Brian Till (“Till”), and Dr. Jonathan Walker (“Walker”).

Till planned to testify that “there is a general causal relationship between negative publicity about a sponsored celebrity-athlete and diminished consumer perception of a sponsoring brand.”

Gerbrandt planned to testify that “there was a great deal of negative publicity.”

And, Walker planned to testify about how to “estimate the harm to USPS from public disclosure of Armstrong’s PED use.”

Together, the government claimed these three expert witnesses would provide the jury with a framework on which to estimate the amount of damages.²³

The defendants were represented by two expert witnesses: Douglas Kidder (“Kidder”) and Dr. John Gleaves (“Gleaves”).

Kidder planned to testify on the economic benefit that the USPS gained from sponsoring the cycling team, and Gleaves planned to testify that PED use was widespread in cycling, the USPS knew or should have known about the Armstrong PED use, and that the USPS failed to investigate any suspected PED use.

Both the government and the defendants filed motions to keep the opposing expert witnesses from testifying.²⁴

The Armstrong Challenge to the Government Expert Witnesses

Armstrong challenged all three of the government expert witnesses on the grounds that their testimonies were not relevant to the case, and that the government was attempting to prove damages under an impermissible theory that the fair market value of the USPS sponsorship agreement was zero due to the revelation that the team was doping.

The court agreed that the government cannot argue that the sponsorship had zero value, because as previously stated in the SAIC precedent, it is impossible to place a value on the sponsorship at all. Therefore, to the extent that the government experts would attempt to make that argument, their testimony would be considered inadmissible.

Armstrong also argued that even with a permissible theory of damages, the government experts’ testimony was still irrelevant because it did not give the jury a means to quantify the damages or give evidence to any amount that the damages may be.

The government responded that although the amount of the damages may be uncertain, there was certainty that damages were incurred. The government referenced *Story Parchment Co. v. Paterson Parchment Co.*, which ruled that “while a plaintiff seeking to recover must ordinarily prove the fact of injury with reasonable certainty, proof of the amount of damages may be based on a reasonable estimate.”

Furthermore, the court recognized that the quantification of damages in this case was “a task no doubt made more difficult by the delay in public awareness of Armstrong’s doping caused by his concealment.”²⁵

The three expert testimonies in tandem would provide the jury with grounds beyond a “mere speculation or guess” to measure an award of damages. Each of the expert witness testimonies was based on more than mere speculation, and was relevant to prove the government’s damages.

Armstrong’s argument implied that the court should consider each of the government expert witnesses individually when determining their relevance, specifically pointing out that Till and Gerbrandt did not plan on providing numerical estimates in their testimonies.

The court disagreed with Armstrong here, referencing the precedent set in *Rothe Dev. Inc. v. Department of Defense* that established “a court may not exclude an expert’s otherwise reliable and relevant testimony simply because, without more, the testimony is insufficient to prove a proponent’s entire case.”²⁶

Armstrong also challenged the government expert witnesses individually.

The Armstrong Challenges to Gerbrandt

Armstrong challenged Gerbrandt’s qualifications to be an expert witness in the case, as well as the reliability of the methodology that Gerbrandt applied in creating his testimony.

Armstrong challenged Gerbrandt’s qualifications to testify on the damages incurred by the USPS, claiming because he had no formal education in the valuation of negative publicity, he was not qualified to testify about the negative publicity the USPS incurred from the Armstrong doping scandal.

As stated in the *Federal Rules of Evidence*, for a witness to testify as an expert, he or she must be qualified based on “knowledge, skill, experience, training, or education.” The court found that Gerbrandt’s more than 30 years of experience as a media and entertainment analyst qualified him to testify on the subject.

Armstrong challenged Gerbrandt’s methodology, stating it did not pass the *Daubert* test, because the methodology was not the product of reliable scientific methods or principles. Specifically, he argued that Gerbrandt used unreliable methodology when showing that the USPS received negative publicity from the doping revelation and when calculating the total number of negative media impressions.

The Gerbrandt expert report concluded that “the harm to USPS resulting from such a large volume of negative impressions would necessarily outweigh the value of any benefits received by USPS resulting from positive impressions during the sponsorship period.” The court partially sided with Armstrong on this issue. This was because Gerbrandt mainly

focused on the calculation of the total number of negative media impressions, while not calculating the number of positive media impressions.

Therefore, the Gerbrandt statement that “negative impressions would *necessarily* outweigh positive impressions” lacks support. The court stated that Gerbrandt was free to opine that the USPS received negative publicity, but he could not argue that the negative impressions outweighed the positive impressions without a foundation for that argument.

Armstrong also challenged the reliability of the Gerbrandt methodology for calculating the total number of negative media impressions, but the court disagreed. Gerbrandt relied on the “premiere independent sources for marketing, advertising, public relations, internet and social media, and entertainment decisions and purchases” such as Nielson Co., which mainly tracks television ratings, and Cision, which focuses more on editorial coverage.

Gerbrandt analyzed data from these companies for media that connected Armstrong with PED use, and then researched the number of viewers of each source. Based on this methodology, Gerbrandt found that there were 41,912 media sources that connected Armstrong to PED use, which made approximately 154.4 billion impressions.

Gerbrandt explained his methodology, stating that he used keywords and search terms that connected Armstrong to PED use, as well as constraining the search to only articles that mention the USPS in some fashion.

The court ruled that the Gerbrandt methodology for calculating negative impressions was reliable and, therefore, admissible.²⁷

The Armstrong Challenges to Till

Armstrong did not challenge Till’s qualifications to testify as an expert witness. However, Armstrong did challenge the reliability of Till’s methodology when showing that negative press coverage of Armstrong had harmed consumer’s impressions of the USPS. Again, the court disagreed.

Armstrong argued that Till failed to apply any principles or methods to the specific facts of the case. This argument was not accepted because the court frequently allows testimony of expert witnesses on the topic of general academic or scientific principles, such as the general theory of causation.

Till cited generally accepted academic articles on the theory that negative publicity regarding a sponsor athlete tarnishes the brands that the athlete



has promoted. The court accepted Till’s expert testimony on this topic.²⁸

The Armstrong Challenges to Walker

Finally, Armstrong challenged the validity of the Walker testimony on the possible monetary impact that negative coverage of the Armstrong use of PEDs had on the USPS. Armstrong argued that his methodology was “composed of entirely of speculation” and was not reliable. Again, the court disagreed.

Armstrong claimed that because Walker did not calculate the specific impact of the negative coverage on the USPS, his testimony was not relevant. The Walker methodology relied on information about the change in the stock price of public companies that sponsored athletes that received extreme negative press coverage like Armstrong, such as Tiger Woods. This methodology is known as an “event study,” which measures the effect that an event had on the stock price of publicly traded companies affected by the event.

Because the USPS is not a publicly traded company, Walker was not able to perform an event study on the impact of Armstrong’s doping scandal on the USPS. Walker instead specifically focused on event studies done on comparable companies that are in the parcel delivery industry.

The court concluded that the Walker testimony was sufficiently reliable to be admissible.²⁹

SUMMARY AND CONCLUSION

The court stated that the government expert witnesses would provide the jury with a sufficiently nonspeculative framework for determining the damages that the USPS incurred, due to the negative publicity it received from the scandal.

This framework followed the precedent set in *USA v. SAIC*—when the market value that conforming goods or services would have had is impossible to determine, then the fact-finder should base damages on the amount the government actually paid minus the value of the goods or services the government received or used.

In this case, it was considered impossible to accurately calculate the market value of the sponsorship of a PED-tainted cycling team versus the market value of the sponsorship of a clean cycling team. Therefore, the court allowed the framework for the measurement of damages to be:

1. the price paid by the government to sponsor the team, less
2. the value the government received during the sponsorship period.

The government established that the USPS paid approximately \$41 million to the defendants during the sponsorship period and hoped to establish that any benefit that the USPS received from the sponsorship was wiped out due to the negative press coverage that the USPS received from the scandal.

Because the government filed the complaint under the FCA, it was in a position to receive triple the damages that are determined to have been incurred, and because the case was originally brought by Landis, he was permitted to receive up to 25 percent of any proceeds the government received.

On April 19, 2018, Armstrong settled the case with the government and agreed to pay \$5 million. The settlement came less than two weeks before a jury was to be selected for the trial. Landis was reported to expect to receive \$1.1 million, or 22 percent, of the proceeds, as well as \$1.7 million to cover the legal costs he incurred over the nearly eight years he was involved in the case.³⁰

Because the case settled, the expert witnesses did not make their cases to a jury. However, the arguments and debates leading up to the trial revealed a variety of interesting damages measurement methods.

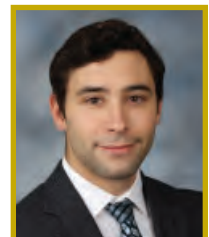
Given the unusual aspects of this case, the generally accepted damages measurement methods were difficult to apply. Had the trial proceeded, the experts on both sides would have been faced with the challenging task of convincing a prospective jury of a damages amount, or lack thereof.

The damages measurement complexities in this case highlight the importance of having experts who can create and defend relevant, reliable, and sometimes creative testimony. The *Daubert* challenges put forth in this case highlight the importance of having experts whose qualifications can hold up under scrutiny.

Notes:

1. Juliet Macur, “Armstrong Drops Fight Against Doping Charges,” *The New York Times* (August 24, 2012).
2. *Ibid.*: 2–3.
3. “Statement from USADA CEO Travis T. Tygart Regarding the U.S. Postal Service Pro Cycling Team Doping Conspiracy,” U.S. Anti-Doping Agency (October 10, 2012), www.usada.org.
4. Macur, “Armstrong Drops Fight Against Doping Charges.”
5. Complaint for Violations of Federal False Claims Act, United States ex rel. Landis v. Tailwind Sports Corporation, No. 10-cv-00976, U.S. Dist. Ct. (D.C. June 10, 2010).
6. False Claims Act, 31 U.S.C. § 3729 (a).
7. *Ibid.*, § 3730 (d).
8. United States Complaint, United States ex rel. Landis, v. Tailwind Sports Corp. Tailwind Sports LLC, Lance Armstrong, and Johan Bruyneel, No. 10-cv-00976, U.S. Dist. Ct. (D.C. April 23, 2013).
9. *Id.* at 3.
10. *Id.* at 1.
11. *Id.* at 5.
12. *Id.* at 7.
13. *Id.* at 8–9.
14. *Id.* at 24–27.
15. United States ex rel. Landis v. Tailwind Sports Corp., 234 F.Supp.3d 180, 186 (D.C. 2017).
16. Roman L. Weil, Daniel G. Lentz, and David P. Hoffman, *Litigation Services Handbook*, 5th ed. (Hoboken, NJ: John Wiley & Sons, 2012), 4–35.
17. *Ibid.*
18. United States ex rel. Landis v. Tailwind Sports Corp., 234 F.Supp.3d 180, 198.
19. *Id.* at 200.
20. *Id.* at 201.
21. *Id.* at 202.
22. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
23. United States ex rel. Landis v. Tailwind Sports Corp., No. 10-CV-009756, 2017 WL 5905509 at *6 (D.C. Nov. 28, 2017).
24. *Id.* at *1.
25. United States ex rel. Landis v. Tailwind Sports Corp., 234 F.Supp.3d 180, 204.
26. United States ex rel. Landis v. Tailwind Sports Corp., 2017 WL 5905509 at *6.
27. *Id.* at *8.
28. *Id.*
29. *Id.* at *9.
30. Juliet Macur, “Lance Armstrong Settles Federal Fraud Case for \$5 Million,” *The New York Times* (April 19, 2018).

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Analysis of Fraudulent Conveyance Actions

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Disputes over allegedly fraudulent conveyances have become more common in bankruptcy cases. Fraudulent transfer allegations are also common in transactions such as leveraged buy-outs and recapitalizations. Analysts are frequently asked to provide expert opinions in these actions for trustees, debtors-in-possession, creditors, and other third-party plaintiffs. The law in this area is contained in the United States Bankruptcy Code and is centered around the avoidance powers granted to trustees and other relevant parties, specifically Section 548 fraudulent transfers and obligations. Generally, the analysis of fraudulent conveyances involves the determination and testing of whether a transfer meets the criteria of either actual or constructive fraud. This discussion summarizes these criteria and describes some of the relevant tests conducted in fraudulent conveyance analyses. This discussion also summarizes a possible badges of fraud analysis often applied to prove fraudulent intent in conveyance actions.

INTRODUCTION

Analysts are often called on to perform analyses and to issue expert opinions related to allegedly fraudulent conveyances (also known as fraudulent transfers). Such actions generally occur in a bankruptcy context and address the issues described in the United States Bankruptcy Code (“Code”).

The plaintiff is often a trustee, debtor-in-possession (“DIP”), or creditor of the estate. The plaintiff alleges that but for certain fraudulent transfers, the creditors would have collected more of its outstanding debts. The defendants are either the estate or the trustee who either approved or did not set aside the allegedly fraudulent conveyance.

The primary purpose of the trustee in a bankruptcy setting is the fair and efficient administration of the estate. The Code outlines the many duties and powers of the trustee. In order to assist the trustee to fulfill his or her duties, bankruptcy law provides the power to set aside or “avoid” certain asset transfers from the estate.

For example, if a debtor transferred estate assets to a third party with the intent to defraud its creditors, then the transfer may be categorized as a fraudulent conveyance. In this instance, the trustee may, with the bankruptcy court’s approval, set aside the conveyance. Alternatively, a third-party creditor of the estate may sue the estate seeking the avoidance of the allegedly fraudulent transfer.

Bankruptcy law differentiates fraudulent conveyances as either actual fraud or constructive fraud. Actual fraud focuses on the “actual intent to hinder, delay, or defraud” creditors of the estate. As one may imagine, proving intent is a difficult proposition for many trustees and creditor plaintiffs seeking recovery in bankruptcy court. Various state and federal courts have accepted the use of “badges of fraud” analyses to assist in proving intent in these matters.

Constructive fraud focuses on transfers where the estate received “less than reasonably equivalent value” in exchange for the transfer. Such a transfer may be considered a fraudulent conveyance if the debtor:

1. is insolvent,
2. is unable to pay its debts as they became due, or
3. has unreasonably small capital on the transfer date.

Multiple analytical dilemmas exist in these scenarios. The most important of which is that the Code is silent on the definition of “reasonably equivalent value.”

The purpose of the analyst’s expert opinion is the determination of whether the transfer(s) in question meet the qualifications of either actual or constructive fraud. These analyses may be prepared for the plaintiff, defendant, or as a neutral in an arbitration setting. If the court determines the transfer was a fraudulent conveyance, the trustee may recover the property (avoid the transfer) as part of the estate.

This discussion summarizes the Code and related law related to fraudulent conveyances. This discussion also addresses the tests which may be performed by the analyst in a fraudulent conveyance analysis. Finally, much of this discussion assumes the trustee fills the role of plaintiff in the dispute over whether the transfer is fraudulent. In reality, the DIP or third-party creditor may also fill this role.

ROLES AND RESPONSIBILITIES OF THE TRUSTEE

The Code assigns a host of duties to the bankruptcy trustee. These duties are specified in Code Section 704, with the relevant sections summarized as follows:

11 U.S. Code Section 704: Duties of Trustee

- (a) The trustee shall—
 - (1) collect and reduce to money the property of the estate for which such trustee serves, and close such estate as expeditiously as is compatible with the best interests of parties in interest;
 - (2) be accountable for all property received;
 - (3) ensure the debtor shall perform his intention related to property securing consumer debt;
 - (4) investigate the financial affairs of the debtor;

(5) if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper;

(6) if advisable, oppose the discharge of the debtor;

(7) unless the court orders otherwise, furnish such information concerning the estate and the estate’s administration as is requested by a party in interest;

(8) if the business of the debtor is authorized to be operated, file with the court, with the United States trustee, and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic report and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the United States trustee or the court requires;

(9) make a final report and file a final account of the administration of the estate with the court and with the United States trustee.

A reader of the above duties may be surprised that there is no mention of any fiduciary obligation of the trustee to the creditors. While outside the scope of this discussion, fiduciary law suggests that the trustee has obligations to the various classes of creditors, although possibly in varying degrees.

For example, the duty to “collect and reduce to money the property of the estate” has been interpreted by courts as a fiduciary role. More relevant to this discussion are the powers granted to the trustee and how the trustee may wield those powers.¹

In addition to the trustee’s ability to hire experts, obtain financing, acquire, and/or sell assets, the Code provides the trustee with significant avoidance powers. These powers are detailed in Code Sections 544, 545, 547, 548, and 549.

While the following is not an exhaustive analysis of the trustee’s powers, it will provide the reader with a general understanding of the trustee’s avoidance powers, and more specifically, how the trustee may avoid fraudulent conveyances. The latter is the focus of this discussion and is detailed in Section 548, Fraudulent Transfers and Obligations.

CODE PROVISIONS FOR FRAUDULENT CONVEYANCES

Section 544(a) is sometimes referred to as the “strong-arm clause” and provides the trustee the rights of a judicial lien creditor or a purchaser of real estate. Section 544(b) grants powers like those of an unsecured creditor.

11 U.S. Code Section 544: Trustee as Lien Creditor and as Successor to Certain Creditor and Purchasers

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b)

(1) Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.



(2) Paragraph (1) shall not apply to a transfer of a charitable contribution (as that term is defined in section 548(d)(3)) that is not covered under section 548(a)(1)(B), by reason of section 548(a)(2). Any claim by any person to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court shall be preempted by the commencement of the case.

Section 545 allows the trustee to avoid the fixing of a statutory lien.

11 U.S. Code Section 545: Statutory Liens

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien—

(1) first becomes effective against the debtor—

(A) when a case under this title concerning the debtor is commenced;

(B) when an insolvency proceeding other than under this title concerning the debtor is commenced;

(C) when a custodian is appointed or authorized to take or takes possession;

(D) when the debtor becomes insolvent;

(E) when the debtor's financial condition fails to meet a specified standard; or

(F) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien;

(2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists, except in any case in which a purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law;

(3) is for rent; or

(4) is a lien of distress for rent.

Section 547 allows the trustee to avoid certain preference payments within 90 days of the petition date.

11 U.S. Code Section 547 – Preferences

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Section 548 allows the trustee to avoid certain fraudulent transfers and differentiates transfers based on intent. Section 548(a)(1)(A) states that any transfer made within two years before the petition date, whether made voluntarily or involun-

tarily, may be set aside if such transfer was made with the actual intent to hinder, delay, or defraud any creditor.

Section 548(a)(1)(B) states that any transfer made within two years before the petition date, whether made voluntarily or involuntarily, may be set aside if the estate received less than a reasonably equivalent value in exchange for the transfer and either:

1. the estate was insolvent,

2. the property remaining with the debtor was an unreasonably small capital,

3. the debtor incurred debts would be beyond the debtor's ability to pay, or

4. transfer was to or for the benefit of an insider.

11 U.S. Code Section 548 – Fraudulent Transfers and Obligations

(a)

(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B)

(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(ii)

(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(II) was engaged in business or a transaction, or was about to engage in business or a

transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

Section 549 allows the trustee to avoid certain transactions subsequent to the petition date.

11 U.S. Code Section 549 – Postpetition Transactions

(a) Except as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate—

(1) that occurs after the commencement of the case; and

(2)

(A) that is authorized only under section 303(f) or 542 (c) of this title; or

(B) that is not authorized under this title or by the court.

FRAUDULENT CONVEYANCE LITIGATION

Thus far this discussion has focused on the powers of the trustee and the circumstances under which the trustee may avoid certain types of transfers. In these instances, the trustee avoids or sets aside the transfer (after proving the requirement of the case to the appropriate court) and the assets are returned to the estate.

In other situations, the trustee or the DIP administering the estate neglects to avoid the fraudulent transfer. Such events may lead to litigation against the estate, the trustee, or the DIP by one or more creditors of the estate.

It is common practice for counsel for estates, trustees, and DIPs to retain analysts to examine allegedly fraudulent conveyances and to provide

expert opinions in bankruptcy and other courts. These analyses generally begin with an examination of Code Section 548.

The Code differentiates fraudulent transfers as either actual fraud or constructive fraud. The former assumes actual intent by the estate to hinder, delay, or defraud one or more creditors of the estate. Therefore, the plaintiff in any fraudulent conveyance action claiming actual fraud will be burdened with the proof of intent. Since intent is a difficult proof, the courts have accepted various versions of the “badges of fraud” analysis to aid this analysis.

Further discussion of the badges of fraud is presented below.

Alternatively, claims for constructive fraud do not require proof of intent. Rather constructive fraud requires that the estate received less than a reasonably equivalent value in exchange for the transfer along with one of four additional requirements.

First, the estate was insolvent on the date of the transfer or became insolvent because of the transfer. Second, the estate retained unreasonably small capital subsequent to the transfer. Third, the estate was unable to pay debts as they became due because of the transfer. Fourth, the estate made the transfer for the benefit of an insider.

The analyst may provide expert opinions on whether the transfer meets any or all of the criteria of fraudulent conveyances as of the time of the specific transfer. Limitations for both actual and constructive fraud claims for fraudulent conveyances are within two years prior to the bankruptcy petition date.

There are additional exemptions noted in Section 548 addressing transfers to qualified religious and charitable entities that are beyond the scope of this discussion.

Finally, any analysis should consider state law variances. For example, a majority of states utilize the guidelines contained in the *Uniform Fraudulent Transfer Act* (“UFTA”) while others govern by the *Uniform Fraudulent Conveyance Act* (New York and other states). The UFTA was approved and adopted in 1984 by the *Uniform Law Commission* (“ULC”). In 2014, the ULC made modifications to the UFTA and renamed it the *Uniform Voidable Transactions Act* (“UVTA”).

The UVTA is largely the same as the UFTA. The purpose of each of these acts is to prevent estates from fraudulently transferring assets in order to avoid current or anticipated claims by creditors.

ACTUAL FRAUD

The analysis of actual fraud is based on whether the estate made the transfer with the actual intent to hinder, delay, or defraud its creditors. As the proof of intent would require the reading of the perpetrator's mind, the courts rely on circumstantial evidence of fraud.

Since *Treyne's Case*,² courts have used various badges of fraud analysis as a tool to determine intent. In 2014, the UVTA codified 11 badges of fraud for consideration.

While different courts may assign different weights to each factor (or no weight at all), the following list of factors is a useful tool for the analyst to consider in fraudulent conveyances matters:

1. The transfer or obligation was to an insider—Transfers to close family members, business associates, or corporate entities with similar ownership or board membership may receive scrutiny from the courts.
2. The debtor retained possession or control of the property transferred after the transfer—Joint ownership or actual control over transferred assets may signal intent to hinder, delay, or defraud creditors.
3. The transfer or obligation was disclosed or concealed—Collusion between parties may be a significant indicator of fraud.
4. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit—If the relevant transfer is made at, or about, the time litigation is threatened or initiated, fraud may be present.
5. The transfer was substantially all the debtor's assets—The sale of a substantial portion of the debtor's assets at less than fair value may indicate intent.
6. The debtor absconded—Transfers made hurriedly and secretly may signal intent to hinder, delay, or defraud creditors.
7. The debtor removed or concealed assets—The movement of assets outside the ordinary course of business or the hiding of assets may be an indicator of fraud.
8. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred—The reasonably equivalent standard is generally used with other badges as a basis for fraud.
9. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred—Insolvency is

a frequent badge in fraud in fraudulent conveyances, especially when other badges are present. Solvency tests are addressed later in this discussion.

10. The transfer occurred shortly before or shortly after a substantial debt was incurred—Transfer made at or near the time of incurred debts (and for similar amounts) may be a signal of fraud.
11. The debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor—Collusion between parties may be a significant indicator of fraudulent intent.

The above list of the badges of fraud should not be considered exhaustive. State and federal courts continually update badges of fraud to deal with more complex fraudulent activity.

CONSTRUCTIVE FRAUD

The analysis of a constructive fraud claim is based on whether the estate received reasonably equivalent value for the transfer. Unfortunately, the Code neither defines nor provides a formula for the computation of reasonably equivalent value.

If nothing of value is exchanged for the transfer, the analysis is straightforward and demonstrates that the transfer meets the standard of constructive fraud. In more complex cases, assets like cash or marketable securities may be exchanged for less liquid assets such as intellectual property (patents, trademarks, and copyrights), debt instruments, or real estate.

The trustee or DIP should then prove that the values are (1) not equivalent and (2) not *reasonably* equivalent.

While a detailed analysis of the reasonably equivalent value concept is beyond the scope of this discussion, the reader should understand that the courts make such determinations on a case-by-case basis and evaluate the merits based on the cumulative facts of the case. The main concern of the court will be whether there was harm to the creditors of the estate.

Assuming the analysis demonstrates the estate received less than reasonably equivalent value, the next step is the analysis of the following four tests to determine if a fraudulent conveyance occurred.

First, was the estate insolvent on either the date of transfer or immediately subsequent to the transfer? Solvency is analyzed using the balance sheet test. If the fair value of the assets is greater than

the fair value of the liabilities, the estate passes the balance sheet test.

Second, subsequent to the transfer, did the estate possess unreasonably small capital? This is analyzed using the capital adequacy test (also referred to as the “reasonable capital test”).

If in the short term (generally one year or the operating cycle), the estate has capital sufficient to meet its operating expenses, capital expenditure requirements, and debt payment obligations, the estate passes the capital adequacy test.

Third, did the estate possess the ability to pay its debts as they become due? The ability to pay debts is analyzed using the cash flow test. If the estate can pay its projected obligations from excess cash at the transfer date, from cash flow generated during the projection period or from unused credit facilities, the estate passes the cash flow test.

And finally, was the transfer to or for the benefit of an insider? Context is necessary to determine whether the recipient is an insider. For instance, for an individual debtor, an insider may be an immediate or close family member. In a corporate estate, an insider may be a board member or senior executive. Transfers in the ordinary course of business are generally exempt from this category. If the transfer is not to an insider, the estate passes the insider test.

If the estate received less than a reasonably equivalent value for the transfer and failed any of the four tests noted above, the trustee or DIP may ask the court to consider the transfer fraudulent and set the transfer aside.

In the Winter 2014 issue of *Insights*,³ Gilbert and Wishing presented a detailed discussion of the balance sheet, capital adequacy, and cash flow tests. Additionally, they presented a procedural and due diligence checklist that may be useful to analysts and other users of fraudulent conveyance opinions.

SUMMARY AND CONCLUSION

Fraudulent conveyance actions are complex and are in no way assisted by the vague language contained in the United States Bankruptcy Code. Prior to becoming involved in a fraudulent conveyance case, the analyst should gain a general understanding of the relevant bankruptcy law and avoidance powers of the trustee along with a specific understanding of Section 548, Fraudulent Transfers and Obligations.

The analyst's first step is to examine the allegedly fraudulent conveyance and determine whether the transfer meets any of the conditions of either actual or constructive fraud. If conditions exist that make the transfer appear to hinder, delay, or defraud one or more of the estate's creditors, the



analyst may perform a badges of fraud analysis to determine fraudulent intent.

Fraudulent intent is required to prove actual fraud. Courts have used such analysis to avoid fraudulent conveyances with as few as one badge of fraud in existence. Multiple badges may significantly strengthen the fraud case.

If the circumstances surrounding the allegedly fraudulent transfer does not meet the criteria for actual fraud, the analyst's next step is to analyze the tests of constructive fraud.

The analyst determines whether the estate received less than reasonably equivalent value for the transfer. If so, the analyst may also conduct solvency (balance sheet), capital adequacy, and cash flow tests. Finally, the analyst determines whether the transfer was to an insider. The failure of any of these tests may indicate the existence of a fraudulent conveyance.

Once a determination of either actual or constructive fraud is made, the plaintiff (trustee, DIP, or creditor) may seek avoidance of the transfer and recovery of either the asset or compensation to the trust. The plaintiff may also obtain an injunction against future asset disposals.

Notes:

1. See generally John A.E. Pottow, “Fiduciary Duties in Bankruptcy and Insolvency,” *The Oxford Handbook of Fiduciary Law* (University of Michigan, March 29, 2018).
2. Twyne's Case, 76 E.R. 809 (Star Chamber, 1601).
3. Katherine Gilbert and Kyle Wishing, “Due Diligence and Analytical Procedures for Fraudulent Conveyance Opinions,” *Willamette Management Associates Insights* (Winter 2014).

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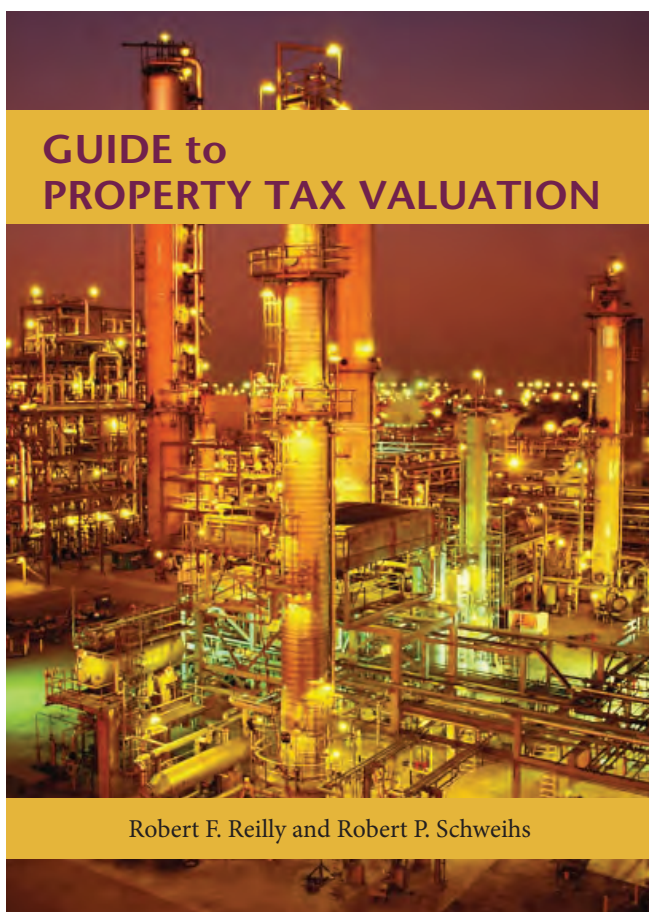


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GUIDE TO PROPERTY TAX VALUATION

Robert F. Reilly and Robert P. Schweih

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The Role of the Royalty Base and the Royalty Rate in Determining Economic Damages Using Reasonable Royalties in Patent Infringement Litigation

Andrew M. Fisher

A damages analyst (“analyst”) may be engaged to opine on economic damages arising from cases of patent infringement. In patent infringement litigation, the analyst may estimate a reasonable royalty to measure the amount of damages to compensate the afflicted party. The analyst is tasked with navigating this process, which may include the selection of the appropriate royalty base and royalty rate. While the process can be somewhat ambiguous, judicial decisions establish precedent. Such precedent provides the analyst with a general framework to navigate the reasonable royalty process. This discussion focuses on two variables that are used to determine a reasonable royalty, namely: the royalty base and the royalty rate. In addition, this discussion summarizes the hypothetical negotiation analysis and the Georgia-Pacific factors. Finally, this discussion explores how the selection of the royalty base and the royalty rate have been interpreted by the courts through a review of two recent decisions by the U.S. Court of Appeals for the Federal Circuit.

INTRODUCTION

The U.S. Code, Title 35, Section 284, provides the standard for measuring economic damages in patent infringement cases:

Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest costs as fixed by the court.¹

To receive compensation for the infringement, patentees may be entitled to receive patent damage

awards in the form of (1) lost profits or (2) reasonable royalties.

While a lost profits analysis is one method for measuring the amount of damages to be awarded in patent infringement cases, lost profits is a separate analysis that is outside the scope of this discussion. Instead, this discussion focuses on measuring damages using a reasonable royalty analysis.

Section 284 notes that a reasonable royalty should be used to establish the lower bound for damages awards in patent infringement cases. Reasonable royalty damages may be identified:

1. by analyzing established royalties for the patent or
2. by ascertaining a hypothetical royalty for the patent.

When available, an established royalty generally provides the best measure of damages since it contemplates actual market-based transactions for the subject patent.

However, due to the nature of patent infringement, established royalties are often unavailable. As a result, a hypothetical royalty is commonly used as the basis to assess the damages award in a reasonable royalty analysis.

A reasonable royalty is the hypothetical amount that compensates the patentee for the infringing party's use of the patent. To contextualize this, a reasonable royalty is typically thought of as the payment that would have resulted from a hypothetical negotiation between a willing licensor and a willing licensee at or just before the point in time that the initial infringement began.²

While Section 284 states that the reasonable royalty should be sufficient to compensate for the infringement, it does not suggest a specific method to use in the estimation of the royalty.

This discussion focuses on the estimation of the reasonable royalty through the use of the royalty base and royalty rate.

Once these variables have been determined, the reasonable royalty is calculated by multiplying the selected (1) royalty base and (2) royalty rate to conclude the amount of damages attributable to the patented feature, on a per-unit basis.

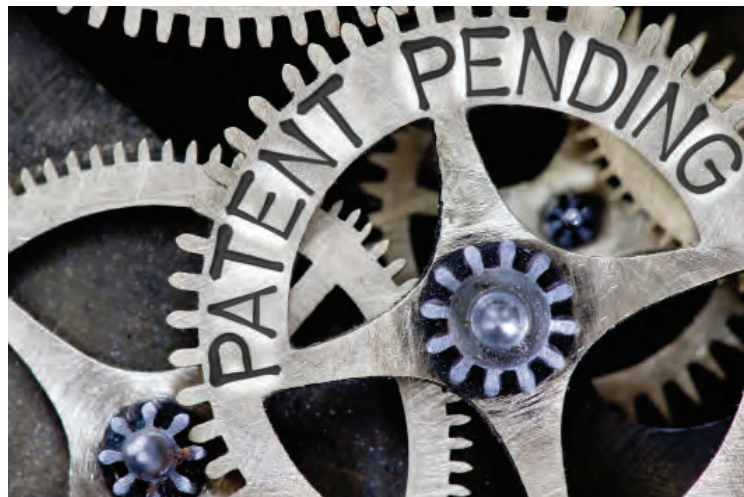
ROYALTY BASE

The royalty base is the selected level of value for the accused product containing the patented feature that is used to calculate the recovery of damages. The royalty base should capture the marginal value of the patented feature itself, with respect to the value of the product embodying the patented feature.

Because the royalty base is the foundation on which the reasonable royalty calculation is built, the selection of a suitable royalty base is important in estimating a reasonable royalty.

There are two generally accepted methods to assess the value of the royalty base:

1. The entire market value rule ("EMVR") (i.e., the sales price of the entire product embodying the patent)
2. The smallest salable patent practicing unit ("SSPPU") (i.e., the sales price of the component, within a larger product, that embodies the patented feature)



As the name suggests, the EMVR calculates the recovery of damages based on the market value of the entire product. The application of the EMVR becomes complicated when the infringed patent is part of a multicomponent product (i.e., a product containing several other valuable features in addition to the patented feature).

However, the EMVR can be applied to a multicomponent product if the patent holder can demonstrate that the patented feature, alone, constitutes the basis for consumer demand.

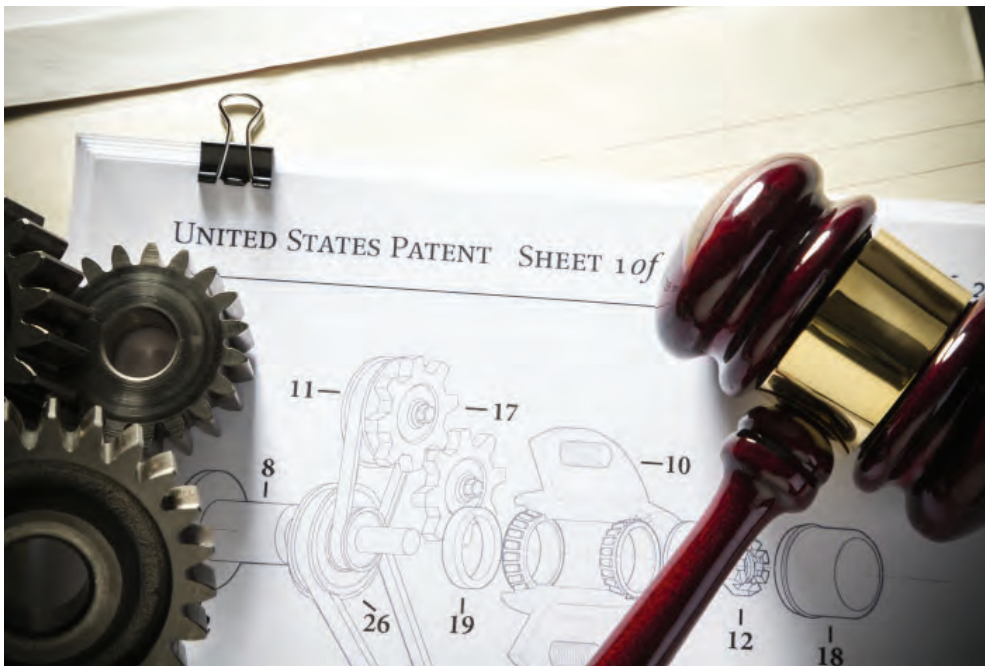
Specifically, in order to apply the EMVR to a product, three conditions should be met:

1. The infringing feature must be the basis for consumer demand for the entire product, including the parts beyond the patented feature.
2. The infringing and noninfringing features must be sold together so that they constitute a functional unit or parts of a complete machine or single assembly of parts.
3. The infringing and noninfringing features must be analogous to a single functioning unit.³

When the accused product fails to meet any of the three conditions outlined above, the Federal Circuit has ruled that, generally, the royalty base should be based on the market value of the SSPPU.⁴

The rationale for using the SSPPU to select the royalty base is to isolate the value of the patented feature from the value of the other, unpatented features, within a multicomponent product. Selecting a more precise royalty base helps to prevent the analyst from awarding compensatory damages on the value of the unpatented features of the product.

Sometimes the SSPPU, itself, is a multicomponent product. If the SSPPU contains valuable features in



addition to the patented feature, it is necessary to further apportion the value of the patented feature within the SSPPU.

It may be difficult to discern the value of the patented and unpatented features that comprise the SSPPU, given that the units are nonsalable in nature. However, it is important to apportion the value of the SSPPU between the patented and unpatented features so as not to overstate the marginal value of the patented feature.

One possible method to apportion the value within the SSPPU is through the selection of a royalty rate.

To better understand the royalty base, let's consider the case of *Laser Dynamics, Inc. v. Quanta Computer, Inc.*,⁵ which considered the selection of the royalty base in the context of a laptop computer. The infringed patent covered a method of optical disc discrimination that enabled the optical disc drive ("ODD") to identify whether the disc inserted into the drive was a CD or a DVD. In other words, the patented feature related to the function of the ODD, which is just one of many important component functions of a laptop computer.

In the first District Court trial, the LaserDynamics, Inc. ("LaserDynamics"), expert attempted to apply the EMVR to select the royalty base. Under the EMVR, the sales price of the entire laptop would be selected as the royalty base.

However, because no evidence was presented to indicate that the ODD drove the entirety of demand for the finished laptop product, the District Court ruled that the EMVR was improperly invoked. The

ruling was confirmed by the U.S. Court of Appeals for the Federal Circuit.

On the other hand, in the second District Court trial, the SSPPU was applied to determine the royalty base. Here, the LaserDynamics expert relied on the market value of the ODD.

The market value of the ODD was based on the sales price of a replacement ODD unit. The replacement ODD unit was determined to be representative of the market value of the ODD, independent of the completed laptop unit and, therefore, a good indication of the marginal value of the patented feature. The selection of the market value of the SSPPU containing

the patented feature, the ODD, was upheld by the U.S. Court of Appeals for the Federal Circuit as an appropriate royalty base.

ROYALTY RATE

In the context of damages analysis for patent infringement, the royalty rate is the portion of the royalty base that a hypothetical licensor would receive from granting a licensee the right to use the patent. The royalty rate is typically expressed as a percentage of the royalty base.

The selection of the royalty rate can further assist the analyst in apportioning the damages between the patented and unpatented features, beyond the selection of the royalty base.

When the entire market value of the product is selected for the royalty base, the royalty rate is used to apportion the damages to the value of the patented feature. Since a patented feature rarely accounts for 100 percent of the marginal value of a product, the selection of the royalty rate is a crucial step in apportioning damages when the EMVR is used to select the royalty base.

On the other hand, when relying on the SSPPU as the royalty base, the royalty rate acts as a supplemental tool that is used to further refine the apportionment of damages to the value of the patented feature. The royalty rate can be used to further apportion the damages when the SSPPU is a multi-component product.

HYPOTHETICAL NEGOTIATION ANALYSIS AND THE *GEORGIA- PACIFIC* FACTORS

As previously mentioned, reasonable royalties may be identified by analyzing existing royalties for the subject patent. However, existing royalty agreements for the subject patent rarely exist. Because of this, damages analysts commonly rely on the hypothetical negotiation analysis to develop a reasonable royalty.

The *Georgia-Pacific* factors (the “GP” factors) provide a framework for the analyst to estimate a royalty base and a royalty rate to determine a reasonable royalty in the hypothetical negotiation analysis. During this process, the analyst considers the GP factors to determine the reasonable royalty that would arise from a hypothetical negotiation between a willing licensor and a willing licensee at the time the infringement began.

The assumptions in a hypothetical negotiation analysis are that:

1. the patent is valid and
2. the patent has been infringed.

The case of *Georgia-Pacific v. U.S. Plywood Corp.*,⁶ established a list of 15 factors, known as the GP factors, that can be used to assist in the selection of a reasonable royalty. The GP factors prompt the analyst to consider, amongst other factors, the following:

1. The existing license agreements, if any, for the infringed product or other relevant products
2. The profitability and commercial success of the infringed product
3. Whether the licensor and licensee are commercial competitors
4. The incremental benefit of the patent over previous versions
5. The portion of the profit that should be credited to the patented feature

GP factor number 15 asks the analyst to consider the royalty that would arise out of a hypothetical negotiation between a willing licensor and a willing licensee at the time the infringement began. The first 14 GP factors summarize important issues that would likely be considered during a hypothetical negotiation process.

However, the extent that each GP factor influences the royalty will vary from case to case. It is

possible that one instance of patent infringement may only warrant the application of one or two GP factors, while another instance of patent infringement warrants the use of eight or nine GP factors to support the reasonable royalty that has been concluded.

It is up to the analyst to consider the facts of the specific case and exercise their best judgement and expertise when selecting the appropriate GP factors to analyze during the hypothetical negotiation analysis.

RELATIONSHIP BETWEEN THE ROYALTY BASE AND THE ROYALTY RATE

Generally, the broader the scope of the selected royalty base (i.e., the entire market value of a multicomponent product), the lower the selected royalty rate, and vice versa. If the royalty base and the royalty rate are estimated appropriately, so as to apportion the damages between the patented and unpatented features, the royalty base and the royalty rate should be inversely related.

Let's consider the following reasonable royalty example to demonstrate the inverse relationship between the royalty base and the royalty rate.

Let's assume that the patented feature is part of a multicomponent product containing several other valuable features. As presented in Exhibit 1, for illustrative purposes, the appropriate royalty base could be derived using Method A, the entire market value of the product, or using Method B, a version of the SSPPU.

Regardless of the selected royalty base, the royalty rate should be adjusted accordingly to account for the marginal value of the patented feature with respect to the value of the selected royalty base. In Method B, the market value of the royalty base is \$10, whereas the royalty base in Method A is \$100.

As mentioned, the selected royalty rate should be higher in Method B than in Method A, because the marginal value of the patented feature accounts for a larger portion of the market value of the royalty base in Method B. As shown, the selected royalty rate for Method A is 3 percent and the selected royalty in Method B is 30 percent.

Let's note that the concluded reasonable royalty, on a per-unit basis, is \$3 using both methods. Mathematically, it does not matter how the value of the patented feature is apportioned as long as the patented feature is apportioned, so as to ascribe an accurate amount of value to the patented and unpatented features within the product.

Exhibit 1 The Royalty Base and Royalty Rate Relationship

	Method A (Entire Market Value of Product)	Method B (Smallest Salable Patent Practicing Unit)
Entire Market Value of Multicomponent Product	\$100	NA
Market Value of Component with Patent Feature	NA	\$10
Value of Royalty Base	\$100	\$10
Selected Royalty Rate	3%	30%
Concluded Value of Reasonable Royalty Per-Unit Basis	\$3	\$3

The purpose of this example is simply to illustrate the relationship between the royalty base and the royalty rate and demonstrate how this relationship affects value in the reasonable royalty calculation.

In practice, however, the decision to apply the EMVR or the SSPPU will be based on each specific case. As usual, the analyst should consider the facts and circumstances of the specific case when determining the best method to apportion damages.

POWER INTEGRATIONS, INC. v. FAIRCHILD SEMICONDUCTOR INTERNATIONAL, INC.

In July 2018, in an appeal from the U.S. District Court for the Northern District of California, the U.S. Court of Appeals for the Federal Circuit (the “Federal Circuit Court”) overturned the use of the EMVR to determine the royalty base.

This decision illustrates the additional scrutiny that is applied when the EMVR is used to select the royalty base.

Overview of the Appeal

Power Integrations, Inc. v. Fairchild Semiconductor International, Inc.,⁷ involved a Federal Circuit Court appeal of damages awarded in the District Court ruling. The U.S. District Court for the Northern District of California found Fairchild Semiconductor International, Inc. (“Fairchild”), guilty for infringing patents owned by Power Integrations, Inc. (“Power Integrations”), that covered switching regulators and a power supply controller. The District

Court awarded damages of \$139.8 million to Power Integrations.

Fairchild appealed the use of the EMVR to determine the reasonable royalty, citing that the evidence provided was insufficient to support the use of the EMVR.

Assessing the Royalty Base

The Federal Circuit Court suggested that when conducting an apportionment analysis for multicomponent products, such as the accused products in *Power Integrations v. Fairchild*, the royalty base should be no larger than the smallest salable unit embodying the patented invention.⁸

The Power Integrations damages expert relied on the EMVR to select the royalty base for the infringed multicomponent products. When the entire market value of a multicomponent product is used as the royalty base, the analyst risks concluding a reasonable royalty that overstates the damages award by inadvertently including damages for noninfringing elements of the product.

As previously mentioned, to use the EMVR for a multicomponent product the patented feature should be the basis for consumer demand. Court precedent, as established in *LaserDynamics v. Quanta Computer*, dictates that the burden of proof falls on the patent holder to show that the patented feature is the sole factor creating consumer demand for the infringing product.⁹

Showing that a single feature provides the basis for consumer demand can be difficult to prove. In *Power Integrations v. Fairchild*, the Federal Circuit Court explained the following:

1. Only showing that consumers perceive the patented feature to be a valuable aspect of the product is not sufficient to prove that the patented feature provides the basis for demand.
2. The fact that consumers purchase the product containing the patented feature does not itself prove that the patented feature provides the basis for demand.

Consequently, if the infringing product contains other valuable features, the only way to support the use of the EMVR is to show that the other features did not influence the consumer's purchasing decision.

The Appeals Court Decision

The Federal Circuit Court ruled that the Power Integrations expert failed to provide evidence that the other features contained in the infringing products did not influence consumer demand. Since Power Integrations failed to show that the patented feature was the sole feature creating consumer demand for the accused products, they did not meet the burden of proof necessary to use the EMVR for a multicomponent product as the royalty base.

As a result, the Federal Circuit Court vacated the damages award of \$139.8 million and remanded the case for a new trial.

EXMARK MANUFACTURING CO. V. BRIGGS & STRATTON POWER PRODUCTS GROUP, LLC

In January 2018, in an appeal from the U.S. District Court for the District of Nebraska, the Federal Circuit Court affirmed the use of the EMVR for a multicomponent product, citing that apportionment for the infringed patent may still be achieved through the selection of the royalty rate.

The decision by the Federal Circuit Court to allow the use of the EMVR to select the royalty base for a multicomponent product demonstrates the potential flexibility that may be available to analysts when apportioning damages between patented and unpatented features.

Overview of the Appeal

Exmark Manufacturing Co. v. Briggs & Stratton Power Products Group, LLC,¹⁰ considered the infringement of an Exmark Manufacturing Co. ("Exmark") patent for lawn mower flow control baffles.



The District Court jury concluded that Briggs & Stratton Power Products Group, LLC ("Briggs"), infringed the Exmark patent and awarded damages of \$24,280,330.

The District Court doubled the amount of the damages award because it was determined that Briggs willfully infringed the Exmark patent.

In its appeal, Briggs contested several aspects of the District Court's judgement including (1) the selection of the value of the entire lawn mower as the royalty base and (2) the use of a 5 percent royalty rate.

Using the EMVR for a Multicomponent Product

Briggs argued that the District Court incorrectly allowed Exmark to rely on the value of the whole lawn mower as the royalty base. Instead, Exmark should have apportioned the value of the flow control baffle by selecting a smaller royalty base.

The Federal Circuit Court disagreed with the Briggs claim, citing that apportionment can be achieved through:

1. the selection of the royalty base, so as to reflect the value of the patented feature;
2. the use of a royalty rate that is adequately discounted to account for the value of the product's unpatented features; or
3. a combination of the aforementioned factors.¹¹

The Federal Circuit Court claimed that the use of the market value of the lawn mower as the royalty base was particularly appropriate in this case for the following reasons:

1. The asserted claim was directed towards the lawn mower as a whole.

2. Licensing agreements, which are often used as the basis for ascertaining a reasonable royalty rate in a hypothetical negotiation analysis, are typically structured based on the sale price of the entire commercial product.

The Federal Circuit Court added that the EMVR is particularly applicable when the patented feature does not have an established market of its own, as was the case with the subject flow control baffle.

If the selected royalty rate proportionately accounts for the value of the patented feature with respect to the base, there is nothing inherently wrong with using the entire market value of the product.¹²

Supporting the Selected Royalty Rate

When selecting the entire market value of the product as the royalty base, the damages can still be apportioned through the royalty rate. The Federal Circuit Court suggested that one possible way of selecting the appropriate royalty rate is through an analysis of the GP factors. As a general guideline, the expert should link the pertinent GP factors from the case to the selected royalty rate.¹³

While it is not required that experts be mathematically precise in their explanation, some indication of why, and to what extent, the analyzed factors affected the selection of the royalty rate should be included.

In *Exmark v. Briggs*, the Exmark expert outlined some of the advantages that the patented feature possessed over previous products, citing GP factors 9 and 10. However, the Exmark expert failed to provide an explanation that connected the advantages to the selection of the 5 percent royalty rate.

The Appeals Court Decision

In response to the Briggs contentions, the Federal Circuit Court affirmed the District Court's ruling that the use of the entire value of the lawn mower as the royalty base was admissible. However, the Federal Circuit Court overturned the District Court's ruling of the proposed 5 percent royalty rate because the expert did not link the specific evidence presented in the case with the selection of the 5 percent royalty rate.

As a result, the Federal Circuit Court vacated the damages award and remanded the case for a new trial on damages.

CONCLUSION AND SUMMARY

Due to the one-off nature of patent infringement litigation, court decisions tend to provide guidance that is specifically tailored to the case in question.

As evidenced by the Federal Circuit decision to vacate the damages in both the cases discussed herein, the estimation of a reasonable royalty in patent infringement litigation is a delicate process to navigate. This discussion provided examples for when the EMVR may, and may not, be relied on in the selection of the royalty base for a multicomponent product.

Power Integrations v. Fairchild demonstrates the additional scrutiny with which the royalty base is analyzed when the entire market value of a multicomponent product is selected as the royalty base. On the other hand, *Exmark v. Briggs* provides an example of when it is appropriate to use the entire market value of a multicomponent product as the royalty base.

Understanding when to apply the EMVR has become more important as complex technologies and multicomponent products have become increasingly prevalent.

Additionally, the *Exmark v. Briggs* decision brings attention to the complex process of apportioning infringement damages. Here the court upheld that apportionment can occur through (1) the royalty base, (2) the royalty rate, or (3) a combination of both.

As always, analysts should consider the specific facts of the case when deciding the most appropriate methodology to determine the reasonable royalty.

Notes:

1. U.S. Code, Title 35, Section 284.
2. Nancy J. Fannon and Jonathan M. Dunitz, *Calculating Economic Damages in Intellectual Property Infringement Cases*, 2nd ed. (Portland, OR: Business Valuation Resources, 2016), 480.
3. *Ibid.*, 484.
4. *Ibid.*, 483.
5. *Laser Dynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51 (Fed. Cir. 2012).
6. *Georgia-Pacific Corp. v. United States Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970).
7. *Power Integrations, Inc. v. Fairchild Semiconductor International, Inc.*, 904 F.3d 965 (Fed. Cir. 2018).
8. *Id.* at 977.
9. *Id.* at 979.
10. *Exmark Manufacturing Company Inc. v. Briggs & Stratton Power Products Group, LLC*, 879 F.3d 1332 (Fed. Cir. 2018).
11. *Id.* at 1348.
12. *Id.* at 1348 and 1349.
13. *Id.* at 1350.

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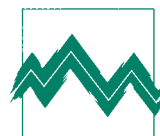
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Working with Testifying Experts and Consulting Experts

Lerry A. Suarez and Jason M. Bolt

This discussion considers the process of selecting an expert (whether a testifying expert or a consulting expert) to assist in litigation. This discussion summarizes (1) the role for which the expert may be hired, (2) the necessary qualifications for the expert, (3) the party that hires the expert, and (4) the challenges faced by a testifying expert. This discussion should assist both legal counsel seeking to retain an expert and analysts that may be looking to serve as testifying experts.

INTRODUCTION

An expert is oftentimes sought to educate the trier of fact (referred to hereafter as the “court”) on certain issues subject to litigation. When legal counsel seeks out an expert, the expert may be hired for a variety of roles, including (1) to provide expert witness testimony or (2) to provide consulting services.

In litigation involving financial issues, a valuation, damages, or forensic accounting analyst (collectively “analyst”) is typically retained in the dispute. The process to hire such an analyst is a difficult task as there are many factors that affect the selection of a qualified analyst.

The federal standards for expert witness testimony have evolved over time, and understanding the current standards is important when selecting an analyst to serve this function. Three Supreme Court decisions, sometimes known as the *Daubert* trilogy, have been adopted in Federal Rule of Evidence 702 (“Rule 702”), and an increasing number of state courts have adopted the principles laid out in Rule 702.

Not all states have adopted Rule 702, so making oneself aware of the laws applicable in a particular state is important when determining the use of an expert.

This discussion summarizes the information available to help counsel and their clients make an informed decision when selecting an expert. The

objective of this discussion is to provide an explanation of the process of hiring an expert in regard to litigation involving financial issues. Finally, this discussion considers (1) the role for which an expert may be hired, (2) necessary qualifications for the expert, (3) who hires the expert, and (4) the challenges that the expert may face in a litigation setting.

TYPICAL ROLES OF THE EXPERT

When referring to an expert providing litigation support services, there are two roles that fall under those services: (1) the testifying expert and (2) the consulting expert. The role an expert may fill depends on the circumstances for each specific case. There are different needs, expectations, rules, and professional guidelines that apply to each respective role.

Testifying Expert

The role of a testifying expert is to render an expert opinion at trial. The purpose of a testifying expert is to educate the trier of fact, which may be a judge and/or jury members in the subject matter subject to litigation.

Generally, the testifying expert is hired for a special skill, knowledge, education, work experience, or training pertaining to the issues subject to

the litigation. The court may lack the subject matter expertise provided by the testifying expert. The subject matter expertise is helpful to the court to make an educated and knowledgeable ruling.

Typically, federal courts and many state courts require that a testifying expert submit a written report stating the opinions and the bases for those opinions that the expert will present in court. Rule 26 of the U.S. Federal Rules of Civil Procedure should also be followed by the expert witness when submitting reports to the federal courts and the state courts which have adopted the federal rules.

The following information should be included:

- A complete statement of all the expert's opinions, and the basis and reasons for them
- The data or other information the expert considered in reaching opinions
- The expert's qualifications, including publications authored by the expert in the prior 10 years
- A listing of cases in which the expert testified in the prior four years
- Compensation of the expert¹

These rules do vary on a court-by-court basis. Therefore, the expert witness should obtain an understanding from the attorney about the specific rules for disclosure in the venue for each case.

Regarding compensation of the expert, all types of compensation (whether direct or indirect) are to be included. Experts generally charge for litigation services engagements as they do other consulting engagements, with fees based on hours extended and hourly rates, plus expenses. Fixed fees are also an option. Due to the unpredictable nature of litigation work, this can be risky as some cases can become extremely lengthy.

Contingent fees are not an appropriate form of compensation for an expert witness, as this would persuade the expert witness to form a biased testimony. In fact, the American Bar Association and many state bars make it an ethical violation for counsel to proffer testimony from an expert witness who receives contingent compensation.²

Consulting Expert

A consulting expert is hired by an attorney to be a consultant and advise the disputing party and its legal team about the facts, issues, and strategy of the case. A major difference between a consulting expert and a testifying expert is that a consulting expert does not testify at trial. The consulting expert opinion, discussions, work papers, and impressions

are not subject to discovery by the opposition. Due to this, the opposition often never knows of the expert serving as a consultant.

There are times when a consulting expert may progress from being a consultant to being a testifying expert. When this happens, the expert's work product, writings, work papers, and even notes likely become discoverable. In the event the expert's role changes from consultant to expert witness, the practitioner should consider executing a new engagement letter for the expert witness services to be performed.³

Consulting expert work will typically include analyzing and advising on how best to discredit the opposing expert's work. Sometimes the consulting expert also examines the strengths and weaknesses of the hiring attorney or law firm's case and how best to represent these facts at trial.

For large cases, counsel will sometimes engage both a testifying expert and a consulting expert. Counsel may also retain a consulting expert to evaluate the effects of particularly troublesome facts not shared with the testifying expert.⁴

Advocacy Standards

In all situations, the testifying expert (but not necessarily the consulting expert) is expected to remain unbiased and not act as an advocate for either party. The expert witness should only be an advocate for his or her own work and opinion. Analysts are subject to the professional standards and codes of ethics of the professional organizations of which they are members.

Two of the professional standards related to valuation analysts are the *Statement on Standards for Valuation Services* ("SSVS") and the *Uniform Standards of Professional Appraisal Practice* ("USPAP").

The SSVS Section 100.14 (Objectivity and Conflict of Interest) recognizes that "objectivity is a state of mind. The principle of objectivity imposes the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest."⁵

USPAP states, "An appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests." The conduct provision specifically identifies that an appraiser "must not perform an assignment with bias," and "must not advocate the cause or interest of any party or issue." Under the management provision of the ethics rule, "an appraiser must not accept an assignment or have a compensation agreement for an assignment, that is contingent on . . . a direction in assignment results that favors the cause of the client."⁶

Testifying experts should not have any bias when performing the tasks they are assigned. Testifying experts should perform their own analyses and be able to defend those analyses.

Other Opportunities to Be an Expert

Aside from the typical court and litigation hearings that testifying experts are needed for, there are some other roles that an expert will be asked to take on. One of these roles is an alternative dispute resolution (“ADR”) which can use the expert in a number of different ways. The other role that will be mentioned in this discussion is when the expert is needed in international arbitration.

Role of Expert in Alternative Dispute Resolution

ADR refers to processes for resolving a dispute between two or more parties other than through formal litigation in a court system.⁷

In these situations, analysts do not have to appear in court; rather, they may present their opinions to a neutral party.

In an ADR:

parties will typically engage experts to evaluate financial issues in a dispute, similar to the use of experts in litigation matters. These issues most frequently involve damages claimed. Experts can also perform financial analysis and related fact finding to help establish the facts supporting liability arguments.⁸

Generally, through previous experiences, experts will have the necessary expertise to discover more information than what is produced through a formal discovery.

Due to data limitations in some cases, the expert may rely on assumptions. As a result, the expert may consult with the legal counsel that hired the expert to see whether the opinion or assumption is fair and how it may be challenged. Since there will be no testimony, the expert will have to explain his or her opinion very thoroughly in the report and exhibits prepared for the parties involved.

Role of Expert in an International Arbitration

[E]xperts in an international arbitration perform the same tasks as those of domes-

tic arbitration, with some additional considerations. They will need to understand in each case to whom they owe their duty and to check whether any special rules exist that might govern the conduct of the assignment.

Just as attorneys work with local attorney, experts who lack experience in the local country should consider working with someone in the country where the transactions and dispute occurred.⁹

Having a contact in the country where the dispute is taking place can prove to be very important for the expert, especially if they have never performed analyses in that country before. The local contact will help the expert to understand tax and accounting rules and regulations, prior case law, local culture, and best business practices.

A local contact may make the process of developing an opinion more efficient for the expert as the contact will know where to find the necessary information and will know the proper tools that will assist the expert in the dispute at hand.

HOW TO QUALIFY AS AN EXPERT

Qualifying as an expert, whether as a consulting expert or as a testifying expert, varies on a case-by-case basis. Forensic accountants, damages analysts, and valuation analysts should become familiar with the local state and county laws and ensure their qualifications are sufficient to be accepted as a testifying expert.

The services required for each specific case will determine whether an individual will qualify as an expert witness. In general, Rule 702 provides the basis for evaluating the merit and relevance of a financial expert’s testimony in those cases in which federal rules apply.

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify thereto in the form of an opinion or otherwise.¹⁰

These criteria for the qualifications of the expert should govern the services provided by an expert. It is helpful to note that the definition uses “or,” allowing for a range of criteria to be considered. The hiring of an expert is considered on a case-by-case basis. Having a variety of these qualifying criteria

would certainly make an expert more of a preferred option.

An expert who has the pertinent accounting credentials, valuation credentials, and/or fraud examination credentials will likely be considered more qualified on the list of candidates to be selected for a case. The following is a list of skills that an expert may possess and what type of issues those skills would be applicable to:

1. **Accounting and Auditing.** The accounting and auditing profession may be used to provide damages analysis in litigation cases. Typically, damages analysis includes using the books and records of the disputing parties in order to make a determination. Accounting skills are fundamental when looking at books and records in order to assess damages in a specific case. Experts often need to understand financial statements, financial systems, journals, and ledgers.
2. **Cost Accounting.** When providing a measurement of damages, cost accounting skills are typically required. Damages are a remedy in the form of a monetary award to be paid to a claimant as compensation for loss or injury. In order to figure out how much damage has been done, an expert is brought in to determine the costs associated with the business.
3. **Economic Analysis.** Economists and accountants perform both macro- and micro-economic analyses in a litigation services engagement. Development of elasticity functions, analyzing market structure and market or pricing behavior, or assessing barriers to entry can prove important in claims for antitrust damages or for price erosion claims in a patent infringement matter.
4. **Market Analysis.** Market analysis often focuses on the collection of quantitative data about supply and demand, buyers and sellers, competitors, and other participants in a particular marketplace. Experts can help collect and assess the required data. Examples include the number or concentration of competitors in a particular market or computation of the market share of each participant, and trends driving changes to such market data.
5. **Statistics.** Economists and many accountants understand statistical techniques such as sampling and regression analysis. An expert may apply sampling when analysis of

an entire population is too time-consuming or expensive for the case. Regression analysis may help to project sales or suggest cost relations.¹¹

Credentials

Having a license or credential is not necessary in order to be a testifying expert. However, to improve the credibility of an analyst, having some sort of credential or license is helpful.

Depending on what sort of skills are in need according to some of the items listed above, there are different credentials available to the professional. Some of those credentials include, but are not limited to, certified public accountant (“CPA”), accredited in business valuation (“ABV”), accredited senior appraiser (“ASA”), certified valuation analyst (“CVA”), chartered financial analyst (“CFA”), and certified fraud examiner (“CFE”).¹²

WHO HIRES THE EXPERT?

In litigation matters, counsel look for experts in the specific field subject to the dispute. For instance, in a lawsuit claiming damages for patent infringement, counsel may consider financial professionals with expertise in both (1) intellectual property valuation and (2) damages analysis. Counsel seeks expert advice when negotiating a settlement or preparing for trial. Experts provide specialized knowledge to counsel.

The book *Litigation Services Handbook: The Role of the Financial Expert* (the “*Litigation Services Handbook*”) provides a concise summary of the traits sought by counsel when seeking an expert:

The ideal expert (1) has never testified before and has no relationship with the hiring attorney, firm, or client, so that the jury will be disinclined to regard him as a hired gun, but (2) has substantial experience in litigation analyses, testimony, and response to cross-examination.¹³

It is nearly impossible that both of the aforementioned qualities can exist simultaneously. An “ideal” expert referenced by the *Litigation Services Handbook* often does not exist. As a result, the hiring counsel may weigh the pros and cons of prospective candidates in relation to the case in question.

To avoid the appearances of a conflict of interest, it is ideal for counsel to select an expert with whom they have had few prior relationships. In reality, counsel is most likely to select an expert that they

are familiar with and understand the quality of the work of the expert. Generally, substantial experience is preferred, so the expert can be relied on when being questioned or having to deal with various challenges.

Counsel for the parties involved in litigation interview and retain experts both for their particular expertise and for their ability to communicate their opinions effectively.

Prior to the trial, experts typically assist counsel by educating the counsel on a number of issues such as the documents and data to request, drafting relevant questions for the opposing expert witness, drafting relevant questions to pose to opposing counsel, and reviewing relevant documents provided.

If the expert is to be used as a testifying expert, the expert will then analyze the documents received, reach an opinion, and, if needed, explain its relevance to the court. The expert may then produce a report (written or oral) or submit an affidavit about the expert's findings.

There is the possibility that the expert will be named as a witness and provide testimony in court. When serving as a testifying expert, the opposing counsel usually deposes the expert to learn his or her background and the bases for the opinions in the case. As defined in the *Litigation Services Handbook*, a deposition is the oral testimony of a witness questioned under oath by counsel, who can use the written record later at trial under certain circumstances.

CHALLENGES FACED BY AN EXPERT WITNESS

Once a professional is selected as a testifying expert, it is understood that the testifying expert should be an unbiased fact finder for the court and not an advocate for the party of which he or she is hired. Counsel are advocates for their clients, so the testifying expert should exercise caution when offering an expert opinion. When the validity and admissibility of an expert opinion is challenged by opposing counsel during a hearing, it is referred to as a *Daubert* challenge.

A *Daubert* challenge was so named after three cases, or what is commonly referred to as the *Daubert* trilogy. The cases that make up the *Daubert* trilogy are (1) *Daubert v. Merrell Dow Pharmaceuticals, Inc.* (1993); (2) *General Electric Co. v. Joiner* (1997); and (3) *Kumho Tire Co. v. Carmichael* (1999). The factors that go on to affect Rule 702 from the *Daubert* trilogy are described from each case below.¹⁴

Daubert v. Merrell Dow Pharmaceuticals, Inc.

The Supreme Court ruling in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,¹⁵ provided additional clarity on standards for the admissibility of expert testimony in federal courts. From this case, there were criteria outlined to aid in the assessment of the reliability of expert testimony. Those guidelines are listed below:

1. Has the technique or method been tested?
2. Has the technique been subject to peer review and publication?
3. What is the known or potential rate of error?
4. Has the relevant scientific community widely accepted the technique?

In the end, judges hold the role of evaluating the qualifications of expert witnesses and the relevance and reliability of their testimony.

General Electric Co. v. Joiner

There are two significant matters, decided by the Supreme Court, that come from the *General Electric Co. v. Joiner* case.¹⁶

The first matter is that the Supreme Court clarified that district courts should assess an expert's conclusions, as well as methodologies, under the *Daubert* standard.

The second matter is about the standard of review that appellate courts should use in *Daubert* decisions. The Supreme Court said with respect to the *Daubert* decisions, appellate courts should continue to "give the trial court the deference that is the hallmark of abuse of discretion review."

The Supreme Court ruled that an abuse of discretion standard of review is the proper standard for appellate courts to use in reviewing a trial court's decision of whether it should admit expert testimony.

Kumho Tire Co. v. Carmichael

In the case of *Kumho Tire Co. v. Carmichael*,¹⁷ it was determined that the *Daubert* analysis applied to not only scientific testimony, but nonscientific testimony as well. This means all expert testimony is subject to *Daubert* challenges. The court added, however, that "the test of reliability is 'flexible,' and *Daubert's* list of specific factors neither necessarily nor exclusively applies to all experts or in every case."

This decision highlights the importance for nonscientific experts, including financial experts such as economists, accountants, and appraisers to carefully consider the relevance and reliability of their testimony, and whether they have the qualifications to provide it.

Furthermore, the decision emphasized that courts should not take a checklist approach when evaluating relevance, reliability, and qualification: *Daubert* allows flexibility for courts to determine the most pertinent information assessing these factors.

Rule 702 Update

As mentioned earlier, Rule 702 is referred to when determining the merit and relevance of a financial expert's testimony before the *Daubert* trilogy. Subsequent to *Kumho*, in 2000, Congress amended Rule 702 to codify the rulings made in the three cases described above. Rule 702 now reads as follows:

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

- a) The expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
- b) The testimony is based on sufficient facts or data;
- c) The testimony is the product of reliable principles and methods; and
- d) The expert has reliably applied the principles and methods to the facts of the case.¹⁸

Rules and laws can vary state by state. Since the *Daubert* trilogy took effect on Rule 702, several state courts have adopted the *Daubert* standard. As of 2019, more than 40 states have adopted the *Daubert* standard, or have adopted a substantially similar standard, while the remaining states continue to use the previous standard. In most cases, the previously used standard is the *Frye* standard. As a result, the *Daubert* admissibility criteria present an important consideration for financial experts at both the state and the federal courts.

Reasons for Financial Expert Witness Exclusions

A *Daubert* challenge is a method for excluding witness testimony. If the expert is unable to demonstrate that the expert's methodology and reasoning

are scientifically valid and can be applied to the facts of the case, the expert's testimony will be at risk of being excluded from the litigation. Depending on the facts and circumstances, the testifying expert may consider engaging or consulting with the counsel that hired the testifying expert during a challenge of the professionals' expert opinion.

Additionally, one reason for the exclusion of a testifying expert is a lack of reliability. Some reasons that courts would exclude testimony due to lack of reliability include the following:

1. Failing to use sufficient data
2. Failing to rely on enough data to form an opinion
3. Failing to consider necessary information
4. Failing to use generally accepted methods¹⁹

Another reason for courts to exclude a testifying expert's testimony is due to relevance. Rule 702 states that expert testimony may be admissible if it "is relevant to the task at hand" and "would be helpful to the trier of fact or to answer the factual question presented."

The reasons that courts would exclude testimony due to lack of relevance include (1) lay testimony that does not reflect the appropriate level of expertise and (2) an expert who draws legal conclusions.

In the case *Eshelman v PUMA Biotechnology*, the court excluded the opinion and testimony of the expert witness due to lack of reliability.

The first factor discussed in the decision is the ability to test, reproduce, or independently verify the analysis of the testifying expert. In this case, because the analysis conducted was subjective, the analysis could not have been reliably reproduced or independently verified.

The second factor considered was whether the expert's theory or technique had been subjected to peer review and publication. In this case, it had been subjected to peer review and publication, but not in a way that would apply to the facts of the case in question.

Another factor considered was the existence and maintenance of standards and controls, and the court found that the methodology used had not been sufficiently controlled by any type of standard.²⁰

Lastly, qualification is another reason for the exclusion of a testifying expert. Rule 702 allows expert testimony to be provided by a witness who is "qualified . . . by knowledge, skill, experience, training, or education." Courts have interpreted this requirement in different ways, in most instances taking a broad view of the expert's qualifications based

on a holistic analysis of the Rule 702 qualification factors.

In the decision in *ResCap Liquidating Trust v. Home Loan Center, Inc.*, the court excluded, in part, certain opinions from the defendant's testifying expert. The plaintiff argued that the testifying expert was not qualified to suggest how residential mortgage-backed securitization ("RMBS") litigants would have valued claims during settlement. This is because the testifying expert had not encountered RMBS claims as a litigant, mediator, or judge.²¹

SUMMARY AND CONCLUSION

Understanding the type of expert that is needed and in what capacity the expert is needed can be a challenging task. The variety of roles for different controversy matters involving forensic accounting, damages, or valuation disputes turn the hiring of an expert into a process that needs to be taken seriously.

Legal counsel should do their due diligence on exactly the type of expert they are looking for. Analysts should make themselves aware of the challenges that may come up, specifically in regard to *Daubert*.

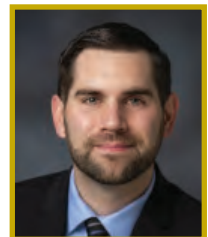
Due to possible challenges, it is typically the best procedure to retain an experienced testifying expert, as he or she likely will have come across these various challenges and will know best how to avoid or combat said challenges. Most likely the opposing attorney will have also hired an experienced testifying expert, so retaining a professional with prior testimony experience will not be an issue as both experts will be of similar stature.

The fact of the matter is, both hiring counsel and prospective experts should do their due diligence. In order to be successful in the hiring process, hiring counsel should form an understanding of what they are looking for and what laws pertain to the state the case is being disputed. Counsel should select the appropriate expert in the necessary capacity. Analysts should do their best to obtain the necessary knowledge in the field and to become familiar with the state laws that apply in the subject case.

Notes:

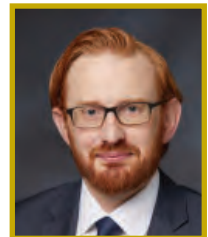
1. Federal Rules of Civil Procedure, Rule 26 (December 1, 2018): 39.
2. "Model Rules of Professional Conduct," American Bar Association (August 16, 2018): Rule 3.4.
3. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, *Litigation Services Handbook: The Role of the Financial Expert*, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), 2.3.

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7. Weil, Lentz, and Evans, *Litigation Services Handbook*, 1.18.
8. Ibid., 1.25.
9. Ibid., 1.28–1.29.
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11. Ibid., 2.7–2.8.
12. For further reading, refer to Charlene M. Blalock and Charles A. Wilhoite, "Professional Designations: Evaluating Expert Witness Credentials in Divorce Cases Involving Professionals," *Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner*, 4th ed., William F. Murray, ed. (NY: Wolters Kluwer, 2018).
13. Weil, Lentz, and Evans, *Litigation Services Handbook*, 1.4.
14. Ibid., 3.2–3.4.
15. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
16. *General Electric Co. v. Joiner*, 522 U.S. 136 (1997).
17. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999).
18. Weil, Lentz, and Evans, *Litigation Services Handbook*, 3.4.
19. Forensic & Valuation Services Practice Aid: "Serving as an Expert Witness or Consultant" (American Institute of Certified Public Accountants, 2019): 23.
20. *Eshelman v. PUMA Biotechnology, Inc.*, No. 7:16-CV-18-D, 2019 WL 1092572 (E.D. N.C. Mar. 8, 2019).
21. *ResCap Liquidating Trust v. Home Loan Center, Inc.*, No. 14-cv-1716, 2018 WL 4489685 (D.Minn., Sept. 19, 2018).



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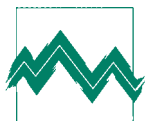
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Summary of Financial Projection Issues in Recent ESOP Litigation

Kyle J. Wishing, Frank “Chip” Brown, Chelsea Mikula, Esq., and Khatija Sajid

This discussion identifies issues with management-prepared financial projections that have been raised by the U.S. Department of Labor (the “DOL”) and by private plaintiffs in employee stock ownership plan (“ESOP”) litigation. The objective of this discussion is to inform ESOP advisers, ESOP sponsor companies, and prospective ESOP sponsor companies of the factors to consider when preparing and assessing company management’s financial projections. This discussion includes a review of (1) conversations with representatives of the DOL, (2) fiduciary process settlement agreements, and (3) recent ESOP litigation.

INTRODUCTION

Company financial projections are often one of the primary inputs into a business or stock valuation analysis. After all, the value of a business today is based on what the business will earn tomorrow. Analysts generally rely on financial projections to estimate the future income of a business.

A well-developed financial projection can serve as a road map for the sponsor company and a building block for the financial adviser’s business valuation. On the other hand, unsupported financial projections typically lead to inaccurate opinions of value (as the saying goes, “garbage in, garbage out”).

The issue of reliance on management-prepared financial projections is particularly relevant for ESOP trustees and for the trustee’s financial advisers. Trustees and their advisers consider such financial projections when assessing whether a transaction price represents adequate consideration.

Adequate consideration for privately held securities is defined in Section 3(18)(b) of the Employee Retirement Income Securities Act of 1974 (“ERISA”) as “the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.”

On May 17, 1988, the DOL issued the “Proposed Regulation Relating to the Definition of Adequate Consideration” (the “DOL Proposed Regulation”) to further define the term “adequate consideration.” Although the DOL Proposed Regulation was never made into law, it is standard practice for trustees and financial advisers to consider the DOL Proposed Regulation when assessing ESOP sponsor company transactions.

The DOL Proposed Regulation defines fair market value as “the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for the asset.”¹

The issue of reliance on management-prepared financial projections is frequently listed as one of the elements that can lead the trustee to enter into a prohibited transaction on behalf of the ESOP.

This discussion highlights communication and commentary from the DOL with respect to financial projections. This discussion reviews the following three sources to provide an overview of the issues related to financial projections:

1. Direct communication from DOL representatives
2. Fiduciary process settlement agreements
3. Recent ESOP litigation

Understanding the commentary from the DOL can only improve the review and assessment of company financial projections.

NOTES FROM THE Q&A WITH TIM HAUSER

Tim Hauser, the deputy assistant secretary for program operations of the Employee Benefits Security Administration (“EBSA”) (effectively, the chief operating officer of EBSA, the DOL agency that enforces ERISA) stated that “a common problem [with ESOP sponsor company appraisals] is reliance on unrealistic projections.” He further stated that the use of “aggressive and unrealistic projections [is] a chronic problem with ESOPs.”²

Mr. Hauser noted the inherent conflict of interest when “management projections” are prepared by the counterparty to the ESOP in a transaction (that is, when the selling shareholders or subordinates to the selling shareholders prepare the financial projections).

According to Mr. Hauser, many of the cases brought by the DOL have involved a lack of scrutiny from ESOP fiduciaries, where “ESOP fiduciaries are accepting projections without asking themselves about how realistic the projections are.”

The DOL often sees a standard disclaimer in valuation reports that (1) the analysis is based on management-prepared financial projections and (2) the financial adviser will not vouch for the financial projections. In Mr. Hauser’s opinion, ESOP fiduciaries need to insist on more than management’s representations related to financial projections.

Some basic questions that Mr. Hauser proposed to ask as part of the trustee’s due diligence are as follows:

- How do the company projections compare to the company performance and any projections of the company’s peers?
- How do the financial projections compare to the historical performance of the company?
- How plausible is it that the company could really go forward with these financial projections?
- How volatile or sensitive are the financial projections to various assumptions?

- What happens if the financial projections are off by a couple percentage points?
- What happens if there is a recession?
- Will the company be able to service the debt in these types of downside scenarios?
- What will happen to the company’s value as competition drives down profits or as performance reverts to the mean?

Mr. Hauser claimed that the DOL has not filed suit against anyone for failing to predict a recession (referring to the recession that began in 2008). He stated that the focus of the DOL is whether the fiduciary acted prudently, loyally, and in good faith at the time of the transaction.

FIDUCIARY PROCESS SETTLEMENT AGREEMENTS

To date, there have been five fiduciary process settlement agreements between the DOL and independent trustees (“process agreements”).³ Members of the DOL have referred to the terms of the process agreements as best practices for ESOP practitioners.⁴

The terms of the process agreements are very similar—identifying the differences in each process agreement is beyond the scope of this discussion. This discussion considers the terms of the process agreements that apply directly to the review of management-prepared financial projections.

The process agreements ask that the fiduciary:

- identify the individuals responsible for providing any financial projections relied on in the valuation report;
- identify whether those individuals have or reasonably may be determined to have any conflicts of interest in regard to the ESOP (including but not limited to any interest in the purchase or sale of the subject ESOP sponsor company stock);
- identify whether those individuals serve as agents or employees of persons with such conflicts and the precise nature of any such conflicts; and
- record in writing how the trustee and the trustee financial adviser considered such conflicts in determining the value of ESOP sponsor company securities.

The process agreements request that the fiduciary:

1. document in writing an opinion as to the reasonableness of any financial projections considered in connection with the transaction and
2. explain why and to what extent the projections are or are not reasonable.

At a minimum, the analysis should consider how the financial projections compare to—and whether they are reasonable in light of—the ESOP sponsor’s five-year historical averages and/or medians and the five-year historical averages and/or medians of a group of guideline public companies (if any exist) for the following metrics, unless five-year data are unavailable (in which case, the analyses should use averages extending as far back as possible):

- Return on assets
- Return on equity
- Earnings before interest and taxes (“EBIT”) margins
- Earnings before interest, taxes, depreciation, and amortization (“EBITDA”) margins
- Ratio of capital expenditures to sales
- Revenue growth rate
- Ratio of free cash flow to invested capital to sales

If the ESOP sponsor company is projected to meet or exceed its historical performance or the historical performance of the group of comparable public companies on any of the metrics described above, the trustee should document in writing all material assumptions supporting such projections and why those assumptions are reasonable.

According to the process agreements, trustees should perform the following:

- They should describe the risks facing the ESOP sponsor that could cause the ESOP sponsor’s financial performance to fall materially below the financial projections relied upon by the trustee financial adviser.
- They should analyze and document in writing whether the ESOP sponsor will be able to service the debt taken on in connection with the transaction (including the ability to service the debt in the event that the ESOP sponsor fails to meet the financial projections relied on in the stock valuation).
- They should critically assess the reasonableness of any financial projections (particularly management projections), and if the valuation report does not document in

writing the reasonableness of such projections to the trustee’s satisfaction, the trustee will prepare supplemental documentation explaining why and to what extent the projections are or are not reasonable.

If the trustee believes the financial projections are unreasonable, the trustee should ask its financial adviser to account for the unreasonable financial projections in its valuation, request new and reasonable projections from management, or reject the transaction. The trustee should document the bases for its decision.

PROJECTION ISSUES RAISED IN RECENT ESOP LITIGATION

We reviewed recent ESOP litigation, including (1) judicial opinions related to cases brought against ESOP fiduciaries and (2) complaints raised by the DOL for ESOP cases that either settled before going to trial or are currently pending.

We reviewed the following judicial opinions:

- *Brundle, on behalf of Constellis Employee Stock Ownership Plan v. Wilmington Trust N.A.* (the “Constellis litigation”)
- *Perez v. First Bankers Trust Services, Inc., et al.* (the “SJP litigation”)

We reviewed the following ESOP-related complaints brought by the DOL. Each of these complaints raised specific issues with respect to the financial projections utilized by the trustee and the trustee’s financial adviser as part of an ESOP transaction.

- *Acosta v. Big G Express, Inc., et al.* filed on November 29, 2017 (the “Big G litigation”)
- *Acosta v. Wilmington Trust, N.A. et al.* filed on August 22, 2017 (the “Graphite Sales litigation”)
- *Acosta v. Reliance Trust Company, Inc., et al.* filed on May 4, 2017 (the “Tobacco Rag litigation”)
- *Perez v. First Bankers Trust Services, Inc., et al.* filed on December 28, 2016 (the “Sonnax litigation”)
- *Perez v. Bankers Trust Company et al.* filed on November 14, 2016 (the “Mona Vie litigation”)
- *Perez v. Adam Vinoskey et al.* filed on October 14, 2016 (the “Sentry litigation”)
- *Perez v. Commodity Control Corporation et al.* filed on January 20, 2016 (the “Commodity Control litigation”)

- *Perez v. Gruber Systems, Inc., et al.* filed on May 29, 2015 (the “Gruber litigation”)
- *Perez v. PBI Bank, Inc., et al.* filed on August 29, 2014 (the “AIT Labs litigation”)
- *Perez v. First Bankers Trust Services, Inc., et al.* filed on November 28, 2012 (the “Maran litigation”)
- *Perez v. First Bankers Trust Services, Inc., et al.* filed on November 28, 2012 (the “Rembar litigation”)
- *Solis v. Greatbanc Trust Company et al.* filed on September 28, 2012 (the “Sierra Aluminum litigation”)
- *Solis v. Dennis Webb et al.* filed on April 25, 2012 (the “Parrot Cellular litigation”)
- *Solis v. Herbert Bruister et al.* filed on April 29, 2010 (the “Bruister litigation”)

We refer to the judicial opinions and the DOL complaints collectively as the “case list.” Each case alleges a breach of fiduciary duty against the respective ESOP fiduciary or fiduciaries. All but one of the cases were brought by the DOL—the *Constellis* litigation was raised by an ESOP participant. For simplification purposes, we will refer to the DOL and the *Constellis* litigation plaintiffs collectively as “plaintiffs.”

For each litigation case discussed herein, reliance on projections is just one of the criticisms raised by plaintiffs. In addition, the complaints present only one side of the argument. This discussion is not meant to state whether the procedures undertaken were right or wrong, but rather, to provide an overview of plaintiffs’ positions with respect to projections.

The *Constellis* litigation is the only case in our case list that specified a damages amount related to the projections. In the *Constellis* litigation, management’s growth projections were one of the nine valuation factors considered in the plaintiff’s calculation of damages.

The plaintiff’s expert estimated total damages related to management’s growth projections of \$8,650,000. The court stated that both sides made compelling expert analyses related to the projections, and with the lack of a precise mechanism for resolving the two sides, assigned damages of \$4,325,000 (the midpoint of the two estimates) related to the use of management’s projections. The court ultimately concluded total damages of \$29,773,250.

For the other cases, there is no way of knowing (1) the severity of the projection issue and (2) whether the ultimate conclusion (i.e., the settle-

ment or the damages assignment) was attributable to the allegations related to projections.

Exhibit 1 presents a summary of (1) the projection issues raised by the DOL and (2) judicial commentary/decisions related to financial projections.

We grouped the financial projection issues into the following broad categories:

1. Revenue growth rate
2. Profit margins
3. Inconsistent with historical results
4. Inconsistent with industry expectations
5. Inconsistent with economic expectations
6. Inconsistent with prior financial projections prepared by company management
7. Failure to adequately address compensation
8. Inconsistent level of capital expenditures
9. Customer concentration
10. Failure to account for a cyclical industry
11. Inappropriate long-term growth rate
12. The lack of financial projections

Below is a review of the nature of these specific projection categories. This review provides (1) a summary of the general comments from plaintiffs with regard to projections and (2) specific examples related to each of the broad categories from individual cases.

Revenue Growth Rate

The revenue growth rate was the most common issue related to management-prepared financial projections raised in our case list.

Often, the complaints specified the reason that the growth rate projections were unreliable (such as the projection was inconsistent with historical growth rates, industry growth rates, or economic growth rates).

Profit Margins

The projected margins were an issue raised in eight cases from our case list. The margins generally were critiqued with regard to the subject company’s historical margins and/or industry margins.

For instance, the *Tobacco Rag* litigation complaint characterized the operating margin projections as “unduly optimistic” and “out of line with projections within the most analogous industry.”⁵

Inconsistent with Historical Results

Another issue raised in the case list filings was that the financial projections (in terms of either revenue

Exhibit 1 Summary of ESOP-Related Judicial Matters

Financial Projection Issue	Total (16 cases)	Constellis	SJP	Big G Express	Graphite Sales	Tobacco Rag	Sonnax	Mona Vie	Sentry	Commodity Control	Gruber	AIT Labs	Maran	Rembar	Sierra Aluminum	Parrot Cellular	Bruister
Revenue Growth Rate	12	X	X	X	X		X	X			X	X	X		X	X	X
Profit Margins	8					X	X				X	X	X		X	X	X
Inconsistent with Historical Results	9		X		X		X	X		X	X		X		X		X
Inconsistent with Industry	8		X	X		X				X		X	X		X		X
Inconsistent with Economy	3		X	X									X				
Prior Projections	2	X										X					
Compensation	3					X								X		X	
Capital Expenditures	2											X			X		
Cyclical	4		X						X				X		X		
Customer Concentration	5	X	X			X							X				X
Long-Term Growth Rate	2						X			X							
Lack of Projections	1								X								

growth, margins, or cash flow) were inconsistent with historical measures.

Often, the case list filings compared the subject company's historical revenue compound annual growth rate ("CAGR") to the projected revenue CAGR. In a few instances, total projected revenue over a certain period was compared to historical revenue over the same historical period.

For instance, the *Maran* complaint compares the total revenue of \$471.2 million generated by Maran from 2002 to 2006 to the total Maran projected revenue of \$782.2 million from 2007 to 2011.⁶

Projected profit margins were compared to the subject company historical profit margins.

One of the ways that projected cash flow was critiqued was a comparison of historical cash flow over, say, a five-year period versus projected cash flow over the projected five-year period. As an aside, the cash flow comparison is not as straightforward as the revenue and margin comparisons, because there are various measures of cash flow (i.e., cash flow to invested capital, cash flow to equity, operating cash flow, etc.). This type of comparison should be done on an "apples-to-apples" basis.

Failure to consider and/or adjust financial projections for recent, interim-period results was cited by the DOL as an issue in the SJP and Graphite Sales litigations. In both instances, the respective

company was underperforming its projections for the current year, and no adjustments were made to the financial projections.

The *Gruber* complaint critiqued the Gruber management projections because the financial projections disregarded the liabilities and operating losses related to the company's operating division in China. According to the complaint, this inconsistency with historical results caused the projections to be "highly optimistic."⁷

The *Mona Vie* complaint argued that the revenue growth rates in management-prepared projections were inconsistent with company trends, based on the *Mona Vie* decline in revenue in 2009 and 2010 and the recent decrease in distributor enrollment, which was considered a key driver of growth for *Mona Vie* as a multilevel marketing company.⁸

According to the *Mona Vie* complaint, the trustee financial adviser "attempted to remedy the use of unrealistic growth projections by applying a specious 50 percent discount rate in its discounted cash flow analysis. It is an improper valuation method to address doubt in the achievability of management projections by merely increasing the company specific risk premium component of the discount rate in a discounted cash flow analysis. Instead of proceeding with the transaction, [the trustee] should have asked *Mona Vie* management to adjust the projections to account for the perceived deficiencies

or request new projections from Mona Vie that were reasonable.”⁹

The *Sonnax* complaint criticized the financial projections as follows:

The projections forecasted robust and steadily increasing revenue and margin growth for Sonnax. Sonnax based these projections on five historical years surveyed. However, each of the five years forecasted was higher than Sonnax’s best historical year, which itself was significantly higher than any of the other four historical years. And the steadily rising growth assumed in the projections is undermined by the erratic and often declining growth in the five historical years surveyed.¹⁰

Inconsistent with the Industry

There were eight cases from the case list filings that mentioned that the projections were inconsistent with industry expectations. This issue was generally in terms of either revenue growth or margins as compared to the guideline publicly traded companies and/or industry reports.

The *Maran* complaint provides an example of this type of projection issue. According to the complaint, the Maran fairness analysis did not appropriately address revenue growth relative to industry revenue growth. Maran produced primarily private label denim apparel for retailers such as Wal-Mart, K-Mart, and Kohls, whereas higher-end denim products from guideline companies were the industry’s “hottest segment.”¹¹

The complaint inferred that the financial adviser failed to differentiate between the expected growth for higher-end companies and the lower growth of private label products.

Inconsistent with the Economy

There were three cases from the case list that specifically mention that the financial projections were not consistent with economic expectations. This issue was generally raised with regard to projected revenue growth.

For instance, the *Big G* complaint states that projected revenue growth of 13 percent was inconsistent with the company’s historical CAGR of 8 percent, given the declining economic conditions.¹² The Big G ESOP installation transaction was completed on October 29, 2009.

The *Maran* complaint stated that the “U.S. economy was showing clear signs of slowing down” at the time of the Maran transaction (the Maran transaction was closed November 2006). The valua-

tion report provided by the trustee financial adviser stated that “economic growth expectations point towards a slowdown for 2006 relative to 2004 and 2005 levels.”¹³

According to the *Maran* complaint, these factors were not accounted for in the fairness opinion analysis that was performed for the ESOP transaction.

Inconsistent with Prior Projections

There were two instances where the financial projections that were relied on were considered inconsistent with prior financial projections. In both of these instances, the subject companies had previous valuations that were performed for non-ESOP purposes.

The *AIT Labs* complaint states that the ESOP transaction projections were “substantially above” the financial projections that were used by another valuation firm a few months before the ESOP transaction as part of a tax valuation analysis.¹⁴

In the *Constellis* litigation, the trustee did not review previous financial projections prepared by company management. Previously, Constellis management prepared projections for (1) an earlier proposed acquisition of Constellis and (2) a valuation analysis prepared for transfer tax purposes.

A review of these previous projections would have revealed that Constellis management had previously only prepared one-year financial projections (as opposed to the five-year financial projections that were provided for the ESOP transaction). Also, Constellis management had prepared “inflated” projections as part of the prior Constellis sales process that was unsuccessful.

According to the *Constellis* judicial opinion, the “failure to request those previous projections resulted in a number of missed opportunities to appreciate some of the risks behind the projections relied upon by the [trustee financial adviser].”

Compensation

There were three cases from the case list where “compensation” was a financial projection issue.

The *Rembar* complaint commented on the financial projections for failing to include a level of compensation for a new CEO. The Rembar transaction involved a selling shareholder that was the retiring company CEO, and there was no compensation included for a replacement CEO.

The Tobacco Rag litigation commented on the trustee financial adviser’s “adjustments to earnings for executive compensation where no evidence indicated the Company’s executives had agreed to cut their compensation.”¹⁵

The *Parrot Cellular* complaint argued that a \$12 million deferred compensation agreement with one of the selling shareholders was not adequately included in the projection and/or the valuation analysis.

Capital Expenditures

Two of the cases from the case list had issues related to capital expenditures. These issues generally related to financial projections that excluded capital expenditures that were otherwise necessary to achieve the financial projections.

The *AIT Labs* complaint highlighted the disconnect between the AIT Labs historical capital expenditures of approximately 12.0 percent of revenue versus the projected capital expenditures that were 0.9 percent of revenue. The trustee financial adviser's report stated that AIT Labs had a competitive advantage, because it had a business model that adopted leading edge technology.¹⁶

The financial projection included consistent revenue growth, but the capital expenditures that supported the growth were diminished. This disconnect was not documented in the report.

In the *Sierra Aluminum* litigation, the company planned to acquire a third aluminum press. This press would increase the company's production capacity, which was limited as of the transaction date.

According to the *Sierra Aluminum* complaint, the financial projections did not include a capital outlay for the new press, which was expected to cost between \$13 million and \$15 million. The complaint also mentions that the press could have been treated as an operating lease, but there was no adjustment for increased operating expenses in the financial projection either.¹⁷

Cyclical

The failure to account for a cyclical business was listed in four cases from the case list.

The *SJP* litigation financial projection included flat revenue growth in 2007, 4 percent revenue growth in 2008, 6 percent revenue growth in 2009, 8 percent revenue growth in 2010, and 6 percent revenue growth in 2011. This projected growth was criticized by the DOL based on the industry headwinds and the cyclical nature of the residential construction industry. The expert for the DOL adjusted management projections by applying (1) a 15 percent decrease in revenue in 2007 and (2) a 5 percent revenue growth rate thereafter.¹⁸

The *Sierra Aluminum* complaint criticized the fairness analysis for failing to account for "the pos-

sibility of a drop in aluminum prices, an increase in raw material costs or, at a minimum, a reversion to average prices."¹⁹

The *Sierra Aluminum* transaction was completed on June 20, 2006, when aluminum prices and demand for aluminum products were heightened.

Customer Concentration

Customer concentration was an issue for five cases on the case list. This criticism generally referred to failure to adequately address the risk associated with customer concentrations in the financial projections.

The *Maran* complaint noted that Wal-Mart accounted for 50.8 percent of the Maran sales prior to the ESOP transaction. The Maran contract with Wal-Mart was renewed on an annual basis, with no guarantee of renewal. Also, the trustee financial adviser report stated that Wal-Mart had been "increasingly successful at sourcing private-label denim directly from suppliers."

According to the complaint, Wal-Mart had considerable leverage over Maran for future negotiations.²⁰

According to the *Constellis* judicial opinion, "[a]nother red flag to which [the trustee] did not adequately respond was the riskiness of Constellis' contract concentration." At the time of the ESOP installation transaction, approximately 70 percent of the Constellis revenue was from two contracts. It was alleged that the trustee did not consult with either of the primary customers of Constellis.

According to the *SJP* judicial opinion, one customer (Hovnanian Homes) accounted for approximately 60 percent of SJP revenue as of the transaction date. While the offering memorandum provided by the SJP seller representatives stated that SJP had been steadily diversifying away from Hovnanian Homes, the opposite was true.²¹

The Hovnanian Homes 2006 annual report stated that 2006 was "a challenging year for our company as we encountered a sudden downturn in many of our housing markets." The annual report also stated that Hovnanian Homes planned to operate its business as if housing markets were in a prolonged downturn. Part of the Hovnanian Homes tightening strategy involved "aggressively renegotiating with key partners" to reduce costs.

Long-Term Growth Rate

The long-term growth rate was criticized in two cases from the case list. In the income approach valuation method, the expected long-term growth rate is an input that is generally applied to the company income stream into perpetuity.

In the Sonnax litigation, the complaint characterized the trustee financial adviser's use of an 8 percent terminal growth rate as "unreasonable." According to the complaint, typical terminal growth rates are between 2 percent and 4 percent.²²

Lack of Financial Projections

It may come as a surprise, but there was one instance where an ESOP transaction was criticized for not including financial projections. In this instance, the income approach direct capitalization method was relied on. All income approach methods are based on future income. However, the direct capitalization method relies on a constant (or steady state) income amount that is not overtly projected.

The *Sentry* complaint criticized the "profit projections" relied on by the financial adviser. The profit projections were based on the company's historical earnings from 2007 to 2009. It was alleged that the earnings estimate did not rely on the results from 2004 to 2006, when the company's performance was not as strong.

According to the complaint, the valuation focused on the results in the "peak years," which is inappropriate for an "extremely cyclical" business.²³ For perspective, Sentry designs and sells equipment such as conveyors and bottling machines for soft drink manufacturers.

SUMMARY AND CONCLUSION

For years, ESOP advisers have requested revised regulations from the DOL that would provide guidance for implementing successful ESOP transactions. It is unlikely that new regulations will be issued any time soon.

In lieu of administrative regulations, this discussion provides a summary of the issues raised by the DOL and by private plaintiffs related to management-prepared financial projections. Improving the preparation and assessment of financial projections should lead to informed decisions by ESOP trustees and successful ESOP transactions—a win for ESOP participants, selling shareholders, the DOL, and ESOP advisers.

Notes:

1. DOL Proposed Regulation Section 2510.3-18(b) (2).
2. Quotes in this section come from a discussion authored by Chip Brown, CPA, from the Spring 2015 issue of Willamette Management Associates *Insights* titled "Q&A with Tim Hauser of the U.S. Department of Labor."

3. The five process agreements have been with GreatBanc Trust Company; First Bankers Trust Services, Inc.; James F. Joyner; Alpha Investment Consulting Group, LLC; and Lubbock National Bank.
4. See the EBSA news release dated June 3, 2014, "Others in the industry would do well to take notice of the protections put in place by [the Sierra Aluminum process agreement]," and the Q&A with Tim Hauser, "If people follow the [Sierra Aluminum process agreement] as best practices, we all would be hugely better off."
5. See paragraph 37(a) of the Tobacco Rag complaint.
6. See paragraph 32 of the Maran complaint.
7. See paragraph 26 of the Gruber complaint.
8. See paragraphs 18 and 20 of the Mona Vie litigation complaint.
9. *Id.*, paragraph 19.
10. See paragraph 29 of the Sonnax complaint.
11. See paragraph 41 of the Maran complaint.
12. See paragraph 20(j) of the Big G complaint.
13. See paragraph 31 of the Maran complaint.
14. See paragraph 41 of the AIT Labs complaint.
15. See paragraph 37(f) of the Tobacco Rag complaint.
16. See paragraph 43 of the AIT Labs complaint.
17. See paragraphs 47 and 48 of the Sierra Aluminum complaint.
18. See paragraph 723 of the SJP opinion.
19. See paragraph 55 of the Sierra Aluminum complaint.
20. See paragraphs 35 and 36 of the Maran complaint.
21. See paragraph 149 of the SJP opinion.
22. See paragraphs 27 and 28 of the Sonnax complaint.
23. See paragraph 15(a) of the Sentry complaint.

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ESOP Financial Feasibility Analysis Procedures

Robert F. Reilly, CPA

Employee stock ownership plans (“ESOPs”) are occasionally involved in litigation and other regulatory challenges. The regulatory challenges may be brought on by the U.S. Department of Labor (“the DOL”) or the Internal Revenue Service (the “Service”). The litigation claims may be filed by the DOL or by the ESOP participants themselves. The DOL may allege that the ESOP participants paid more than adequate consideration for the sponsor company stock or that the sale of the sponsor company stock to the ESOP was a prohibited transaction. Occasionally, the sponsor company noncontrolling selling shareholders may proceed with litigation claims—typically against the sponsor company controlling shareholder who initiated the ESOP formation. These noncontrolling shareholders may allege that they did not receive a fair price for the stock they sold to the ESOP. While it will not eliminate all litigation claims, an ESOP financial feasibility analysis is an important procedure in the process of installing an ESOP at a sponsor company. Such an ESOP financial feasibility analysis provides evidence regarding (1) the selling shareholders’ and the company board’s due diligence procedures and (2) the controlling shareholder’s and the board’s exercise of its business judgment.

INTRODUCTION

Even when it is implemented and administered with the best of intentions, an employee stock ownership plan (“ESOP”) may become involved in either litigation or regulatory challenges. Sometimes, the DOL may claim that the ESOP participants paid too much for the purchase of the shares of the ESOP sponsor company. In these instances, the DOL may allege that the sponsor company selling shareholders participated in a prohibited transaction.

Sometimes the ESOP participants themselves may claim that they paid too much for the purchase of sponsor company shares. In these instances, the allegation of “paid too much” means that the ESOP trust paid more than fair market value for the sponsor company common stock.

Sometimes, the DOL or the ESOP participants may claim that the ESOP trustee breached its fiduciary duty (to the participants) in the ESOP formation or in subsequent sponsor company stock purchase transactions. Sometimes, the DOL or the ESOP participants may allege that the independent financial adviser to the trustee practiced with gross negligence in performing its stock valuation and other transaction advisory services.

Occasionally, the sponsor company noncontrolling shareholders may file litigation against the sponsor company controlling shareholders—that is, the party who initiated the ESOP formation process. These noncontrolling shareholders may claim that they sold their sponsor company stock for less than a fair price.

Before a private employer company proceeds with the formation of an ESOP, that company

may perform an ESOP formation feasibility analysis. The purpose of an ESOP formation feasibility analysis is to give both the selling shareholder(s) and the sponsor company management/directors the information they need to determine whether to move forward with the ESOP formation and the ESOP stock purchase transaction.

The results of the feasibility analysis should enable the sponsor company, the ESOP trustee, the legal counsel to all parties, and the selling shareholder(s) to structure a transaction that is beneficial to all parties. Of course, such a transaction should be fair to the to-be-formed ESOP from a financial point of view.

This discussion summarizes the process of the ESOP formation financial feasibility analysis. And, this discussion summarizes how the parties to the ESOP formation may use the information developed in the financial feasibility analysis.

In making the decision of the private company to implement an ESOP purchase of sponsor company stock, the shareholders have to consider whether (and at what price) to sell their company shares to the ESOP.

The shareholders also have to decide whether they are willing to give up ownership control of the sponsor company to a new owner—that is, to the ESOP. This transfer of ownership control consideration is also relevant in the ESOP formation structure where the sponsor company itself (and not the current shareholders) sells treasury shares to the ESOP.

The sponsor company managers and directors have to consider whether the company can afford to finance the ESOP stock purchase transaction—particularly if the ESOP formation transaction is a leveraged stock purchase. The managers and directors also have to consider the other (nondebt service) ESOP-related costs—such as plan administration expenses, regulatory compliance expenses, and financial statement impact “costs.”

The information developed during the ESOP financial feasibility analysis allows these parties to decide whether or not an ESOP stock purchase transaction is an effective strategy for achieving their various objectives. Each ESOP financial feasibility analysis may be different—depending on each



sponsor company situation. However, most ESOP feasibility analyses contain the basic considerations in order to:

1. provide meaningful information to all parties and
2. avoid costly mistakes that could impair the long-term success of the ESOP.

THE ESOP FINANCIAL FEASIBILITY ANALYSIS

In general, an ESOP feasibility analysis should consider the following transaction pricing and structuring questions:

- What parties will actually sell the sponsor company shares to the to-be-formed ESOP?
- How will the to-be-formed ESOP finance the purchase of the sponsor company stock?
- How will this new stock acquisition financing (if any) affect the cash flow of the sponsor company?
- What is the best plan design for the sponsor company? For example, should the sponsor company merge the to-be-formed ESOP with its existing 401(k) plan?
- What are the Employee Retirement Income Security Act (“ERISA”) and the Internal Revenue Code (and state securities law) regulations related to an ESOP that the sponsor company management and the selling shareholder(s) should know about?

- What if the actual sponsor company future results of operations vary—positively or negatively—from any sponsor company financial projections prepared at the time of the sponsor company stock purchase transaction?
- How does the selling shareholders' desired sale price for the sponsor company stock compare to the range of stock fair market values estimated by the valuation analyst ("analyst") working for the to-be-formed ESOP trustee?

INITIAL CONSIDERATIONS

The initial considerations regarding the ESOP feasibility analysis may be assessed by the selling shareholder(s)—with the help of the sponsor company management. That is, the ESOP feasibility initial considerations may be determined without the need to retain an independent financial adviser or legal counsel.

In general, private companies that are reasonable candidates to successfully implement an ESOP formation—and to sponsor a sustainable ESOP—have the following characteristics:

- Be a private U.S. company
- Employ more than 50 full-time employees
- Have an established track record of consistent profitability and earnings growth
- Have at least 10 years of operating history
- Report at least \$20 million in company annual revenue
- Have one or more owners who are interested in investment liquidity and in a diversification of their personal wealth
- Have one or more owners who are interested in ownership/management succession planning and in the transition of company ownership to the employees
- Have one or more owners who would consider accepting a reasonably conservative stock value (i.e., a price at the lower end of the range of market participant transaction prices)
- Have a senior management team that supports the concept of an ESOP formation (and of the employee ownership of the sponsor company)

The controlling shareholder(s) should assess the company relative to these benchmark char-

acteristics in order to determine if the company is a reasonable candidate for an ESOP formation. This initial feasibility analysis may be performed internally within the company—that is, without the company having to spend large amounts of time and money.

That is, if the private company, the selling shareholders, and the company management do not "pass" these threshold characteristic "tests," then the company may not be a particularly good candidate for an ESOP formation. The company stockholders and management do not need to proceed to the financial, valuation, or administrative "tests" associated with an ESOP formation.

The next procedure of the feasibility analysis is for the company shareholders and company management to become more familiar with the ESOP installation process. This procedure should include familiarity with the financial, legal, administrative, and regulatory aspects of an ESOP formation. The ESOP Association and the National Center for Employee Ownership are useful resources for this type of information.

This "process familiarity" procedure should allow the parties in interest to address questions such as the following:

- Can the differing goals and objectives of the various company shareholders—and of the other parties to the proposed transaction (e.g., management team, employees, nonselling shareholders, etc.)—be achieved through the formation of an ESOP?
- Would a company merger or a sale to a strategic buyer—or some other type of company liquidity event—be better suited to achieve the objectives of the company shareholders, management, or other parties?
- What percentage of the company stock will the to-be-formed ESOP own after the stock purchase transaction? And, which shareholders will sell or redeem their shares as part of the ESOP sponsor company stock purchase transaction?
- How will the company management—and the current controlling shareholder(s)—react to the inevitable changes in voting/control rights and in corporate governance?
- How will the current management succession planning be addressed in relation to the stock ownership change transaction? How long will the selling shareholders (assuming they are also company managers

or directors) remain in their current management roles? How will the successors to the current executive management or board of directors be identified and transitioned in order to maintain operational management continuity on a going-forward basis?

- Is it desirable for the company to merge the to-be-formed ESOP with the company's existing 401(k)—or other employee benefit—plan?
- What happens to any existing management incentive (compensation) plans? Will a new management compensation plan be introduced at the same time as the ESOP stock purchase transaction?
- Which of the company employees will (and will not) be eligible to participate in the to-be-formed ESOP?

Consideration of these questions may help to clarify the strategic objectives (and the personal objectives) of all interested parties to the company ownership transition. In order for the ESOP formation to be successful, the means of achieving these strategic objectives (and these personal objectives) should be evaluated as part of the ESOP feasibility analysis.

If these initial procedures indicate that financing an ESOP stock purchase transaction is a reasonable alternative for achieving the objectives of most of the interested parties, then it may be time for the company to retain experienced ESOP advisers. These ESOP advisers should address some of the more technical (and complex) ESOP formation feasibility issues. These ESOP advisers typically include a trustee, legal counsel, an independent financial adviser, and perhaps others.

TYPICAL COMPONENTS OF AN ESOP FINANCIAL FEASIBILITY ANALYSIS

A comprehensive ESOP feasibility analysis typically includes several transaction planning, pricing, structuring, administrative, and legal considerations. These considerations typically include the following:

- A preliminary valuation of the sponsor company stock to determine the approximate fair market value price that the to-be-formed ESOP could or may pay

- A quality of earnings (or stockholders' equity) analysis to determine how the to-be-formed ESOP would affect (1) the existing company shareholders and (2) the company's future financial performance
- A plan design study to determine the most beneficial stock ownership transition transaction structure and which plan features to incorporate in the to-be-formed ESOP
- A liquidity study to assess the future demands that the ESOP stock repurchase obligation may eventually make on the sponsor company

THE PRELIMINARY VALUATION ANALYSIS

A sponsor company stock preliminary valuation analysis is an important component of the ESOP financial feasibility analysis. It is one of the procedures that should be performed early in the process. Accordingly, this preliminary valuation analysis may be performed by an analyst without undertaking a comprehensive due diligence investigation.

Therefore, the analyst typically cannot provide a final opinion of the fair market value of the sponsor company. Rather, the analyst provides an opinion of a reasonable—but not final—range of fair market value indications for the sponsor company stock.

The estimation of the sponsor company stock value is complex—and important to the ESOP formation decision. Accordingly, the parties usually retain an analyst who is experienced in performing ESOP—and ERISA-related—stock valuations.

Typically, the selling shareholders (and/or the company) and the trustee to the to-be-formed ESOP each retain their own independent analyst at this stage of the feasibility analysis. Regardless of whether the analyst is retained by the selling shareholders or by the to-be-formed ESOP trustee, the analyst's preliminary value conclusion is typically expressed as a range of fair market values for the sponsor company stock.

At this stage of the feasibility analysis, an analyst experienced in performing ESOP—or ERISA-related—stock valuations will typically estimate a reasonable range of stock values without preparing a narrative valuation report. Consequently, the expense associated with this preliminary valuation analysis is usually less than the expense associated with the analyst's final stock valuation analysis (and the preparation of a written narrative valuation report).

“[T]he preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process.”

The estimation of the preliminary range of company stock fair market values is often considered on the “critical path” of the ESOP formation process. It is important for the parties to find out early if:

1. the preliminary stock value range is less than the per-share stock price desired by the selling stockholders and
2. structuring alternatives, such as earn-outs or warrants, cannot be used to encourage the selling stockholders to accept the preliminary stock price.

In such an instance, other strategies may have to be considered to increase the ownership transaction attractiveness to the selling shareholders.

Such “other” strategies may include waiting until the subject company’s financial performance improves, reducing company operating expenses, and the like.

If the company’s principal shareholders are not willing to sell their stock to the ESOP, or to permit the company to issue new shares of stock at a price within the preliminary range of fair market values estimated by the analyst, then the ESOP formation process may be abandoned.

Therefore, the preliminary range of fair market values for the company stock should be concluded as early as possible in the ESOP feasibility process. That way, the shareholders can change direction and evaluate other liquidity alternatives—while still minimizing the expense incurred to pursue an ESOP formation strategy that will ultimately be unsuccessful.

THE QUALITY OF EARNINGS ANALYSIS

The following components of the financial feasibility analysis can all be performed concurrently:

1. The quality of earnings analysis (which includes what is often called a stockholders’ equity analysis)
2. The company liquidity study
3. The ESOP design study

In fact, these financial and administrative analyses can be performed at the same time that the

preliminary stock valuation analysis is being performed.

The quality of earnings analyses should address several of the important questions typically asked by the company’s principal shareholders. These principal shareholders are typically interested in the following considerations, particularly for the time period during which the ESOP stock purchase loan will be outstanding:

- How will the ESOP affect the fair market value of their (retained) stock?
- How will the ESOP affect the company’s expected cash flow and the company’s expected profitability?
- What dilution effect will the ESOP-owned shares have on the company stock fair market value?

If the company already has an existing pension and/or profit sharing plan, the quality of earnings analysis may also compare:

1. the effects of the ESOP stock ownership in contrast to
2. the effects on the stock ownership (without the ESOP formation) of the existing plans.

The quality of earnings analysis typically applies management-prepared financial projections—projections with alternative growth and profitability assumptions and other ESOP transaction variables—to create several alternative scenarios. The analyst performs this scenario analysis to illustrate the resulting impact of the to-be-formed ESOP on:

1. the sponsor company cash flow and
2. the sponsor company stock value.

The cash flow component of the quality of earnings analysis can also be used as a structuring tool to help evaluate a mixture of stock purchase financing options. The alternative ESOP stock purchase financing options may include varying levels of bank debt versus seller financing—as well as the assorted terms and conditions of the proposed financing structure.

In the quality of earnings analysis, some of the analysis variables that are typically adjusted (or “stress tested”) in order to construct alternative scenarios include the following:

- Revenue growth rate
- Profit margin
- Amount of the sponsor company operations-related bank financing

- Amount of—and terms of—the ESOP stock purchase bank financing
- ESOP stock purchase bank financing terms (interest rates, covenants, maturity, required prepayments, guarantees, etc.)
- Amount of any selling stockholder-provided financing
- Selling stockholder subordinated debt terms (interest rates, maturity, required prepayments, warrants, etc.)
- Refinancing of the company's existing bank debt
- Expected future capital expenditure investments
- Expected future working capital investments



Often, the analyst applies the management-prepared financial projections as a “base case” scenario in the quality of earnings analysis. The analyst then adjusts (or “stress tests”) the revenue, expense, investment, and income variables in order to create alternative financial scenarios. These alternative scenarios may include financial projections that reflect prospective operations under optimistic, pessimistic, and zero growth conditions.

These alternative scenarios typically hold all other company operational variables constant across the various sets of conditions. The goal of stress testing the operational variables in these alternative scenarios is to illustrate how the sponsor company could fare under alternative sets of operating circumstances.

THE LIQUIDITY ANALYSIS

The liquidity analysis component of the ESOP feasibility analysis is intended to estimate the amount of the ESOP stock repurchase obligation that the sponsor company may incur over the next, say, 10 to 15 years. This ESOP stock repurchase obligation results from the employee expected terminations of service due to death, disability, retirement, and so forth.

The liquidity analysis typically does not address the source of funding for the ESOP stock repurchase obligation. Nonetheless, this liquidity analysis is a valuable tool that can help sponsor company management estimate the timing of—and the amount of—the funding that may be needed for repurchasing the allocated shares from departing employees.

This information allows the sponsor company management to make the appropriate financing, insurance, or other liquidity plans.

THE PLAN DESIGN STUDY ANALYSIS

The greater the flexibility included into the design of the ESOP documents themselves, the more effectively the ESOP will be able to accomplish its objectives.

The ESOP design study will typically address the following issues:

- Participant eligibility
- Vesting schedules
- Timing of the benefit distributions
- Forfeitures
- Contribution levels
- Allocation formulas
- Past service credit
- Early retirement policies
- A charter or bylaw provision that restricts the stock ownership to the employee group

The use of one or more special classes of stock (e.g., nonvoting stock, preferred or convertible preferred stock, etc.) may also be addressed in the ESOP design study.

Some of the other questions that may need to be considered in the ESOP design study include the following:

- Who will (and will not) be able to participate in the to-be-formed ESOP?
- Must the sponsor company distribute shares of stock to employees at retirement—or at other required distribution dates—if the employees demand it, or can the sponsor

company limit the form of distributions to cash?

- What company divisions or subsidiaries may be excluded from the plan?
- Who will (and who will not) be able to vote the shares of the ESOP-owned sponsor company stock—and under what circumstances?
- Should the sponsor company combine other benefit plans, such as a 401(k) plan, with the ESOP?
- What will happen to the sponsor company's existing pension or profit sharing plan?
- Is the existing company pension plan overfunded, underfunded, or adequately funded?
- What about the selection of the ESOP fiduciary/trustee, and of any possible administrative and/or advisory committee(s)?

The consideration of income tax issues should also be part of the plan design phase of an ESOP feasibility analysis. The relevant income-tax-related issues may include the tax implications of ESOP-related legislation, regulations and administrative rulings, and judicial precedent.

In addition, all of the interested parties should consider the implications of the following issues:

1. The “tax-deferred reinvestment” or “tax-free rollover” election available for the selling shareholders with regard to the sale proceeds of the company stock to an ESOP
2. The tax deductibility to the sponsor company of dividend payments if paid to the ESOP participants or used to repay the ESOP stock purchase loan
3. Compliance considerations for an S corporation sponsor company owned by an ESOP
4. Any new or currently proposed tax regulations or legislation

If a deferred profit sharing or money purchase pension plan already exists at the sponsor company, it is normally “frozen.” The assets of the existing benefit plan will typically remain invested in a diversified securities portfolio.

However, the employees can be given the option to invest a portion—or all—of their assets from a profit sharing, money purchase, or 401(k) plan into either (1) the company stock or (2) part of the ESOP stock purchase transaction.

Almost all ESOP sponsor companies either maintain or establish a diversified 401(k) plan that is not

invested in the company stock. However, in some cases, a sponsor company may decide to merge its existing 401(k) plan with the ESOP.

In these situations, employees that are invested in the sponsor company's 401(k) plan are given the opportunity to invest their money into the ESOP. These funds are considered part of the stock purchase transaction financing. These funds are used to purchase the sponsor company shares from the selling shareholder(s).

All federal and state securities laws should be complied with, and “full disclosure” should be provided to, the company employees. Full disclosure can be a fairly burdensome requirement for a private company.

As mentioned above, there are both expenses and risks associated with a new ESOP formation. For example, the sponsor company will be required to create a disclosure memorandum.

The disclosure memorandum typically describes the following:

1. The nature of the company business operations
2. The company's historical financial performance
3. Management expectations for the company's future financial performance
4. The risks associated with investing in the company stock
5. Other information that an investor may require in order to make an informed investment decision

The disclosure memorandum is then distributed to the company employees. The employees are typically given 20 to 30 days to make their decisions about investing in the company stock. The distribution of this disclosure memorandum may be considered a risk to the ESOP formation process. This is because, often, the company employees may not have the financial sophistication—or the desire—to evaluate all of the information provided in the disclosure memorandum.

Therefore, some employees may simply elect not to invest in the sponsor company stock. As a result, the company may not receive the level of employee participation that was expected for the ESOP formation.

In some cases, the company may make financial advisers available at no cost to the employees. These financial advisers may be provided in an effort to give the company employees the resources they need to make an informed investment decision. However, due to the expense associated with

giving employees the option to invest their 401(k) or profit sharing assets in the company stock, the company management should carefully weigh the risks versus the probability of success before pursuing this option.

If the management determines that this option will be pursued, then a temporary “floor price” is usually attached to the sponsor company stock acquired with assets from other benefit plans. This temporary floor price often remains in effect until the ESOP’s stock purchase loan is completely repaid.

In most cases, this “floor price” is calculated as the fair market value of the company stock without taking into account the impact of the ESOP’s stock purchase loan.

The ESOP design features should also allow for factors that will positively influence employee motivation. For example, an accelerated vesting schedule may serve to motivate employee participation in the ESOP. However, as a means to prevent vested employees from terminating their employment prematurely in order to receive large account balances, the sponsor company may postpone the distribution of accounts to terminated employees for a certain time period.

The transfer of voting rights is also a concern for many shareholders of a private company. However, this issue has not actually resulted in a problem for ESOP-owned sponsor companies. The requirement to “pass through” voting rights to employees of private sponsor companies is a function of state law.

However, the voting rights “pass through” is usually only required for issues such as mergers, consolidations, recapitalizations, sale of the business, liquidation, dissolutions, and similar types of transactions.

When a trusted, experienced management team has a proven track record of successfully operating the business to achieve growth and profitability, the employees are generally content to not be involved in the management of the sponsor company.

SUMMARY AND CONCLUSION

Upon the completion of the ESOP financial feasibility analysis, the findings are typically presented to the company board of directors or to the ESOP formation committee.

The professionals involved in conducting the ESOP financial feasibility analysis may include the analyst, an ESOP consultant, investment bankers, lenders, the senior management team, legal counsel, and the selling shareholders. It is important for all of these parties to:

1. anticipate potential ESOP formation obstacles and
2. have reasonable solutions to each of these obstacles.

Based on such anticipatory consideration, any last-minute obstacles or issues can be evaluated as part of the decision-making process of the company board of directors and of the ESOP formation committee.

Further, the evaluation of the ESOP feasibility is an ongoing part of the ESOP formation

process. As valuation, structuring, and financing decisions are made, circumstances (both for the company and for the selling shareholders) may change. In such instances, various alternative ownership transition opportunities may be considered.

Ultimately, the different aspects and considerations of the ESOP financial feasibility analysis should be updated. This updated analysis should reflect the most current set of facts related to the sponsor company—in order to confirm the continued financial feasibility of the ESOP formation.

Finally, the decision to enter into a transaction to buy the company’s shares and to pay a fair market value price for those company shares is made (on behalf of the to-be-formed ESOP participants) by the ESOP fiduciary.

ESOP sponsor companies (and the company’s selling shareholders) sometimes face litigation claims and regulatory challenges related to the new ESOP formation.

Sometimes, the ESOP trustee, the financial adviser to the ESOP trustee, and other parties may become involved in these litigation claims or regulatory challenges. And, sometimes the sponsor company noncontrolling shareholders may also raise issues with regard to the ESOP stock purchase transaction.

A comprehensive ESOP financial feasibility analysis will not eliminate the potential of litigation or regulatory challenges. However, the ESOP financial feasibility analysis does provide evidence of the due diligence and business judgment that was exercised by the various parties to the ESOP formation process.

Robert Reilly is a managing director of the firm and is resident in our Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.



“Finally, the decision to enter into a transaction to buy the company’s shares and to pay a fair market value price for those company shares is made . . . by the ESOP fiduciary.”

Insights Wins the APEX 2019 Publication of Excellence Awards Competition

INTRODUCTION

We are proud to announce that the quarterly business valuation journal *Insights*, published by Willamette Management Associates, received a publication excellence award in the 2019 APEX Award of Excellence competition.

This is the tenth year in a row that the thought leadership in *Insights* has been recognized with an Apex Award of Publication Excellence.

APEX AWARDS OF PUBLICATION EXCELLENCE

The APEX Awards of Publication Excellence are presented based on an annual competition for writers, editors, publication staffs, and business and non-profit organization communicators. International

in scope, the APEX competition recognizes outstanding publications ranging from institutional newsletters and magazines to corporate annual reports, brochures, and websites.

There were nearly 1,300 entries in the APEX 31st annual awards program. *Insights* was a winner in the Magazine & Journal Print category of the 2019 annual APEX award of excellence competition.

"We are honored to receive the APEX

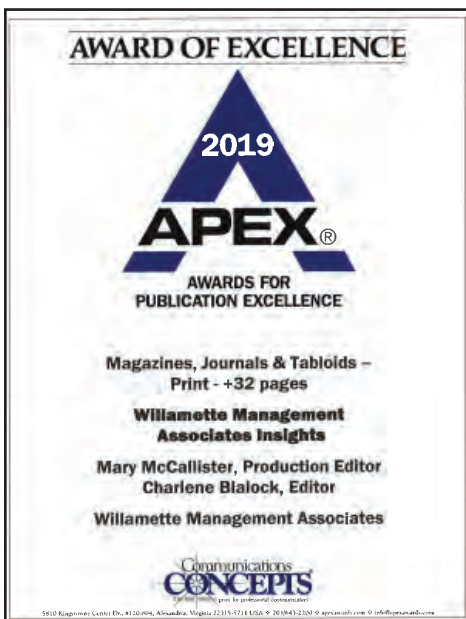
Publication of Excellence Award for our quarterly business valuation journal *Insights*," said firm managing director Robert Reilly. "This is the tenth year in a row that we have received the APEX recognition for publication excellence in the Magazine & Journal Print category. This award motivates us to continue to provide thought leadership in a journal that focuses on the business valuation, forensic analysis, and financial opinion disciplines."

Each quarterly issue of *Insights* presents current thought leadership related to one or more of our firm's financial advisory services disciplines. These professional disciplines include economic damages measurement and lost profits analysis, business and security valuation, intangible asset and intellectual property analysis, intercompany transfer price analysis, bankruptcy and reorganization analysis, forensic accounting and expert testimony, and corporate transaction opinion services.

Each quarterly *Insights* issue typically includes about 8 to 10 discussions. In most of the 96-page issues, about two-thirds of the *Insights* discussions are written by Willamette Management Associates authors. And, about one-third of the *Insights* discussions in each issue are authored by lawyers, bankers, accountants, or academics who are not associated with Willamette Management Associates.

ABOUT WILLAMETTE MANAGEMENT ASSOCIATES

Founded in 1969, Willamette Management Associates provides thought leadership in its business valuation, forensic analysis, and financial opinion services. Our clients range from substantial family-owned companies to Fortune 500 corporations. And, our clients also include financial institutions, the accounting and audit profession, the legal community, and government and regulatory agencies.



On Our Website

Recent Articles and Presentations

Robert Reilly, a managing director of our firm, and John Ramirez, a vice president of our firm and director of our property tax valuation services practice, delivered a presentation to the 49th Annual Taxation of Communications, Energy, and Transportation Properties Conference. The conference was held in Wichita, Kansas, July 28-August 1, 2019. The title of Robert and John's presentation was "Standards of Value and Premises of Value—What Is Appropriate for Unit Valuations?"

Robert and John's presentation discusses applying the correct standard of value and premise of value in unit principle property tax valuations. They examine defining the unit of property to be valued. Robert and John discuss using fair value purchase price allocations as an indication of fair market value in the valuation of the taxable unit. They consider the differences in fair value and fair market value procedures and valuation variables and review examples of the calculation differences. Robert and John summarize applying investment value transactional data when developing fair market value valuations and considering differences in investment value transactional data and fair market value valuations.

Robert Reilly and Connor Thurman, an associate in our Portland office, delivered a presentation to the 49th Annual Taxation of Communications, Energy, and Transportation Properties Conference. The conference was held in Wichita, Kansas, July 28-August 1, 2019. The title of Robert and Connor's presentation was "Finding Alpha—Measuring the Size Risk Premium and Company-Specific Risk Premium in the Unit Principle Valuation Cost of Capital."

The measurement of alpha is a component of the discount rate and the capitalization rate. Robert and Connor explore industries that are often subject to the unit principle of valuation.

They discuss the components of alpha in measuring the discount rate and the cap rate. Robert and Connor examine the measurement of the components of alpha. Finally, they provide illustrative examples of the application of alpha in a unit principle valuation.

Jason Bolt, a manager in our Portland office, delivered a presentation to a conference in Bellevue, Washington, that was held on July 11, 2019. The conference was sponsored by the National Center for Employee Ownership and was called "ESOP Nuts and Bolts: What You Need to Know About Employee Stock Ownership Plans." The title of Jason's presentation was "ESOP Plan Designs That Work."

There is no one-size-fits-all ESOP. The right plan depends on many factors. Jason discusses areas that cause confusion in the design of an ESOP. These issues are best dealt with up front. Jason explores the steps needed to set up an ESOP and summarizes ESOP plan design best practices.

John Ramirez, a vice president of our firm and director of our property tax valuation practice, along with Brad Gorski, director of personal property at Paradigm Tax Group, delivered a presentation to the 43rd Annual Conference of the Institute for Professionals in Taxation, which was held in Vancouver, BC, June 24-27, 2019. John and Brad's presentation was titled "No SPACE for Intangibles—Understanding How to Identify and Remove Intangibles."

Intangible assets are valuable property that most corporate taxpayers own. For property tax purposes, most taxing jurisdictions do not tax intangible assets. Often, assessors and taxpayers fail to exclude intangible asset value from property tax assessments. John and Brad's presentation explores property valuation approaches and methods that may include intangible asset value. They also examine generally accepted intangible asset valuation approaches. They then discuss methods for extracting intangible asset value from the total property value.

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Communiqué

IN PRINT

Robert Reilly, firm managing director, authored an article that appeared in the June 2019 issue of *The Practical Lawyer*. The title of Robert's article was "What Legal Counsel Needs to Know about Forensic Analysis Due Diligence Procedures."

Robert Reilly also authored an article that appeared in the Summer 2019 issue of the *American Journal of Family Law*. The title of Robert's article was "Intellectual Property Valuation for Family Law Purposes: Part I of II."

Robert Reilly also authored an article that appeared in the May/June 2019 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Working with a Valuation Specialist."

Robert Reilly also authored an article that appeared in the June/July 2019 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article was "Forensic Analyst Expert Report and Expert Testimony Guidelines."

Robert Reilly also authored an article that appeared in the August 2019 issue of *Journal of MultiState Taxation and Incentives*. The title of Robert's article was "Extracting Embedded Software from Tangible Property Value."

IN PERSON

Weston Kirk, a vice president in the Atlanta practice office, delivered a presentation at the 44th annual National Trust Closely Held Business Association conference on September 10, 2019. The topic of Weston's presentation was "Valuation and Fiduciary Court Cases Update 2019." The materials for the presentation were prepared by Curtis Kimball, a managing director in our Atlanta office.

Robert Reilly and John Ramirez, Portland office director, delivered a presentation at the Appraisal for Ad Valorem Taxation annual conference at Wichita State University on July 29, 2019. The topic of their presentation was "Standards of Value and Premises of Value—What Is Appropriate for the Unit Principle Valuation?"

Robert Reilly and Connor Thurman, Portland office associate, delivered a presentation at the Appraisal for Ad Valorem Taxation annual conference on July 30, 2019. The topic of their presentation was "Finding Alpha—Measuring Size Risk Premium and Company-Specific Risk Premium in the Unit Principle Valuation."

Kyle Wishing, Atlanta office manager, will be speaking at the annual ESOP conference in Las Vegas being held November 13 through 15, 2019. The topic of Kyle's presentation is "Behavioral Bias and How It May Impact Financial Projections."

ENCOMIUM

George Haramaras, Chicago office associate, has attained the certified public accountant ("CPA") designation for the state of Illinois.

Weston Kirk, Atlanta office vice president, has been nominated to serve as the 2020 co-chair for the 14th annual Balser Symposium, which will take place in Atlanta on Friday, January 31, 2020. The Balser Symposium supports charitable discussions on philanthropy with advisers and families in Georgia. The Symposium is hosted in connection with the Atlanta Jewish Foundation, Community Foundation of Greater Atlanta, and United Way of Greater Atlanta.

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Willamette Management Associates provides **thought leadership** in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

We provide **thought leadership** in valuation, forensic analysis, and financial opinion services for purposes of merger/acquisition transaction pricing and structuring, taxation planning and compliance, transaction financing, forensic analysis and expert testimony, bankruptcy and reorganization, management information and strategic planning, corporate governance and regulatory compliance, and ESOP transactions and ERISA compliance.

Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

For 50 years, Willamette Management Associates analysts have applied their experience, creativity, and responsiveness to each client engagement. And, our analysts are continue to provide **thought leadership**—by delivering the highest level of professional service in every client engagement.

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