

# Litigation SUPPORT



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- White collar crimes
- Matrimonial dissolution
- Product liability
- Copyright or patent infringement
- Business valuations

# Court ruling: Accounting for embedded taxes

A hotly disputed business valuation issue recently was addressed in a seven-years-plus divorce case, one of first impression in New York. In *Wechsler v. Wechsler*, the appellate level court considered the extent to which the value of a holding company owned by the husband should be reduced to reflect the federal and state taxes embedded in the securities owned by the company due to unrealized appreciation.

## DUELING CALCULATION METHODS

The case considered the couple's largest asset, Wechsler & Co. Inc. (WCI), a private C corporation that held only securities. The husband's expert and a neutral expert approved by both parties urged the appellate court to apply the Fifth Circuit's approach in *Dunn v. Commissioner of Internal Revenue Service*.

Under that approach, an actual sale of the company's assets is assumed to occur on the valuation date (the date the divorce action was filed). The value is reduced on a dollar-for-dollar basis by the full amount of tax liability that would arise from the sale of the assets by the hypothetical buyer on that date. As applied to WCI, the value of the company would be reduced by almost \$30 million, based on an effective tax rate of 41.74%.

The trial court had accepted the approach proposed by the wife's expert and reduced WCI's value by 11%, or about \$7.8 million. The 11% figure reflected the "historical" rate of annual taxes paid by WCI, and was determined by comparing WCI's annual taxes paid with its average annual gross revenue.

In its decision, the trial court relied largely on the U.S. Tax Court's decision in *Estate of Jelke v. Commissioner of Internal Revenue Service*. That decision, however, was reversed after the *Wechsler* appeal was argued. A divided panel of the Eleventh Circuit adopted the *Dunn* approach and held that the company's assets should be reduced by the full amount of embedded taxes that would be payable as a result of a sale.

## COURT FINDS HISTORY LACKING

On appeal, the *Wechsler* court noted that it only needed to decide between the *Dunn* approach and



the "historical tax rate" approach accepted by the trial court. Both the husband's and neutral experts "vehemently disagreed" with the historical tax rate approach, which the neutral expert called a "meaningless percentage to apply to capital gains" that ignored the difference between an effective tax rate and the incremental tax rate that would actually apply. If, in any given year, WCI sold securities for a \$10 million capital gain, it would incur incremental taxes at 41.74% of the gain. The husband's expert testified that the correct way to calculate a tax rate is as a percentage of pretax income after expenses.

The appellate court rejected the historical approach of the wife's expert, finding that it doesn't agree "with common sense, conflicts with the reasoned testimony of both the neutral expert and the husband's expert and is without precedential support." Although the court found those reasons sufficient to reject the approach, it also cited additional "sound reasons" to reject the historical approach.

## MORE SOUND REASONS

The court criticized the wife's expert not only for assuming the sale of all assets on the valuation date

but also that a buyer would continue to operate WCI in the future as it had been operated in the past. The method assumes, for example, that a buyer would sell the same number of assets each year and offset income generated by the sales with deductions for salaries and other expenses taken in prior years. As of the trial, however, the IRS was challenging WCI's deductions for those expenses as excessive.

The court found the assumption that WCI would sell assets in the future to the same extent as in the past “even more questionable.” Given the size of the distributive award payable over a period of years and the fact that 88% of the other marital assets went to the wife, the husband would need to sell assets every year to meet his obligations. The court pointed out that this would result in greater annual tax liabilities than in the past.

Finally, the court faulted the assumption that WCI's securities won't depreciate over time. The assumption requires the husband to bear all of the risk that the securities would decline in value, and the husband is already left without “any substantial cushion of assets to protect himself in the event the securities depreciated significantly.” The appellate court concluded that the trial court overvalued WCI by approximately \$22 million.

## WHAT ABOUT LIQUIDATION COSTS?

The husband's expert in *Wechsler v. Wechsler* contended that Wechsler & Co. Inc.'s (WCI's) value should be reduced by the nontax costs of liquidating the company. Because the hypothetical buyer is assumed to liquidate the company's assets upon acquisition, he argued, an additional reduction is warranted to account for the costs the buyer would incur.

The husband's expert calculated the costs by assuming the assets would be liquidated over a six-month period after the valuation date. The court noted that this assumption was inconsistent with the assumption — for purposes of determining the reduction for embedded taxes — that the company's assets are liquidated on the valuation date.

Ultimately, the court declined to reduce the value by the liquidation costs for two reasons: 1) It found no rational basis for determining the amount of the nontax liquidation costs; and 2) it asserted that the amount of any costs it might recognize would be small relative to the overall value of the marital property and might not exceed the costs of additional briefing and fact-finding proceedings.

## EXPERTS MATTER

This case illustrates the difference solid expert testimony can make to the bottom line. If your expert or an opposing expert can't offer precedent to support his or her position, you should closely examine the expert's assumptions. It's a good bet the court will. ▶

## Shareholder damages

# More class action cases, less certainty

The number of securities class action suits has escalated in recent years. According to the Stanford Law School Securities Class Action Clearinghouse, 2008 saw a 19% increase over 2007 filings.

In fact, 2008 produced the highest level of this type of litigation in six years. But because greater market volatility historically correlates with an increased level of securities litigation, these numbers can be expected to rise. Market instability can also complicate the already tricky process of calculating shareholder damages.

## ATTRIBUTING PRICE

To compute shareholder damages, a damages expert must first determine the “true value” of the company's stock during the period at issue. The expert can then extrapolate from that value to estimate the shareholders' damages.

Experts base their calculations on statistically significant price changes not attributable to ordinary market activity. Typically, they compare the daily changes in a company's share price with corresponding changes

in benchmark indexes such as the S&P 500. Alternatively, experts might use an index comprising companies in the same industry, of the same market capitalization or defined by other, customized parameters. It's important to use an index with price changes that generally correlate with the share price changes of the company in question.

Experts use the correlation to predict price changes in the stock for the damages period, which are then compared with the actual price changes that occurred. If the differences are statistically significant, the expert must conduct an event study. This type of study helps determine if a stock's inflated price could be attributable solely to the misrepresentation or omission that's the basis of the litigation, or whether general economic, industrywide or company-specific conditions played a role. Such determinations can be difficult when the market is volatile.

If an expert concludes that a statistically significant price change is the result of a misrepresentation or omission, he or she must determine the stock's true value — or the price it would have traded at in the absence of the wrongdoing. Its true value is used to compute the individual loss for each class member by comparing it with the price the member actually sold at or paid.



## AGGREGATING DAMAGES

Proving or evaluating the damages suffered by every investor who bought or sold a company's

stock during the damages period can be extremely challenging. All of the plaintiffs may not even have been identified. To account for missing data, the class often seeks aggregate damages — a single amount that covers all of the plaintiffs and potential plaintiffs. Damages are then distributed through an administrative claims process.

*Proving or evaluating the damages suffered by every investor who bought or sold a company's stock can be extremely challenging.*

Damages experts often use the proportional trading model (PTM) to calculate aggregate damages. This method uses data on the number of outstanding shares and the stock's trading volume to estimate the number and price of the shares traded during the damages period. The model assumes every share outstanding and available for trading has an equal probability of trading on any day. The expert applies the true value and price inflation to determine aggregate damages based on the number of damaged shares.

Some have criticized the PTM model for failing to account for "in-and-out traders" who conduct multiple trades with shares during the period. A two-trader model may therefore be preferable to a PTM because it contemplates investors who buy and hold, as well as those who trade frequently, thereby reducing the number of active shares.

Both models, however, have been attacked for overstating damages, and some courts have excluded trading model evidence on *Daubert* grounds. Defendants also may argue that aggregate damages are inaccurate because they can't reflect variations in the amount owed each class member.

## DIFFICULT TIMES, DIFFICULT CALCULATIONS

The current rocky economy is likely to lead to a hike in the number of securities actions filed while simultaneously making damages amounts more uncertain. Engaging a damages expert early in the litigation process is the best way to help ensure you have a realistic picture of what the final numbers might look like. ▀

# How computerized testing detects journal entry fraud

Fraudulent journal entries rank among the most common methods of financial statement fraud — in part because they're extremely susceptible to management override of internal controls. But computerized testing can help detect fraudulent entries and reduce the chance a business will suffer devastating financial losses.

## THE LIMITS OF INTERNAL CONTROLS

The Sarbanes-Oxley Act has brought increased and much-needed attention to the importance of internal controls, and many companies have invested heavily in establishing and testing them. Yet, according to a recent study by the Association of Certified Fraud Examiners, internal controls were responsible for the initial detection of fraud in only 23% of occupational theft cases studied. In cases involving fraud committed by owners and executives, internal controls fared even worse, detecting only 15% of such schemes.

Many internal controls are vulnerable to circumvention — especially by executives — who may be motivated to commit financial statement fraud because of their company's aggressive growth targets and bonuses tied to meeting possibly unrealistic objectives. Fraud investigations, then, need to focus not on the company's internal controls themselves, but on the possibility that an employee could, and might be motivated to, circumvent them.

## STANDARD GUIDANCE

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, provides valuable audit guidance that can be applied when investigating fraudulent financial statements. Issued in the wake of the scandals at Enron, WorldCom and Adelphia, SAS 99 notes that “material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting by ... recording inappropriate or unauthorized journal entries throughout the year or at period end....”

SAS 99 requires auditors to:

1. Learn about the entity's financial reporting process and controls over journal entries and other entries,

2. Identify and select journal entries and other adjustments for testing,
3. Determine the timing of the testing, and
4. Interview individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries or other adjustments.

Fraud investigators typically take a similar approach.



SAS 99 was followed by the AICPA's Practice Alert 2003-02, *Journal Entries and Other Adjustments*, which provides guidance on satisfying the responsibilities outlined in SAS 99. It specifically addresses the use of “computer-assisted audit techniques” — which typically offer a more effective and efficient method of searching for unusual entries than manual testing.

## NUTS AND BOLTS

The typical general ledger may contain many suspect entries among its massive volume. Manual testing can only examine a portion of these entries and may easily miss evidence of fraud. Computerized testing, however, considers the entire dataset, reducing the risk of overlooking critical evidence. Such testing also allows fraud experts to devote more time to other aspects of the investigation, such as gathering information about the business and interviewing employees.

As pointed out in the AICPA Alert, computerized testing can locate entries made at unusual times of the day (for example, outside regular business hours) or periods. (Those made at the end of the period or postclosing are more likely to be fraudulent.) Computerized testing also is helpful for finding entries made:

- By unusual users, blank or nonsensical user names, members of senior management or IT workers,
- Electronically, but not documented in the general ledger,
- For nonrecurring transactions,
- For unrelated, unusual or seldom-used accounts, and
- Using round numbers or a consistent ending number.

Computerized testing can prove particularly helpful in situations where manual testing is largely ineffective — for example, when entries exist only



in electronic format and the desired data must be extracted. In such situations, a qualified expert can use report writers, software or data extraction tools, or other systems-based techniques to initially identify appropriate entries for further investigation. One technique simulates different types of accounting transactions. The test follows the flow of transactions as they work their way through the system, uncovering any internal control weaknesses or programming that the fraud perpetrator might have embedded.

### TIME AND MONEY

Computerized testing has its limits and won't replace an investigation conducted by a qualified fraud expert. But with computerized testing, experts can find manipulated journal entries more quickly and accurately. This is likely to save businesses time

and money that might be spent searching random entries and stop fraud schemes before they cause too much damage. ▶

## Are you producing damaging evidence?

### *The implications of electronic metadata*

As the 2006 amendments to the Federal Rules of Civil Procedure (FRCP) make apparent, electronically stored information (ESI) has become one of the most prominent types of litigation evidence. Although creating and storing business records in electronic format offers many advantages, such records contain critical bits of forensic evidence — or, metadata — that aren't found in their hard copy counterparts. When you produce electronic documents, therefore, you also may be producing revealing, even damaging, metadata.

### WHO, WHAT, WHERE, WHEN

The Committee Note to amended FRCP Rule 26(f) defines metadata as “[i]nformation describing the history, tracking, or management of an electronic file.” Every electronic file includes so-called MAC dates — the dates the file was modified, accessed and created — as well as the date it was last printed. If the file was deleted, metadata shows when it was deleted and by which user. Metadata also can show where a file resides on a computer or network,

where it was created, who saved it most recently and the number of revisions.

Metadata is generally characterized as one of two types:

- 1. File (or system).** This type is created by the operating systems that control computers, servers and other devices and is present in all electronic files. The metadata is typically stored separately from the actual file content on a hard drive because it's used to locate the file. File metadata includes data about a file's size, date and time of creation or modification, and whether it is read-only.
- 2. Application.** This kind of metadata is mixed in with a file's content on the hard drive and embedded by the application (such as Word, Excel® or Acrobat®) that created the file. Microsoft Office, for example, generates application metadata that shows tracked changes, comments and deleted text; author; number of revisions; creation date and time; and the last saved date and time.



Evidence in the form of metadata can make or break a case by confirming fraud or negligence, supporting causation or establishing timelines and intent.

## USABLE FORMS

According to FRCP 34(b)(2)(E)(ii), “If a request does not specify a form for producing electronically stored information, a party must produce it in a form or forms in which it is ordinarily maintained or in a reasonably usable form or forms.” This is usually interpreted as requiring “native file format,” which includes metadata.

*If a file was deleted, metadata shows when it was deleted and by which user.*

Metadata changes every time a file is opened. So before it begins to gather and review potentially responsive files, the producing party must preserve requested ESI with its metadata. Forensic experts can help by imaging a company's servers and hard drives before the files stored on them are searched and reviewed.

## DISPUTES ARE COMMON

Parties may disagree about whether metadata must be produced. As with any discovery dispute, the court will consider the relevance of the information to the issues at hand. For example, in a Kansas district court age discrimination case, *Williams v. Sprint*, the defendant produced an electronic Excel spreadsheet that had been scrubbed of its metadata. The plaintiffs argued that metadata showing revisions, deletions and other information could demonstrate discrimination. The court found that the defendant couldn't withhold all metadata, only that protected by privilege.

The *Williams* decision raises another issue to consider when producing metadata: attorney-client and work product protections. In addition to disclosing vital information to the opposing party, inadvertent disclosure of metadata could result in the waiver of subsequent privilege claims.

## DETERMINING A CASE'S OUTCOME

Metadata uncovered during discovery can significantly affect a case's outcome — whether it's determined in a courtroom or by settlement. Before you produce or request ESI, retain a forensic expert who understands all of the implications related to the collection, review and production of metadata. ■



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