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Follow the money: How lifestyle analysis reveals the truth

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Follow the money: How lifestyle analysis reveals the truth

Forensic accounting techniques can reveal hidden assets and sources of income. They can be invaluable in a variety of litigation contexts. For example, forensic accountants can help support a fair division of property in divorce cases, trace and recover funds in fraud cases, gather data relevant to business valuations, and facilitate damages award collection. One of the most effective weapons in an expert's arsenal is lifestyle analysis.

What is lifestyle analysis?

Simply put, lifestyle analysis involves determining and analyzing a person's income, expenses, assets and liabilities. By scrutinizing gaps or mismatches, a forensic accountant can uncover evidence that a party's income or net worth isn't what it appears to be. For example, if a party's known income sources and liquid assets are insufficient to support his or her standard of living, it's likely that he or she is hiding something.

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The first step is to develop a comprehensive financial profile of the person in question. The accountant scrutinizes banking transactions, known income sources and expenditures, and changes in net worth for signs of unreported income or hidden assets.

What techniques do forensic accountants use?

To avoid detection, many individuals with unreported income typically receive it in cash. Forensic



accountants use a number of techniques to show that cash is missing and to estimate the amount, including:

The bank deposits method. This technique is based on the assumption that all funds are either deposited or spent. To reconstruct a party's income, the financial expert 1) analyzes bank deposits, canceled checks and currency transactions, and 2) accounts for cash payments from *undeposited* currency receipts and nonincome cash sources (such as gifts, loans, insurance proceeds and inheritances). Next, the expert deducts funds from known sources from total receipts to arrive at the total funds from unknown sources.

Expenditures method. Also known as the "source and application of funds method," this technique involves analyzing a person's personal sources and uses of cash during a given time period. Sources of

funds may include salaries, inheritances, loans, gifts and cash on hand at the beginning of the period. If the person is spending more than he or she is taking in, the excess likely represents unreported income.

Asset method. Also known as the “net worth method,” this technique operates under the assumption that any unsubstantiated increase in a party’s net worth reflects unreported income. The financial expert begins by estimating the party’s net worth using bank and brokerage statements, real estate records, loan and credit card applications, and other documents. Next, he or she determines the increase in the person’s net worth during the relevant time period and deducts reported income and known expenditures. The excess represents income from unknown sources.

How do experts trace hidden assets and funds?

Proving that a person has unreported income is one thing. Tracing that income to assets or accounts that can be used to support a claim or enforce a judgment is another story, particularly when the person is actively concealing those assets.

To uncover hidden assets, forensic accountants examine a variety of documents, including tax returns, bank records, real estate records, insurance policies and court filings. Loan applications, employment applications and credit reports also may yield valuable clues about the value and location of a person’s wealth. Another potential strategy is to interview people with knowledge about that person’s finances, such as accountants, real estate agents or business partners.

Tax returns are particularly useful. Why? Because people have strong incentives to prepare accurate returns, including the availability of deductions for certain expenditures and the fear of being charged with tax evasion. As a result, tax return entries may reveal clues about assets or income that someone

is otherwise attempting to conceal. (See “Use tax returns as an investigative tool” below.)

How do you read the signs?

Proving, quantifying and tracing unreported income and assets can be a challenge, especially when someone is actively attempting to conceal them. Forensic accountants have the skills and experience to read the signs that lead to hidden wealth, improving the odds of a satisfactory litigation result. ■

Use tax returns as an investigative tool

Tax returns can be a rich source of information about a taxpayer’s financial condition and income sources. Typically, financial experts examine returns from several years to identify significant trends. For instance, an expert may note a large increase in interest or dividend income from one year to the next, which may indicate that the taxpayer sold stocks or other investments. What happened to the proceeds? Here are a few examples of tax return entries that can lead an expert to hidden income or assets:

- ◆ Income from wages may lead to undisclosed business interests.
- ◆ W-2 entries may reveal unknown retirement plans.
- ◆ An examination of real or personal property taxes may reveal undisclosed assets.
- ◆ Entries for state and local income taxes may indicate income or assets in other states.

In addition, Schedule E — “Supplemental Income and Loss” — reports income from partnerships, S corporations, rental properties and trusts. An expert can examine income and expenses for signs that these entities are being used to hide assets. This schedule also reports royalty income, which can reveal undisclosed, income-producing assets.

What can a rebuttal report do for you?

In the midst of contentious litigation and seemingly irreconcilable disputes, it can be hard to know where to turn to find an impartial, well-supported resolution to a difficult matter. That's where a rebuttal report can be helpful.

When courts or shareholders question valuation results — or the conclusions of opposing experts are widely divergent — seeking the advice of another valuator in the form of a rebuttal report can bring much-needed objectivity. An independent analysis from an experienced appraiser can be key to resolving intractable issues and finding a solution that works for everyone.

How to use a rebuttal report

Rebuttal reports can be useful in a variety of situations. For example, suppose two owners dispute the value of their restaurant. The owner hoping to dissolve her interest hires an appraiser who values the business at \$10 million. The other owner's expert estimates that the company is worth \$8.5 million.

Neither side will split the \$1.5 million difference. So, they jointly hire a third expert to compare and contrast the two valuations. After sorting through the minutiae, the rebuttal expert discovers that the

appraisals are remarkably similar, except for two key differences: 1) an adjustment for excess owners' compensation, and 2) an addback for excess working capital.

When court is unavoidable, rebuttal reports help attorneys draft pointed deposition and trial questions.

As a result, the dispute evolves from an ambiguous question about the value of the business to a list of more specific questions:

- ◆ How much are each owner's day-to-day contributions worth?
- ◆ Compared with its competitors, does the restaurant have excess cash on hand?
- ◆ If there's excess cash on hand, how much?

To help the parties make an informed decision, the rebuttal expert also offers citations and reference materials on these two issues.



Simply put, rebuttal reports can facilitate settlement by pinpointing differences and putting technical appraisal issues in more user-friendly language. And, when court is unavoidable, rebuttal reports help attorneys draft pointed deposition and trial questions.

How to determine the best format

Rebuttal reports come in many forms. The appropriate length and

format depend on the time and resources available, as well as the parties' strategic preferences.

For instance, some experts and attorneys prefer oral rebuttals. They argue that less formal discussions generate no tangible report for the opposition to review before court. Accordingly, oral reports preserve the element of surprise and potentially reduce client costs.

The primary downside is that oral rebuttals require attorneys to understand technical appraisal issues well enough to design salient deposition and trial questions. Incomplete testimony often misses key points and frustrates everyone involved. Oral reports also provide judges and jurors with nothing to review during deliberations.

What a rebuttal report contains

Court procedural rules and professional appraisal standards provide little guidance on how to prepare written rebuttals. Some experts issue lengthy formal rebuttal reports; others construct concise letters highlighting key findings.

Content generally includes a description of the appraiser's review procedures and a list of errors

and omissions (or "findings and conclusions"), which is typically footnoted with authoritative references. When reviewing two divergent appraisals, rebuttal experts often break down the difference into its specific sources.

To demonstrate their objectivity, rebuttal experts usually disclose all errors and omissions, not just those that support their clients' financial interests. Many appraisers also attempt to quantify how errors — individually and collectively — might affect the appraiser's opinion.

In addition, rebuttal reports might respond to a rebuttal issued by the opposing expert or to an IRS inquiry. Typically, these responses clarify ambiguities in the appraiser's original report, address alleged errors and defend the appraiser's opinion with authoritative references.

Dispute resolution

You need cost-effective solutions, and the added expense of a rebuttal report might seem an unnecessary option at first glance. But a rebuttal can help fine-tune the work that has already been done by two opposing experts, add perceived objectivity and facilitate resolution of contentious legal matters. ■

Fair value case addresses a mix of valuation issues

In a recent statutory fair value case, *Verghetta v. Lawlor*, a New York trial court addressed several important valuation issues in connection with the buyout of a minority owner of two limited liability companies (LLCs). Although decisions in statutory appraisal actions are state specific and may not apply in other jurisdictions, this case brings up some interesting issues

and teaches a universal lesson about the value of formal training.

A healthy business

Three partners owned roughly equal shares in two LLCs. One LLC held around 30 Planet Fitness franchises. The second LLC had entered into an agreement with Planet Fitness to develop and operate



clubs in southern California. One partner sued the others, asserting breach of contract and various business tort claims and seeking judicial dissolution. The parties agreed to stay the action pending the court's determination of the fair value of the minority partner's interest.

The plaintiff's valuation expert valued the two LLCs at a total of more than \$162 million and the plaintiff's share at around \$53 million. The defendants' expert valued the first LLC at \$6.2 million and the second at \$208,000, concluding that the minority partner's interest was worth approximately \$2.2 million.

Valuation issues

In determining the fair value of the minority partner's interest, the court ruled on several critical valuation issues. Here are some of the highlights:

Expert reliability. The court found the plaintiff's expert, a tax lawyer with no formal valuation training or professional certifications, to be unreliable. Among other things, when valuing the first LLC, he confused projected net income with projected cash flow. So, his discounted cash flow analysis failed to account for capital expenditures and changes in working capital. And his valuation of the second LLC was speculative, because it was based on the net present value of clubs that hadn't yet opened.

Although the defense expert was a "true valuation professional," the court took issue with several aspects of his report. One "major analytical flaw"

was that the expert arbitrarily added a 2.5% terminal growth rate, but he failed to explain why revenue would grow again after years of significant decline.

DLOM. The court also criticized the defense expert's application of a 35% DLOM because it was based, in large part, on a potential deferred tax liability to the sellers. This liability was no more an impediment to marketability, the court observed, than the prospect that the owners would face a capital gains tax were they to sell. Another reason the court cited for disregarding the DLOM is that the defendants had no intention of selling.

Tax affecting. The defense expert "tax affected" the first LLC's projected earnings. Pass-through entities, like LLCs and S corporations, pay no tax at the entity level. But valuation experts often reduce an entity's earnings by an assumed corporate rate — in this case, 18.5%.

The court's opinion was somewhat unclear as to whether tax affecting is ever appropriate in New York, though the court did comment that in this case the tax affecting was speculative and focused too much on the "buyer's side of the equation." Another important rationale for not tax affecting was to avoid further reducing an already underestimated future income stream.

Normalizing officer compensation. In projecting future earnings, the defense expert nearly doubled officer compensation, finding actual compensation to be artificially low. Because the expert presented no comparable compensation data, the court declined to accept this adjustment.

Untying the knot

Many valuation issues can be tied together in one seemingly inextricable knot. As the court unraveled the issues in this case, it arrived at a fair value of \$8.8 million for the plaintiff's interest. The court didn't just split the difference between the two experts' conclusions. Instead, the outcome is closer to the original conclusion set forth by the defendants' "true valuation professional," which highlights the value courts place on formal valuation training. ■

Framing damages

Financial experts put punitive damages into context

In business litigation, without a framework for determining punitive damages, judges and juries could potentially award damages that are either excessive or inadequate. By educating triers of fact about a defendant's financial structure and condition, damages experts can provide the necessary context for a reasonable award.

Appropriate punitive damages depend on several factors, including the level of "reprehensibility" of the defendant's conduct and the ratio of punitive damages to compensatory damages. (Typically, anything more than 10-to-1 is considered excessive.) In addition, federal or state laws may prescribe, or place caps on, punitive damages in certain types of cases. Within these confines, a defendant's financial condition is relevant in determining whether a punitive damages award will deter similar conduct in the future.

Damages experts can help judges and juries make this determination by:

Identifying the party being punished. If a specific division within a company is responsible for plaintiffs' damages, a punitive damages award generally only needs to be large enough to punish that division, even if it won't have a significant impact on the company as a whole.

Calculating profits. A judge or jury may consider the extent to which a defendant profited from its wrongful conduct. A damages expert can assist

the jury in distinguishing profits vs. revenues and accounting for the defendant's expenses.

Putting net worth in perspective. Judges and juries often view a high net worth as a justification for a large punitive damages award. But net worth isn't necessarily an accurate measure of a defendant's ability to pay. For example, a company that's financed

primarily by debt may have a relatively low net worth, even though its resources may be comparable to companies financed primarily by equity.

Analyzing liquidity and cash flow. Even if a company is considered wealthy, it may not have sufficient liquid assets or cash flow to pay a large punitive damages award,

and converting illiquid assets into cash could make it difficult for the company to continue operating. A damages expert can help the judge or jury set punitive damages at a level that will punish the defendant without putting it out of business.

Defining value. A damages expert can educate the trier of fact about different measures of value, such as book value, fair market value and market capitalization. These measures may or may not reflect a defendant's financial condition, depending on economic conditions and the defendant's particular circumstances.

In cases involving punitive damages, expert financial testimony is key to ensure that judges and juries have the proper framework within which to set damages at a reasonable level. ■

