



# Litigation &

V a l u a t i o n

# REPORT

JULY/AUGUST 2007

## Whom can you rely on?

A review of recent *Daubert* challenges

### **Mine games**

Using data mining  
to detect fraud

### **Spell it out for me**

Purchase price allocations  
to noncompete  
agreements

### **Cause/effect:**

**The role of  
causation  
in damage  
calculations**

# Whom can you rely on?

## A review of recent *Daubert* challenges

The U.S. Supreme Court's landmark 1993 decision in *Daubert v. Merrell Dow Pharmaceuticals* has had a profound impact on expert evidence. (See "The *Daubert* basics" on page 3.) More recently, Federal Rules of Evidence (FRE) Rule 702 was amended to reflect the *Daubert* standard.

Under the amended rule, expert testimony is admissible if:

- It is based on sufficient facts or data,
- It is the product of reliable principles and methods, and
- The witness has applied the principles and methods reliably to the facts of the case.

The FRE Rule 702 amendment clarified conflicting issues by adding the last point (applying principles and methods reliably).

### Value judgments

A review of recent *Daubert* challenges shows that courts are increasingly willing to scrutinize valuation experts' methods. Here are a few examples:

#### *In re Greater Southeast Community Hospital Corp.*

The defendants sought to exclude the testimony of the plaintiff's valuation expert. Among other things, the defendants argued that the expert was not qualified to appraise real estate and equipment and instead relied on third-party appraisals to value those assets.

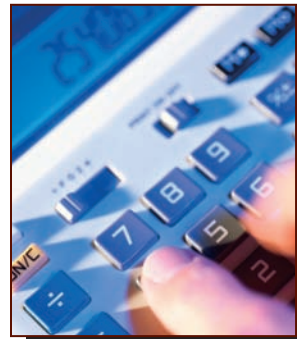
The court permitted the expert to testify, finding it acceptable to "rely upon appraisals prepared by others so long as those appraisals are of the type experts in the field of business valuation would reasonably rely upon."

FRE Rule 702 didn't require the expert to establish that he was qualified to perform real estate and equipment appraisals. Rather, he needed to demonstrate only that he possessed "the requisite knowledge, skill, experience, training, or education to competently render a net asset

valuation opinion based upon an analysis of appraisals prepared by others."

***In re Nellson Nutraceutical Inc.*** The court excluded the debtor's expert testimony on enterprise value, citing the expert's use of a "maverick" discounted cash flow (DCF) analysis.

All four experts involved in the case conducted a DCF analysis as part of their valuations. Basically, the DCF method involves forecasting an enterprise's future cash flows and discounting them to present value. All of the experts divided the debtor's future cash flows into: 1) free cash flows for the period 2006 to 2011, and 2) a terminal value as of the end of 2011. Three of the experts calculated the terminal value based on the debtor's projected earnings before interest, taxes, depreciation and amortization (EBITDA). The debtor's expert, however, used EBITDA minus capital expenditures.



The court found that most business valuation experts would be likely to disagree with the debtor's expert's use of EBITDA minus capital expenditures. In addition, the debtor's expert had invented the methodology for use in this case.

So, though the court found that the debtor's expert was qualified and that his testimony was relevant, his methodology was so unreliable that it rendered his opinion inadmissible.

***Haupt v. Heaps.*** In this case, a state court found that the method the plaintiff's valuation expert used was "too novel" to withstand a challenge under the state law equivalent of the *Daubert* standard.

The plaintiff, a former employee of a technology company, sued the company's CEO, alleging that he fraudulently induced the plaintiff to sell his stock back to the

company for a deflated price. Several months after the plaintiff sold his shares, the company merged with a publicly traded company.

As evidence of the stock's value, the plaintiff attempted to offer audited financial statements attached to SEC forms filed about a year after the plaintiff sold his stock. A footnote to the financial statements valued the stock using the straight-line ramp-up (SLR) method to determine the expense associated with the sale. The SLR method simply plots the stock's known values at two points in time and assumes that its value changed at a constant rate between those two points, without any consideration of actual events.

The plaintiff also sought to introduce an economist's opinion of the stock's value based on the SLR method. Noting that even the plaintiff's expert admitted he had never seen the SLR method of valuation, the court found it too novel to be reliable.

The plaintiff further erred in not offering any witnesses from the company's auditors to explain the financial statement footnote or the SLR methodology. It's unclear, however, whether such testimony would have changed the outcome.

### Be prepared

Since the advent of *Daubert*, courts have raised the bar concerning admissibility of expert witness testimony.

## Mine games

### Using data mining to detect fraud

**F**raud in the United States is an enormous problem, generating more than \$600 billion in losses every year, according to the Association of Certified Fraud Examiners. At the same time, fraud can be difficult to detect. Why? For one thing, fraud — though potentially devastating — is relatively infrequent. In other words, fraudulent transactions make

## The *Daubert* basics

*Daubert v. Merrell Dow Pharmaceuticals* instructs judges to consider four *nonexclusive* factors in determining whether expert evidence meets minimum standards of reliability:

1. Has the expert's theory or technique been tested? Can it be tested?
2. Has the theory or technique been subject to peer review or publication?
3. What is the theory's or technique's known or potential error rate?
4. Is the theory or technique generally accepted in the relevant scientific community?

The Supreme Court's 1999 decision in *Kumho Tire Co. v. Carmichael* confirmed that *Daubert* applies to both scientific and nonscientific evidence, including testimony by financial and business valuation experts.

To ensure your valuation experts are allowed to testify, discuss the *Daubert* standards with them.

It's important to ensure not only that the experts' methods are reliable, but also that they are prepared to explain and support those methods in court. □

up only a small percentage of the total. Also, most perpetrators work hard to conceal their crimes by making fraudulent transactions look just like legitimate ones.

Even small businesses engage in thousands of financial transactions every year, so identifying fraudulent activity can be like searching for the proverbial needle in the

haystack. Fortunately, techniques like data mining make it possible to flag suspicious activity in a timely, cost-efficient manner.

### Technology to the rescue

The advent of the computer has made a variety of business functions more efficient, but it also has enabled businesses to do things that are impractical — if not impossible — to do manually. A good example of this is data mining, which is the process of combing through massive amounts of data to reveal trends. Data mining uses discovery-based approaches that can look at multi-dimensional data relationships concurrently, highlighting those that are dominant or exceptional.

### *There's virtually no limit to the types of patterns and trends data mining can dig up.*

The power of data mining as a fraud detection tool is based on the idea that, while individual transactions often appear legitimate, examining large volumes of data can uncover relationships, patterns and trends that may reflect fraudulent activity.

Consider credit card fraud. A \$15 convenience-store purchase is unlikely to raise any eyebrows. But data

mining may reveal patterns in which fraudsters make small test purchases to confirm that the card is working followed almost immediately by much larger purchases.

### Patterns of deception

There's virtually no limit to the types of patterns and trends data mining can dig up. Here are a few examples:

**Rounding up.** Fraud perpetrators often create phony invoices with nice round numbers, like \$1,000, \$5,000 or \$10,000. Data mining can identify vendors with an unusually high percentage of such amounts.

**Turning up the volume.** A sudden increase in a vendor's volume of invoices or payments per invoice can be a red flag. Data mining can alert an organization when a vendor's billings go up unusually fast.

**Slipping under the limit.** Data mining can spot vendors with an unusually high percentage of invoices that fall just under approval limits.

Data mining identifies trends or patterns outside the norm. Thus, to use it effectively, an organization must create a profile of "normal" behavior. Only then is it possible to recognize "abnormal" behavior.

To create this profile, a company's financial team conducts an in-depth examination of the organization's business processes and data and develops a set of

### Crop patterns: Data mining in action

The U.S. Department of Agriculture's Risk Management Agency (RMA) has been using data mining for several years to combat fraud, waste and abuse in the federal crop insurance program. For example, data mining flags instances of producers whose crop insurance losses are not consistent with those of their neighbors.

According to the RMA, by spotting fraudulent claims before they were paid, this effort saved taxpayers more than \$450 million from 2001 to 2006 — a \$23 return for every dollar invested in the data-mining system. The agency says that preventing fraudulent claims before they're paid also changes claims behavior, resulting in even higher savings over the long term.

In the fight against fraud, prevention is critical, because it's difficult to recover a loss. According to the Association of Certified Fraud Examiners, occupational fraud victims were unable to recover any of their losses in 42.1% of cases. And in another 23.4% of cases, the victims recovered less than one-fourth of what was stolen.

algorithms the data mining system can use to distinguish normal activities from suspicious ones. (See “Crop Patterns: Data mining in action” on page 4.)

### Inquiring mines

Keep in mind that data mining is not foolproof or all-encompassing, and should not be relied on by itself.

Like any type of statistical analysis, data mining sometimes produces “false positives.” This technique is simply one tool available to identify suspicious patterns. To avoid offending innocent parties, it’s essential to confirm the findings using other means. □

## Spell it out for me

### Purchase price allocations to noncompete agreements

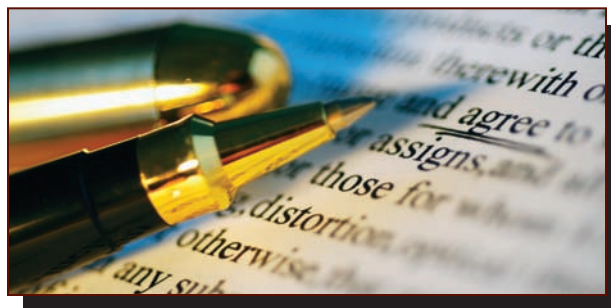
In a recent case, *Becker v. Commissioner*, the Tax Court provides a handy summary of the rules on allocating a portion of a stock purchase price to a noncompete agreement. More specifically, the case illustrates the importance of spelling out price allocations in the purchase agreement.

### Redeeming features

*Becker* involved a purchase agreement between Becker Holding Company (BHC) and William Becker, under which BHC redeemed all of Becker’s stock for more than \$23.9 million. The agreement called for a \$5 million down payment in cash and a promissory note for the balance. The agreement also included a noncompete provision, but it didn’t allocate any of the purchase price to the noncompete agreement.

On its federal tax returns, BHC claimed amortization deductions based on a reported tax basis of \$6,371,000 for the noncompete agreement. Becker, on the other hand, treated the entire purchase price as payment for his stock and reported the amounts he received as capital gains.

The proper allocation of the purchase price was critical to the parties. If BHC prevailed, a significant portion of Becker’s receipts would be recharacterized as ordinary income. And if Becker prevailed, BHC would lose millions of dollars in tax deductions.



### Allocation rules

Applying the law of both the Fifth and Eleventh Circuits, the Tax Court outlined the two main rules regarding purchase price allocations to noncompete agreements:

1. The “mutual intent” rule, and
2. The *Danielson* rule.

In some early cases, the Fifth Circuit applied the “strong proof” rule. Under this rule, when the parties specifically set out the agreement in the contract and assign it a value, “strong proof must be adduced by them in order to overcome the declaration.”

Later cases departed from the strong proof rule and adopted the mutual intent rule. Under this rule, if the purchase agreement does not allocate a portion of the purchase price to a noncompete agreement, the court must determine “whether the parties mutually intended that an allocation of the purchase price be made to the covenant

at issue.” If they did, the court must next evaluate whether the allocation comports with “economic reality.”

The *Danielson* rule is based on a Third Circuit case that was adopted by both the Fifth and Eleventh Circuits. It states that, if the purchase agreement specifically allocates consideration to a noncompete agreement, a party can challenge the tax consequences only if it can show that the agreement is unenforceable because of mistake, undue influence, fraud, duress or other similar circumstances. This is true regardless of whether the allocation comports with economic reality.

The Tax Court noted that the Seventh Circuit applies a different test, in which it “looks to all the evidence pertinent to the covenant to determine if it has independent value and, if it does, [determines] how much the covenant is worth.”

#### Stock answers

In *Becker*, the Tax Court found that both rules produced the same result. Under the *Danielson* test, even though the parties recognized that the noncompete agreement was valuable, the purchase agreement was unambiguous in allocating the entire purchase price to Becker’s stock — and there was no showing of fraud or some similar problem.

Applying the mutual intent test, the court found no evidence that the parties intended to allocate a portion of the purchase price to the noncompete agreement. Although the parties discussed such an allocation *after* the agreement was executed, they didn’t discuss it in their original negotiations.

BHC offered a variety of arguments in an attempt to establish ambiguity with regard to the purchase price allocation, all of which the Tax Court rejected. For example, the company claimed that the parties’ failure to obtain a formal valuation of Becker’s stock demonstrated ambiguity.

The court disagreed, finding the fact that BHC and Becker had agreed to a purchase price for the stock for \$23.9 million “indicates that the parties themselves valued the stock at \$23.9 million. The absence of a third-party appraiser does not render the purchase documents ambiguous.”

#### Clarity counts

Any party drafting or negotiating a noncompete agreement would surely be wise to study *Becker*. Failing to clearly draft the purchase documents could lead to significant litigation headaches down the road. □

## Cause/effect:

### The role of causation in damage calculations

**I**n litigation, liability and damages are often viewed as discrete issues. In some cases, they’re even tried separately. But that doesn’t mean that a financial expert can calculate damages without regard to the wrongful acts that produced them. Damages are required to be proven with reasonable certainty, and damages and causation are inextricably linked.

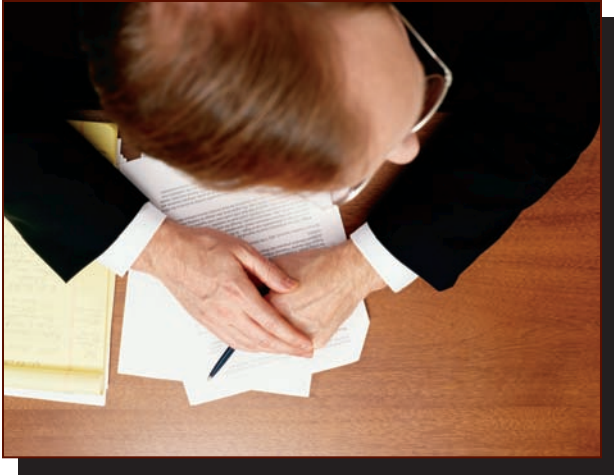
Experts who attempt to establish or challenge damages without examining this relationship are venturing into dangerous territory. Not only do they risk overlooking recoverable damages or including inappropriate

damages, but they also jeopardize the admissibility of their testimony.

#### Causation vs. correlation

Even if liability has been established, the plaintiff’s damages aren’t necessarily all attributable to the defendant’s conduct. Just because two events are correlated doesn’t mean that one caused the other.

Causation is a tricky concept. Suppose that a defendant infringes a plaintiff’s patent and, soon thereafter, the



plaintiff's profits take a nosedive. It's tempting to conclude that the infringement caused the plaintiff's lost profits.

But many interrelated factors can influence a business's financial performance. Perhaps there was a downturn in the plaintiff's industry or in the economy in general. A third party might have entered the market, diverting sales from both plaintiff and defendant.

### 3 possibilities

When a correlation exists between two events — A and B — there are three possible explanations:

1. A causes B,
2. B causes A, or
3. An independent event, C, causes both A and B.

It's up to the expert to dig beneath the surface to uncover the underlying relationships. This can be particularly complex in cases involving lost profits and other financial damages, such as business torts, breaches of contract, intellectual property disputes and antitrust matters.

Separating damages proximately caused by the defendant's conduct from those attributable to market forces, economic trends and other independent factors can require sophisticated financial modeling and statistical analysis. If other factors may have been partially responsible for the plaintiff's damages, the expert needs to consider these other factors and if possible, eliminate — or at least mitigate — the effects of all other possible causes of loss.

### The missing link

In today's post-*Daubert* environment, federal trial courts — as well as many state courts — are scrutinizing expert testimony and excluding it if it fails to meet certain minimum standards of reliability. (See “Whom can you rely on?” on page 2.) Financial experts who fail to establish a link between the defendant's wrongful conduct and the damages the plaintiff seeks to collect may not pass the *Daubert* test.

Consider the case of *MicroStrategy Inc. v. Business Objects*. MicroStrategy sued Business Objects for patent infringement, misappropriation of trade secrets and other claims related to a system for automatically broadcasting information to e-mail applications as well as cell phones, pagers, personal digital assistants (PDAs) and other devices.

The U.S. Court of Appeals for the Federal Circuit affirmed the district court's exclusion of several reports by MicroStrategy's damages expert. The trial court found that the reports used a “flawed methodology that rendered them speculative and unreliable.”

For example, the expert “did not consider relevant factors in [his] damages analysis, and did not link any single instance of misconduct to a specific amount of damages.” Moreover, the expert attributed all of MicroStrategy's losses to the defendant's alleged conduct, despite evidence that the dot-com crash of the late 1990s, as well as an accounting error, contributed to the plaintiff's deteriorating financial condition.

The court recognized that an expert need not consider *every* possible factor responsible for a plaintiff's losses, but found that he or she “still must consider *enough* factors to make his or her opinion sufficiently reliable in the eyes of the court.” The exclusion of this expert's testimony, together with the exclusion of certain nonexpert damages evidence, “left MicroStrategy with little or no evidence of damages or causation.”

### A worthy cause

Attempting to calculate damages without considering causation issues is like working with blinders on. To ensure that your damage theories are accurate and supportable, it pays to discuss causation with your experts. □

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