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Defense damages experts

Developing a winning strategy

In cases involving monetary damages, a critical strategic decision for the defense is whether to engage a damages expert. On the one hand, you don't want the plaintiff's damages calculations to go uncontested. But on the other, presenting your own damages evidence can send mixed signals to the jury, particularly if you're denying liability.

Will the jury see competing damages theories as an invitation to award some amount of damages? Will it be tempted to accept your damages estimate as a compromise?

Three options

When faced with a damages claim, the defense has three options. It can:

1. Focus on challenging liability and not engage a damages expert,
2. Engage a damages expert solely to rebut the plaintiff's expert, or
3. Engage an expert to develop his or her own damages opinion.

As you know, the right strategy depends on the facts of the case. But unless lack of liability is a slam dunk, it's a good idea to engage an expert at least for rebuttal purposes. The effectiveness of a rebuttal strategy depends on the strength of the plaintiff's damages case and the reliability of its expert's assumptions and methods.

Following are two recent cases that illustrate the potential risks and rewards of challenging the plaintiff's damages expert without presenting an alternative damages estimate.

A loss

In *FMS, Inc. v. Volvo Construction Equipment North America, Inc.,* the defendant's rebuttal strategy was unsuccessful. FMS and other sellers of excavators sued Volvo for wrongful termination of their dealer agreements and presented expert testimony on lost profits damages.

Volvo's expert criticized the FMS expert's assumptions and methods but offered no alternative calculation. Volvo also attempted (unsuccessfully) to exclude the plaintiff's damages evidence under *Daubert* as speculative and unreliable. Yet the jury awarded FMS more than $2 million in damages.

The trial court rejected Volvo's argument that the damages evidence was speculative, finding that FMS's expert "used accepted methodology, and supported FMS's owner's testimony with historical financial information and industry projections. While Volvo may disagree with the choices [the expert] made… [his] analysis is not speculative or conjectural such that Volvo could not challenge the basis for

his opinions by cross-examination and the presentation of competing theories."

The court also had this to say about Volvo's decision not to present its own damages calculation: "[Volvo] may have feared that if it put in its own estimate of damages, the jury would be irresistibly attracted to that figure as a compromise. But if so, [Volvo] gambled double or nothing, as it were; and we will not relieve it of the consequences of its risky strategy." (Note: The judgment was later reversed by the Seventh U.S. Circuit Court of Appeals on *liability* grounds.)

A win

In another case, the defendants' rebuttal strategy paid off. The plaintiffs in *Sossikian v. Ennis* sued the defendants for breach of a lease agreement. The plaintiffs operated a gas station on the leased property and claimed that the defendants unreasonably withheld their consent to assignment of the lease in connection with a sale of the gas station business.

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The plaintiffs claimed nearly $1.2 million in damages. Of that amount, $800,000 represented the difference between the lost contract to sell the business for $1.2 million and the gas station's alleged fair market value of $400,000 at the time of the breach. The remaining damages consisted of principal and interest on loans used to pay the gas station's expenses from the time of the breach until the trial date.

The plaintiffs offered testimony by their expert (a real estate broker and a certified appraiser) in support of their valuation of the gas station business. Rather than present an alternative valuation, the defendants used a CPA expert for rebuttal purposes. Among other things, the defense expert testified that:

- He wouldn't have been able to reach a valuation conclusion based on the information considered by the plaintiffs' expert,
- The plaintiffs' expert based his market analysis on "just five comparable properties" and inappropriately used asking prices rather than actual sales prices (the defense expert provided some sources of actual sales data),
- The plaintiffs' expert provided some "general analysis" but offered no analysis "from a purely objective or statistical approach," and
- The plaintiffs' expert relied too heavily on unspecified industry articles to support a large recent drop in the gas station business's value.

On cross-examination, the defense expert acknowledged that he had never valued a gas station before. He also testified that he hadn't valued the business in this case and didn't know whether the outcome would be different if his criticisms and suggestions were considered. Nevertheless, although the

jury found the defendants liable, the plaintiffs were awarded only $43,000.

On appeal, the plaintiffs argued that the jury should have accepted their expert's "uncontradicted" testimony. But the appellate court held that the jury wasn't required to award damages and could reasonably find that the plaintiffs' expert opinion was called into question by the defendants' expert.

Weigh your options

As you can see from the aforementioned cases, the most effective damages defense will vary from case to case. To choose the right strategy, you must consider several factors, including the chances that you'll prevail on liability, the amount of damages at stake, and the strengths and weaknesses of the plaintiff's damages estimate. ◆

1 + 1 = 2

How calculation engagements can provide an *indication* of value

Preparing a formal valuation for a client requires much work on the part of the appraiser. It can, therefore, be costly. But in many situations, a full-blown valuation isn't necessary. That's when an appraiser might suggest using a calculation of value instead. Here's an overview of the difference between valuations and calculations and when it's most advantageous to use a calculation of value.

How they're different

Generally, business appraisal work falls into two categories — valuations and calculations. Formal valuation engagements require more procedures than do calculation engagements.

For example, valuations generate an official "conclusion of value" in conformity with certain professional standards. In contrast, calculations provide an *indication* of value (a calculated value) based on assumptions and procedures to which the client and the appraiser have agreed.

In addition, one of the most time-consuming — and costly — steps in the valuation process is drafting a detailed appraisal report. But a calculation engagement may call for only an abbreviated letter report, numerical exhibits or verbal presentations in lieu of a comprehensive written report.

Situation dictates choice

Calculations can be sufficient when a written report may not be necessary, such as for an owner who's curious about business value for strategic planning or retirement purposes. Calculations also may facilitate settlement talks in shareholder disputes or divorces. Or they might help a client decide whether it's worthwhile to pursue a lawsuit.

Before testifying in court, however, the appraiser is likely to recommend upgrading to a formal valuation report. If settlement appears unlikely, the client probably should opt for a formal valuation report from the get-go.

Take note that calculations may raise a red flag when they accompany gift, estate or charitable donation tax forms. Most valuators recommend a formal report that adheres to IRS guidelines for tax purposes and meets the IRS's Adequate Disclosure requirements. A calculation wouldn't meet those requirements, which can have negative consequences in gift tax situations. This is because the written report typically serves as a valuator's direct testimony, should the return wind up in front of the U.S. Tax Court.

Narrowing the engagement

Clients also can save time and money by omitting specific valuation procedures from a calculation engagement. Or they may specifically prescribe a method they deem most appropriate for the calculation's intended use.

To illustrate: Suppose two disputing partners opt for a calculation — rather than a full-blown valuation report — to facilitate an out-of-court settlement. They specifically agree to omit the guideline public company method when calculating the value of their small private accounting firm. They also stipulate in advance concerning discounts for lack of marketability and control.

However, again, the cost and time savings may be for naught if the partners don't settle. To withstand courtroom scrutiny, calculations generally must be upgraded to formal valuation engagements. If they're not taken to the next level, an appraiser may refuse to testify in court. Be aware, too, that the appraiser's value conclusion after completing the omitted steps or analyses may differ materially from his or her calculation.

Disclosure is key

Some clients have limited access to the subject company's financial data, personnel or facilities. Lack of relevant information can be especially problematic when the client owns a noncontrolling business interest or is a nonmonied spouse in divorce.

But a valuator can perform a calculation without complete access to information. For example, he or she may base the value exclusively on, say, the past two years' tax returns. A calculation also could be performed without interviewing management or conducting site visits. However, all omissions and limitations must be fully disclosed in the calculation letter.

Know the limits

When an appraiser is engaged to perform a calculation, communication is critical. The engagement letter — a legal contract between the client and appraiser — establishes expectations up front. Additionally, valuators specifically list scope limitations in their engagement letters, spreadsheets and written reports. It's imperative that clients and professional advisors understand the limitations of value calculations. Further, in considering whether a calculation engagement is appropriate, the most important factor is the ultimate use (and users) of the appraisal. In some cases, a value conclusion can differ materially from a value calculation.

When it's all said and done

The next time a client requires a business appraisal, consider whether performing a calculation might be a better alternative. After all, it might provide the needed results for less expense. Your valuation advisor can help you make that determination. Be aware, though, that certain circumstances — such as gift and estate tax filings or disagreements that are bound for the courtroom — lend themselves to opting for a conclusion of value. ◆

How do you value a startup company?

It's often said that business valuation is both an art and a science. But when the subject is a new business, the process tends to focus on the "art" side of the equation. Established businesses have track records of earnings and cash flow that can be used to predict future financial performance. If a business doesn't have such a track record, future economic benefits are more difficult to project, and a valuator must look to other factors, many of them subjective, to estimate value.

It's all about the future

Regardless of the type of company involved, valuation is all about the future. A company's value is based on its ability to produce economic benefits — in the form of cash flow, profits or other returns — for its owners and investors. That's why fair market value is commonly defined as the amount at which property would change hands between a willing buyer and a willing seller, when neither party is under any compulsion to buy or sell, and both parties have reasonable knowledge of the relevant facts.

Having a history of revenues and profits enables a valuator or potential investor to predict future financial performance with greater confidence. But a startup's lack of a track record doesn't mean it has no value. It does mean, however, that potential buyers or investors will view the startup's prospects for achieving projected earnings as presenting greater risk. To compensate for that risk, a buyer or investor would demand a greater rate of return, which translates into a lower value.

Management and competitive advantages

Valuators look at a number of factors to estimate a startup's future performance and to gauge the level of risk involved. Among them is the quality of management. Management's skill, experience and performance record with similar businesses is one of the most important predictors of future success.

In addition, management's business plan and financial projections or forecasts are critical factors. Although the valuator may need to discount internal projections or forecasts to reflect management's natural optimism, no one knows the company's products and services, the industry and the market better than the company's founders and senior executives. The valuator will ultimately use management's projections, assuming that they're realistic and based on reasonable assumptions.

Appraisers also look at the experience and value of comparable companies, industry and market statistics, and the

value of intellectual property or other assets that give the company a competitive advantage.

Time, liquidity and state of development

Another critical factor is time. How long will it take before a startup is expected to become profitable? In general, the shorter the time frame, the more valuable the company. That's because a buyer or investor need not wait as long to achieve an "exit" and there's less risk involved.

A related factor is liquidity. That is, a startup may not have begun to generate profits, but does it have sufficient working capital and other liquid assets to fund current operations and absorb short-term losses?

So, a valuator will consider a company's stage of development. For example, a company in the earliest stages — with little more than an idea and perhaps some "friends and family" financing — is less valuable than one with well-developed products and services and financing from venture capitalists or other investors.

The involvement of venture capital firms or other professional investors is an important indicator. These investors perform thorough due diligence in scrutinizing a company's management team, business plan and financial projections, providing greater confidence in a company's ability to succeed and meet its earnings targets. ◆

ACFE SURVEY PROVIDES INSIGHTS ON FRAUD PREVENTION AND DETECTION

Since 1996, the Association of Certified Fraud Examiners (ACFE) has produced a biennial *Report to the Nation on Occupational Fraud and Abuse*. In its 2010 report, the ACFE changed "Nation" to "Nations" to reflect the expansion of its survey (previously limited to the United States) to CFEs worldwide. The fraud estimates in the 2010 report are based on data compiled from a study of 1,843 cases of occupational fraud in 106 nations that occurred between January 2008 and December 2009.

Changing the survey's scope had relatively little impact on the results. Although there were some variations in the data from region to region, overall fraud patterns were similar worldwide. Other notable findings include the following:

- Asset misappropriation schemes were the most common type of fraud but were also the least harmful, with a median loss of $135,000. Financial statement fraud schemes were infrequent but caused the most damage, with a median loss of more than $4 million.
- Frauds committed by high-level perpetrators — such as owners or executives — were three times as costly as those committed by managers and nine times as costly as those committed by employees. They also took much longer to detect.
- Whistleblower tips were, by far, the most common method of detecting fraud.
- Audits and other antifraud controls are relatively ineffective in uncovering fraud, but they serve as a deterrent (surprise audits, in particular). They also reduce the magnitude of fraud losses and the duration of fraud schemes.
- More than 85% of fraud perpetrators had never been previously charged or convicted for a fraud-related offense.
- Perpetrators often display warning signs — most commonly, "living beyond their means" and "experiencing financial difficulties." So, it's important for organizations to train their people to spot the red flags.

You can download the ACFE's full report at acfe.com/rttn/2010-rttn.asp.

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