

Valuation & Litigation Briefing

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Small changes, big impact

The growth rate is an important part of lost profits estimates

One of the more challenging aspects of calculating lost profits is determining the rate at which a plaintiff's revenue would be expected to grow during the damages period. Depending on the amount at stake and the length of the period, small adjustments to the growth rate can have a big effect on the outcome.

Where growth fits in

Courts generally view the "before-and-after" method as one of the most reliable ways to estimate lost profits. This damages theory is based on the assumption that the defendant's wrongful act is the cause of any decrease between the plaintiff's revenue before the injury and that after it.

Typically, the expert begins with revenue during a pre-injury "benchmark" period and applies a growth rate to estimate what the company would have earned during the damages period but for the defendant's conduct. The plaintiff's lost revenue is generally equal to the difference between this

amount and the plaintiff's actual earnings during the damages period.

In computing lost profits, the expert subtracts costs that are avoided as a result of the injury to the business. Adjustments also must be made to reflect any factors other than the defendant's conduct that contributed to lost profits (such as weak economic conditions or increased competition from outside sources).

If the injury is limited to a particular division or product, it may make sense to look at growth data specific to that division or product.

Experts consider several factors when estimating the growth rate, including:

- ◆ Company-specific factors, such as historical growth patterns, demand for products and services, customers, contracts, technology and management experience,
- ◆ Growth projections that management prepares in the ordinary course of business,
- ◆ Average growth rates in the industry and geographic area, and
- ◆ Economic and industry trends.

Generally, a company's historical growth rates during the benchmark period may be a good predictor of future growth, but they shouldn't be relied on without further analysis. If the injury is limited to a particular division or product, it may make



sense to look at growth data specific to that division or product.

How to support the growth rate

Courts are unlikely to accept assumptions about growth unless the expert can establish a clear link between the data used to determine the growth rate and the facts of the case at hand. For example, in *R.F.M.A.S., Inc. v. So*, the U.S. District Court for the Southern District of New York excluded the testimony of the plaintiff's damages expert in a copyright and trade dress infringement case.

Among other errors, the expert forecast growth for a jewelry store (the plaintiff) by plugging data about the past sales of *all* of its products into software that generated a growth curve. The expert defended his method by describing it as "very common" and a "classic" tool for projecting future revenue for new products. Although the expert claimed the method had an "extraordinarily high" success rate for small restaurants, "he had no idea what the success rate was for new products in the jewelry industry."

How (not) to pick a historical rate

Growth rates tend to fluctuate over time. So, it's critical for a damages expert to examine factors that influence these changes and select a growth rate that's a reliable predictor of future growth. For example, in *Manpower Inc. v. Insurance Company of the State of Pennsylvania*, a June 2006 building collapse caused the plaintiff to incur business interruption losses. The U.S. District Court for the Eastern District of Wisconsin found that the plaintiff's expert had used a sound approach to estimate damages overall. But it excluded the expert's damages testimony based on his selection of a growth rate.

The expert could have relied on the subsidiary's 4.79% annual growth rate from 2003 to 2006 or its 3.8% growth rate from January 2005 to May 2006. Instead, he chose a 7.76% growth rate, reflecting growth in the five months immediately preceding the collapse over the same period in the previous year. The expert reasoned that recent

Growth assumptions count!

Growth rates and other assumptions can have a significant effect on an expert's conclusion. To illustrate, consider *Knox v. Taylor*. In this Texas appellate court case, both experts used essentially the same model to calculate lost profits — but they arrived at materially different conclusions:

- ◆ The plaintiff's expert used a 25% growth rate and a 7% discount rate, resulting in approximately \$11 million of estimated damages.
- ◆ The defendant's expert used a 2.8% growth rate and a 30% discount rate, resulting in only \$1 million of estimated damages.

To avoid being perceived as "hired guns," experts should make assumptions based on objective empirical evidence, along with analysis of historical facts and external trends.

growth was attributable to a new-and-improved management team, which would achieve similar growth in the future.

The court rejected this approach, observing that the expert based his assumptions solely on discussions with the new management team. He failed to conduct any analysis to determine whether industry conditions or other factors had contributed to its growth spurt.

Thorough analysis required

Selecting a growth rate takes more than simply applying industry averages, plugging numbers into canned software or extrapolating a company's historical growth curve. A damages expert must thoroughly analyze the factors that influence expected revenue growth for the case at hand. Failure to do so can jeopardize the admissibility of an expert's testimony on damages. ■

How HIPAA affects lawyers and their experts

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was designed to safeguard patients' protected health information (PHI). HIPAA issues may arise in a variety of contexts, including valuations of covered entities, litigation by or against health care providers, and divorce cases in which one spouse has access to the other spouse's PHI. To avoid potentially significant civil and criminal penalties, lawyers and their expert witnesses and consultants should understand their HIPAA obligations.

The basics

Originally, HIPAA applied only to "covered entities," such as health plans and health care providers. But it was later amended to encompass lawyers, accountants and other "business associates" who gain access to PHI through their work for a covered entity. The act also extends to a business associate's subcontractors, including expert witnesses and consultants who receive, maintain, create or transmit PHI as part of their work.

HIPAA's privacy rule mandates that any disclosure of PHI be limited to the minimum necessary to accomplish the intended purpose.

With regard to PHI, the law contains two important rules:

The Privacy Rule. This provision requires attorneys and their experts to safeguard and limit disclosure of electronic and nonelectronic PHI. They also must comply with certain rules regarding electronic transmission of such information.

The Security Rule. This provision applies only to electronic PHI. It addresses three types of safeguards: 1) administrative (such as security



awareness and training, workforce security, and backup procedures), 2) physical (such as controlling access to your facilities or individual workstations), and 3) technical (such as user identification, encryption, automatic logoff and other access controls).

In addition, covered entities that share PHI with lawyers, expert witnesses or consultants — as well as business associates that share PHI with subcontractors — must obtain a business associate agreement (BAA) from the recipient that obligates the business associate to comply with the privacy and security rules, limits the use of PHI in the engagement and otherwise governs the parties' respective obligations.

Limited disclosure

HIPAA's privacy rule mandates that any disclosure of PHI be limited to the minimum necessary to accomplish the intended purpose. In many cases, experts can do their work without receiving PHI.

For example, when valuing health care providers, business valuation experts consider a variety of information, including services provided to patients, payer mix, units, charges, payments, adjustments by service, adjustments by insurer, and aged accounts receivable. This information

can usually be provided to the expert without including patients' PHI.

Attorneys and experts must draft their data requests carefully to avoid inadvertent disclosure of PHI. In light of the HIPAA laws, you can no longer provide a "data dump" of paper and electronic files and leave it to the expert to identify what's relevant.

If it's necessary for an expert to access PHI, he or she must sign a BAA and implement policies,

procedures and other measures to comply with HIPAA's privacy and security rules.

Handle with care

The penalties for violating HIPAA can be severe, but they're avoidable by limiting disclosure of PHI to the bare minimum, complying with HIPAA's privacy and security rules when disclosure is unavoidable and carefully spelling out the parties' respective obligations with regard to PHI. ■

In re Marriage of Cheng

Recent case addresses double-dipping debate

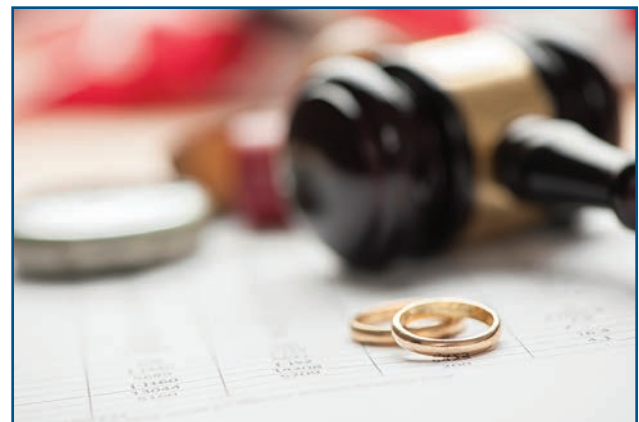
Depending on state law, the issue of "double dipping" may arise when one spouse owns a business and the court awards half of its value to the other spouse plus spousal maintenance based on future business income. The argument against such an award is that the value of a business is derived from its future income, so basing maintenance on the same income stream constitutes an impermissible double recovery.

In *Cheng*, however, the court found a critical distinction between a business that's a going concern and one that's a "diminishing asset." Here's how that distinction affected the property settlement.

A lucrative consulting business

The husband owns a consulting business, Fast Forward Media (FFM), which grew considerably in the years before the divorce. FFM's gross revenue increased from \$275,000 in 2009 to \$1.545 million by 2013. The husband took home more than \$940,000 from the business in 2013.

At trial, both spouses presented expert testimony on the value of FFM. The experts used the



capitalization of excess earnings method, applying four steps to determine value:

1. Project future income.
2. Subtract the husband's replacement income (that is, market compensation for his services).
3. Subtract other operating expenses and taxes.
4. Divide by a capitalization rate.

The trial court split the difference between the experts' conclusions, valuing FFM at \$3.6 million.

The wife was awarded half of that value to be paid in installments over 15 years. The court also awarded her \$20,000 of monthly maintenance for eight months, followed by \$15,000 for two years and \$10,000 for another year.

No double dipping

On appeal, the husband argued that the maintenance award constituted an improper double recovery because both maintenance and the property distribution were based on FFM's future income. The appellate court for the state of Washington disagreed.

It clarified that double dipping occurred in two previous divorce cases because the marital estates included "diminishing assets" (a salvage business and a retirement account) that wouldn't generate significant future income. With no other source of

funds, those owner-spouses would be unable to pay the maintenance award without eroding their interests in the assets.

Conversely, in *Cheng*, FFM was a going concern entity that was expected to continue growing. The husband would have ample income to pay maintenance without eroding FFM's value.

A matter of fairness

Like many issues in divorce, double dipping ultimately boils down to the concept of *fairness*. In Washington and many other states, courts have broad discretion to determine the amount and duration of a maintenance award as long as the outcome is equitable to both sides. Experts and attorneys closely review applicable state laws and relevant court cases to ensure this issue is handled properly. ■

Building a fraud case

When business owners suspect an employee is stealing assets or cooking the books, do-it-yourself fraud investigations can be perilous. It's important for owners to work with an attorney and a forensic accounting specialist to ensure that the case is handled properly and evidence is preserved and admissible. Here's some

guidance on the investigative process, including how experts conduct interviews and gather evidence.

Plan the interview

Skilled interviewers trained in fraud detection know how to spot fraud warning signs, detect deception and pin down suspicions by talking with suspects and their co-workers. The specific information an expert asks employees depends, in part, on the circumstances and individuals involved. But experts generally rely on various financial and accounting standards to frame their questions.

For example, the American Institute of Certified Public Accountants' Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, provides guidance that's useful outside the audit context. According to SAS 99, expert interviewers should ask members of management direct questions



about such issues as specific knowledge of any fraud ploys (or allegations of fraud), understanding of the company's fraud risks, and programs and controls that have been implemented to mitigate specific fraud risks or to otherwise help prevent, deter and detect fraud.

SAS 99 suggests that a fraud interviewer speak not only with a company's management and audit committee, but also with anyone who can provide information helpful in identifying risks of financial fraud. Thus, interviewees might include employees at all levels who are involved in initiating, recording or processing complex or unusual transactions, as well as operating personnel not directly involved in the financial reporting process.

Rank-and-file workers can provide a valuable perspective that's different from those of directors or overseers of the financial reporting process.

Rank-and-file workers can provide a valuable perspective that's different from those of directors or overseers of the financial reporting process. Their responses might corroborate management's responses or indicate that management is wrongly overriding internal controls.

Interview employees

The interview process usually starts with introductions and rapport-building. The interviewer may explain the purpose of the interview and ask questions to which the answers are already known, so he or she can observe the subject's demeanor and degree of candor.

Then the interviewer transitions to more specific questions. He or she encourages the interviewee to do most of the talking — and may even use silence as a tool, as people being interviewed frequently try to fill conversation gaps. The employee may disclose information unintentionally, provide clues or suggest an unplanned, but fertile, line of questioning.

Before ending the interview, the expert will confirm the information elicited. He or she also asks open-ended questions about other individuals to interview and areas to explore.

Gather evidence

Another key task experts perform during a fraud investigation is collecting evidence from the company's internal documents, including:

- ◆ Personnel files,
- ◆ Internal phone records,
- ◆ Emails,
- ◆ Financial records,
- ◆ Security camera recordings, and
- ◆ Physical and IT system access records.

Locating this evidence may require the expert to perform computer forensic examinations. Experts also consider external sources of evidence, such as public records, customer and vendor information, media reports, and private detective reports.

Forensic accounting specialists have been trained on how to review and categorize internal and external evidence, conduct computer-assisted data analysis, and test various hypotheses. Be sure your expert is documenting and tracking every step in the investigation.

When the expert is finished conducting interviews and gathering evidence, he or she will report any findings. You may determine the appropriate format for the report and how distribution will be affected by the need to protect legal privileges and avoid defamation.

Hire a professional

Despite their best prevention efforts, businesses may become victims of white collar crime. When fraud strikes, the use of an outside forensic expert, along with an understanding of the investigative process, can facilitate matters and minimize potential losses. ■



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- Purchase or Sale of Business
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