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Slutsky v. Slutsky
Experts battle over value of law firm in New Jersey divorce

415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
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How to protect expert testimony from *Daubert* challenges

It's been 25 years since the U.S. Supreme Court decided *Daubert*. This case officially made federal district court judges the "gatekeepers" of expert evidence. Solid expert testimony can often make or break a case. So it's critical for attorneys to take steps to help ensure that their experts will withstand *Daubert* challenges.

Case law trilogy

In 1993, *Daubert* established a two-pronged test for admissibility. First, is the reasoning or methodology underlying the testimony scientifically valid? Second, can the reasoning or methodology properly be applied to the facts of the case? In other words, an expert's methodology must be 1) reliable, and 2) relevant.

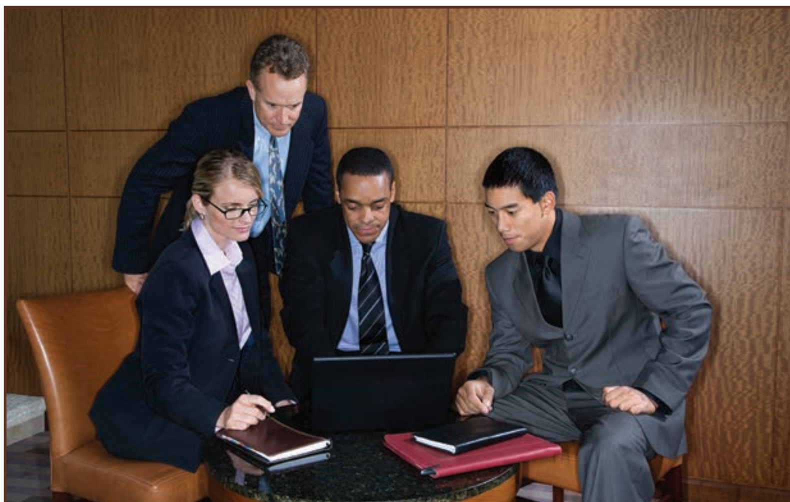
This landmark case also identified four nonexclusive factors to consider in determining reliability:

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 or technical community?

Since *Daubert*, the Supreme Court has decided two more cases that refined this framework. In *General Electric*, the Court directed appellate courts to defer to a district court's ruling on the admissibility of expert testimony and reverse it only if it represents an abuse of discretion.

Then, in *Kumho Tire*, the Court clarified that the *Daubert* standard applies to nonscientific testimony. This case opened the door for *Daubert* challenges against financial experts, including accountants, economists and business valuation professionals.

When financial experts are disqualified under *Daubert*, it's usually on grounds of *reliability*. For example, an expert may be disqualified because he or she relied on insufficient data or used methods that aren't generally accepted.



But some financial experts have been excluded on *relevance* grounds. For example, an expert's testimony may be excluded if it's outside of his or her area of expertise or wasn't tied to the specific facts of the case.

Best practices

To confront *Daubert* challenges, hire experts whose academic credentials, certifications and experience correspond with the relevant issues of your case. For example, be aware of the different skillsets of liability and

Daubert challenge targets expert's qualifications

In *Washington v. Kellwood Co.*, the plaintiff claimed that the defendant had breached a license agreement to manufacture, promote and distribute sports apparel. The defendant brought a *Daubert* challenge against the plaintiff's damages expert — a CPA with extensive business valuation and forensic accounting experience — arguing that he lacked expertise on the apparel industry and marketing.

However, the court decided that the expert was qualified to testify about the apparel industry. It noted that the defendant's argument "would, in essence, disqualify all CPAs from conducting a damage assessment unless they first acquire 'expertise' in the specific industry in which they purport to opine on damages."

But the court determined that the expert's opinions about the defendant's marketing practices were outside the scope of his expertise. The court ruled, "Neither [his] skill, experience, training, or education gives him specialized knowledge about what are or are not reasonable marketing practices."

damages experts, and use them accordingly. Never ask an expert to testify outside of his or her area of expertise.

It's particularly dangerous when financial experts venture into legal territory. For instance, while a forensic expert can safely testify about hidden assets or other evidence of fraud, he or she should avoid making any legal conclusions about whether fraud occurred.

Also, let experts work independently. Experts who rely too heavily on work done by others or on data furnished by others (say, an attorney or the client) run the risk of exclusion.

But don't be afraid to question your expert's methods and assumptions for reliability. Ask yourself: Will the expert's analyses meet the four nonexclusive factors to consider in determining reliability? Many experts use multiple methods to arrive at their conclusions. That way, if one method fails a *Daubert* challenge, an alternative method may still pass muster.

In addition, be critical of whether your expert considered all of the relevant data to draw his or her conclusions. If unused data exists, ask if the expert needs to consider it before finalizing his or her report. Experts who ignore relevant data may be perceived as "hired guns," especially if the data is unfavorable to the client's financial interests.

Finally, discuss your theory (or theories) of recovery with your expert to ensure everyone's on the same page. Experts are sometimes excluded because their damages evidence didn't correspond with the theories of recovery pursued at trial.

Communication is critical

If opposing counsel hits you with a *Daubert* challenge, start by reviewing case law involving similar experts. Doing so may alert you to other potential vulnerabilities in your expert's qualifications and analyses.

Also consider your expert's communication skills. Even if an expert's qualifications are unimpeachable and methods are beyond reproach, he or she must have the ability to communicate his or her opinions clearly and concisely. Work with your expert to ensure that he or she knows how to explain all relevant assumptions and variables to the court. ■

Quantifying lost profits for business interruption claims

Business interruption insurance can provide much-needed cash flow when a hurricane, flood, fire or other disaster strikes. But filing a claim requires detailed analysis and documentation. An outside financial expert can be an invaluable resource, allowing the owner of the damaged business to focus on recovery efforts.

What's covered?

Most business interruption policies require the insured to file a detailed "proof of loss" within a short period (30 days, for example) after a loss occurs. But before estimating losses, it's critical to review the scope of coverage.

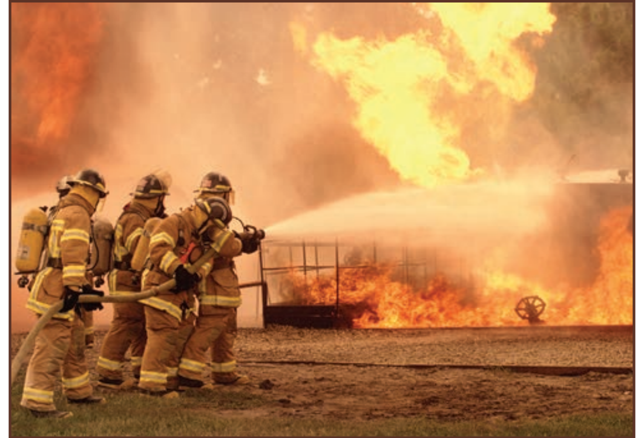
Policies typically reimburse the insured for lost business income (profits) during the loss period. Some also offer more extensive coverage that may include:

Extraordinary expenses. Some policies will reimburse the insured for repairing damaged inventory and equipment, as well as the cost of operating the business at a temporary location until the original location is restored.

Although there are many actions a business can take to limit its damages, not all of them are reasonable.

"Denial of access" losses. This can occur when a natural disaster or other incident causes governmental authorities to block access to a company's property for security reasons, even if the property isn't damaged.

Rebuilding costs. Depending on the policy language, some courts have found that the insured should be reimbursed for the extra cost of safety enhancements or other improvements that would help avoid a similar business interruption in the future.



Some policies may even cover the cost of hiring a financial expert to quantify losses. That's because carriers appreciate the objectivity and thorough analysis that experienced experts bring to the claims process, especially when they're overwhelmed by a major disaster.

How are losses calculated?

Once the scope of coverage is set, it's time to compile a comprehensive, but reasonable, claim. One of the biggest challenges is establishing the insured's "lost business income." An insured's method of accounting can affect how this metric is calculated.

For example, if its financial statements are prepared using the cash method, the carrier's first impulse might be to calculate the loss on that basis. But the insured's expert may be able to demonstrate that the accrual method more accurately reflects its damages.

Carriers also tend to focus on a company's track record to project what its revenues would have been but for the interruption. A financial expert who's familiar with the business and its industry

may be able to point to certain factors — such as industry trends, market changes or company-specific developments — that indicate a higher level of growth going forward.

Determining continuing and noncontinuing costs is another critical issue. Most business interruption policies compensate the insured only for the former. In other words, to calculate lost profits, continuing costs are recoverable because they're incurred despite the business interruption. Noncontinuing costs — such as discretionary marketing expenses that are avoided during the restoration period — aren't recoverable.

For example, suppose that a flood causes a restaurant to shut down for a month. An expert estimates that the restaurant lost $60,000 in profits plus $25,000 in continuing costs, including rent and managers' salaries, during the loss period. So, it files a claim for $85,000. When calculating lost profits, the goal is to make the insured "whole" again, but an accurate claim hinges on a careful review of the policy's terms and definitions.

The insured's duty to mitigate its loss is an area that's ripe for controversy. Although there are many actions a business can take to limit its damages, not all of them are reasonable. For example, a damaged restaurant might be able to reduce its loss by laying off its salaried managers. But that may not be a smart move if the business interruption is relatively short, the cost of hiring replacements when normal operations resume is high, and the loss of experienced staff would hurt the business in the long term.

Timing is essential

To survive a business interruption, damaged businesses need to recover quickly. An experienced financial expert can help put together a persuasive, well-documented and timely insurance claim that maximizes and expedites payments from the carrier. ■

Taxes matter

Plan ahead to minimize tax liabilities in damages litigation

Payment of a damages judgment or settlement almost always has tax consequences for plaintiffs and defendants. The appropriate tax treatment typically depends on the nature of the underlying claim or claims. Here's an overview of the tax issues that may arise in damages litigation, along with some possible ways to improve tax results throughout the litigation process.

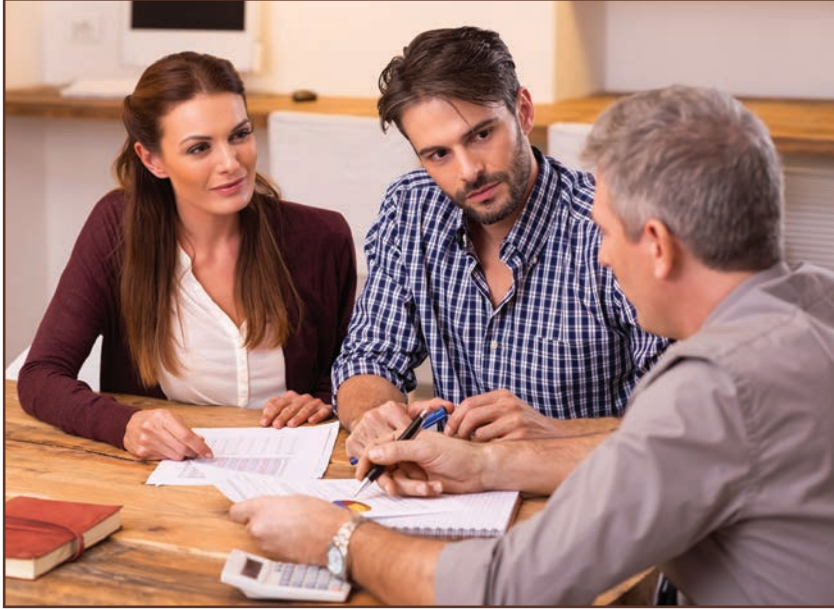
How do taxes impact litigation?

Taxes can have a major impact on how much a plaintiff is awarded — or how much a lawsuit ultimately costs a defendant. For example, let's suppose a client with a marginal effective tax rate of 40% receives a $1 million damages award. If the judgment is taxable as ordinary income, the client will receive only $600,000 after paying taxes. But if the judgment is characterized as nontaxable, the client will receive the entire amount.

Most cases aren't this simple. A case may involve multiple issues and multiple categories of damages, each with different tax implications. But a little planning throughout the litigation process can help ensure the most tax-favored outcome.

How are damages taxed?

Generally, the taxation of judgments and settlements is based on the "origin of the claim." For



For example, in litigation involving real property, a defendant may be required to capitalize rather than deduct a payment. And in certain cases involving investments, a defendant's payment may be treated as an expense that's deductible against only investment income.

How can attorneys plan ahead for tax issues?

You can improve tax outcomes by allocating judgments or settlements, to the extent possible, to claims that are classified as 1) tax-free or lower-taxed income to plaintiffs, and 2) tax-deductible payments for defendants. Although litigants have limited influence over the allocation of a judgment, the chances of a tax-favorable outcome may increase if you draft the complaint and develop the case in a way that supports the preferred allocation — but don't let tax issues compromise your potential recovery.

Generally, the taxation of judgments and settlements is based on the "origin of the claim."

When negotiating a settlement, the parties should discuss the tax implications of the settlement agreement and allocate the proceeds in a manner that generates the greatest tax benefits. As long as your allocation has economic substance, the courts and the IRS will generally respect it.

Need help?

Tax issues are often outside of an attorney's comfort zone. Moreover, tax rates and rules regarding deductions could change if major tax reform is passed. Fortunately, a tax advisor can help you navigate potential tax issues during litigation and develop strategies that minimize adverse tax consequences related to damages awards. ■

example, damages for lost wages or profits are usually taxed as ordinary income. Payments of wages also may trigger payroll tax obligations for both parties. Damages for injury to a building or other capital asset might be treated as a combination of nontaxable return of capital (up to the plaintiff's tax basis) and capital gain.

There's an important exception for damages received on account of "personal physical injuries" and "physical sickness," and the line between physical and nonphysical injuries isn't always clear. When a plaintiff recovers compensatory damages in connection with an auto accident, slip and fall or other physical injury, the damages are tax-free, even if they represent lost wages or other items that ordinarily would be taxable. The theory is that the plaintiff should be returned to the original position or state that existed before the injury occurred. (Also, recovery of medical expenses is tax-free, regardless of whether an injury is physical.)

What about defendants?

It's also important for defendants to consider the tax implications of paying judgments and settlements. Personal liabilities generally aren't tax deductible. But businesses can usually deduct these payments as business expenses — although the deductions may be limited under certain circumstances.

Slutsky v. Slutsky

Experts battle over value of law firm in New Jersey divorce

The Appellate Division of the New Jersey Superior Court recently decided a divorce case that serves as a primer for valuing a partnership interest in a law firm — particularly the goodwill component — for purposes of equitable distribution. Here's why the appellate court reversed and remanded this case to the trial court.

Round one: Wife wins

The husband was an equity partner in a large law firm. He specialized in complex tax matters, billing more than 2,000 hours per year. The firm's shareholder agreement calculated partners' interests based on their termination credit accounts (TCAs).

The wife's expert valued the husband's TCA at just over $350,000 and added nearly $1.2 million for goodwill. But her expert adjusted both figures downward at trial.

On the other hand, the husband's expert valued the TCA at $285,000 and concluded that there was no *separate* goodwill component. The trial judge rejected this opinion, finding it "incredible" that the firm "had no goodwill value." The court simply accepted the wife's expert's unadjusted valuation without explanation — even though the expert adjusted his conclusion during cross examination.

Round two: Husband gets the KO

The appropriate treatment of goodwill in divorce cases varies from state to state, requiring experts to consult with legal counsel. The appellate court's opinion provides valuable insight that may apply in New Jersey and jurisdictions with similar laws. The value of goodwill is subject to equitable distribution in New Jersey, similar to the interpretations in several other states.

One way to evaluate goodwill is to calculate the amount by which the husband's earnings exceeded reasonable compensation of a similarly situated employee. However, the trial judge failed to analyze the differences in the experts' opinions on reasonable compensation, which drove their value conclusions.

The appellate court held that the trial judge should have made specific factual findings to support the value of goodwill. And it should have explained why corrections to the wife's expert's valuation were ignored.

Clearly, the trial court misunderstood the husband's expert's conclusions. Rather than suggest the firm had no goodwill, the expert asserted that the partners' TCAs accounted for goodwill. In addition, because the husband's compensation matched his earning capacity, there was no additional goodwill component.

This case also reminds us that *equitable* isn't necessarily synonymous with *equal*. The trial judge awarded the wife 50% of the husband's interest, but failed to make any findings supporting that result.

Back to the drawing board

The appellate court concluded that valuing a law firm partnership interest demands a "nuanced valuation methodology" with specific factual support. The opinion provides detailed guidance to help the trial court understand how to value the business interest on remand. ■

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415 Sargon Way • Suite J • Horsham, PA 19044
Tel: (215) 675-8364 • Fax: (215) 675-3879
www.wm-cpa.com

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