

Valuation & Litigation Briefing

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Endless River Tech. LLC v. TransUnion, LLC

Shaky expert testimony topples \$18 million damage award

In *Endless River Technologies LLC v. TransUnion, LLC*, the U.S. Court of Appeals for the Sixth Circuit affirmed the U.S. District Court's order overturning an \$18 million jury award, albeit on different grounds. The district court found that the awarded damages constituted lost profits, which were a form of consequential damages barred under the parties' contract.

The appellate court didn't address the issue of whether the damages were consequential. Instead, it focused on the lower court's denial of the defendant's motion to exclude the plaintiff's damages expert, which it found dispositive. The appellate court held that the expert's testimony should have been excluded as both irrelevant and unreliable. This left the plaintiff with "insufficient evidence to prove any amount of damages above the zero dollars awarded by the district court."

Background

The plaintiff was a start-up company formed to develop and market a platform called "Quote

Exchange." The platform served as an online marketplace where insurance companies buy and sell insurance leads. In late 2012, the company created a "pre-development profit projection model" that estimated no revenue in the initial development year, \$16.7 million in revenue during the first year on the market and approximately \$213 million by year four.

On March 31, 2014, the plaintiff entered into a contract with the defendant. Under the terms of the contract, the defendant would fund the development of Quote Exchange, and the plaintiff would act as product designer and technical consultant.

From 2014 to 2017, the parties worked to bring the platform to market, but they were dissatisfied with the platform's performance. It generated only \$240,000 in revenue between 2016 and 2018. The defendant terminated the contract on April 2, 2018. After the termination, the plaintiff continued to believe that the platform had revenue-generating potential. A battle ensued over whether the defendant was required to return the platform's source code to the plaintiff, resulting in this lawsuit. According to the plaintiff, the defendant's refusal to return the source code violated the contract and deprived the plaintiff of the ability to market and monetize the platform. It also claimed that the window for doing so had closed, rendering the source code worthless.

Venture capital approach

The plaintiff hired a valuation expert who applied the venture capital approach to estimate damages. This technique calculates a start-up's



Projection vs. forecast

The court in *Endless River* (see main article) excluded a valuation expert's damages conclusion as speculative, because it was based on the plaintiff's revenue projections, which varied significantly from the start-up's actual results. But is it *ever* appropriate for valuers to rely on projections? And what's the difference between a projection and a forecast?

In most valuation contexts, forecasts are more appropriate. Forecasts estimate *expected* future performance based on historical data, current trends and existing management plans. In contrast, projections predict future performance based on hypothetical *what-if* scenarios. Projections may be used in connection with strategic planning, internal decision-making and merger negotiations. But most other valuation purposes call for forecasts, which reflect reasonable expectations regarding a company's future cash flows or other financial results.

The terms are often used interchangeably. So, when evaluating management's predictions about future financial performance, it's important to assess whether they're forecasts or projections, regardless of how they're labeled.

value based on its expected future revenue. The starting point for the expert's analysis was the plaintiff's estimated revenue from 2014 to 2018 (\$213 million). Then he:

- Applied a multiple of 1.1 times revenue, based on comparable transactions, to arrive at an "enterprise value" of roughly \$234 million in 2018,
- Adjusted the 2018 enterprise value, using a 70% discount rate to reflect perceived market risk, to arrive at an adjusted enterprise value of approximately \$18.9 million on March 31, 2014 (the date when the parties signed the contract), and
- Applied a "revenue growth rate," based on comparable transactions, to arrive at a value of \$59 million on December 1, 2021 (the date of the expert's report).

The expert concluded that the plaintiff's damages equaled what the platform's value would have been on December 1, 2021, but for the defendant's alleged breach of the contract. Later, he revised his damages conclusion to approximately \$55 million as of September 12, 2022 (the trial date).

Expert testimony rejected

The appellate court described the expert's testimony as "riddled with defects." It concluded that

the district court should have excluded the expert's testimony under Federal Rule of Evidence 702 as both irrelevant and unreliable.

The court said that the testimony lacked relevance because the expert valued the platform as of March 2014 and September 2022. But the appropriate measure of damages was the platform's value on April 2, 2018 (the date the contract was breached). Although the expert testified during the Daubert hearing on his testimony's admissibility that he measured damages as of April 2, 2018, the court found that this testimony contradicted his reports and his prior sworn statements.

The court also found the expert's testimony unreliable because 1) he relied on the plaintiff's projections without independently vetting the data, and 2) the projections were speculative. It highlighted the "stark gap" between the plaintiff's revenue projections and the platform's real-world performance.

A tough lesson

The court in *Endless River* sent a clear message: Even if a plaintiff may arguably be entitled to some damages, it can end up with nothing if its expert's testimony is speculative or fails to align with the relevant measure of damages. In this case, the plaintiff learned that lesson the hard way. ■

Tax Court unwinds deathbed FLP transfer

A family limited partnership (FLP) can be a powerful tax and financial planning tool. However, a recent U.S. Tax Court case — *Estate of Fields* — illustrates how an FLP's tax benefits can be lost if it's formed shortly before death and primarily designed for tax reduction.

Last-minute planning

The decedent in this case was diagnosed with Alzheimer's disease in early 2011. Shortly before her diagnosis, in 2010, she appointed her great-nephew as her agent under a durable power of attorney. In May 2016, as his great-aunt's health was rapidly declining, the agent made several estate-planning moves on her behalf. First, he formed AM Fields Management, LLC (the LLC), with himself as the sole member and manager. Then he formed AM Fields, LP (the FLP), with the LLC as the general partner and his great-aunt as a limited partner.

Next, he transferred \$17 million of his great-aunt's assets (most of her wealth) to the FLP in exchange for a 99.941% limited partner interest. The LLC also contributed \$1,000 to the FLP in exchange for a 0.0059% general partner interest. His great-aunt died less than a month after the transfers were made.

Post-death steps

The agent hired a valuation professional to appraise the decedent's limited partner interest. It was valued at approximately \$10.8 million, reflecting a 15% discount for lack of control and a 25% discount for lack of marketability. The interest's appraised value was reported on her timely filed estate tax return.

The decedent hadn't retained sufficient liquid assets outside of the FLP to cover the \$1.45 million in cash bequests and \$4.6 million in estate taxes.



Therefore, the FLP distributed the necessary funds to pay these expenses.

The IRS issued a notice of deficiency, determining that, under Internal Revenue Code Section 2036(a), the undiscounted value of the assets contributed to the FLP should have been included in the decedent's estate. Sec. 2036(a) states that the value of property transferred before death is included in the estate if the decedent retains either 1) the possession or enjoyment of, or the right to income from, the property, or 2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or its income. The IRS also assessed a 20% accuracy-related penalty for the underpayment of tax.

Tax Court ruling

The U.S. Tax Court ruled in favor of the IRS. The great-nephew acted as the decedent's agent under the power of attorney and controlled the FLP's general partner with full discretion to make proportionate distributions. So, until she died, the decedent "effectively held the right to virtually all of the income from her transferred assets."

The court also held that she retained enjoyment of the assets, finding an implicit agreement between her and her agent to make partnership distributions to satisfy her debts. Finally, she had the right, in conjunction with her agent, to dissolve the partnership, liquidate its assets and distribute cash to herself.

The court noted that Sec. 2036(a) provides an exception for transfers that constitute a bona fide sale for adequate consideration. But a sale isn't considered bona fide when there's no legitimate nontax purpose for the transfer. In *Fields*, the estate offered several plausible nontax purposes, including protecting the great-aunt from financial elder abuse and streamlining asset management. However, the court found it more likely that these purposes were "post hoc theoretical justifications" rather than "actual motivations," given the decedent's declining health.

A heavy burden of proof

As *Fields* demonstrates, taxpayers face a heavy burden of proof when claiming that end-of-life transfers are bona fide sales. As a result, FLPs formed shortly before death rarely withstand IRS scrutiny. ■

3 FAQs about the cost approach

A company's balance sheet lists its assets and liabilities, making it a natural starting point for valuing certain types of businesses. The cost (or asset) approach focuses squarely on this snapshot. Rather than discounting future earnings or comparing pricing multiples based on sales of similar companies, the cost approach derives a business's value from the difference between everything it *owns* (assets) and everything it *owes* (liabilities). Here are answers to three common questions related to this approach.

1. Why does book value differ from fair market value?

Figures reported on a company's financial statements (book values) rarely match what hypothetical willing buyers would pay, and hypothetical willing sellers would accept, in the marketplace (fair market values). Several factors contribute to this mismatch, including:

Historic cost accounting. Under U.S. Generally Accepted Accounting Principles (GAAP), assets



may require separate appraisals from outside specialists.

2. When is the cost approach most useful?

The cost approach is particularly helpful for asset-holding companies and small manufacturers whose value tends to be driven by tangible (“hard”) assets. It can also provide a practical valuation floor — a baseline below which a seller is unlikely to accept, absent financial distress. For this reason, the cost approach is often relevant when valuing businesses facing reorganization or liquidation.

are generally recorded at historical cost and then adjusted over time for depreciation, amortization or impairment. The value of assets that appreciate, such as real estate or acquired intangible assets, may be understated on a company’s balance sheet.

Unreported intangible assets and liabilities. Internally generated intangibles (such as customer lists, brands, proprietary processes and goodwill) don’t appear on GAAP balance sheets unless acquired from another company. Similarly, some contingent liabilities, such as pending lawsuits or tax claims, may not be reported.

Cash or tax-basis reporting. Omissions can be even greater for private companies that don’t follow GAAP. These entities may exclude key line items, such as accounts receivable or accounts payable, from their balance sheets, and may use accelerated depreciation methods that undervalue fixed assets.

A valuation professional will identify and value *all* of the company’s assets and liabilities, including those not reported on the balance sheet. Each item is then adjusted to reflect the appropriate standard of value (typically, fair market value). This process can be intensive, and certain assets (such as equipment, real estate and intellectual property)

Courts may also perceive the cost approach as objective and straightforward, compared to more complex valuation techniques. And, when opposing parties submit conflicting valuation evidence, this approach can offer a stabilizing point of reference.

Many buyers and sellers turn to the cost approach in mergers and acquisitions. While not always used to determine the purchase price, this approach provides specific values for individual assets and liabilities. This level of detail enables the parties to negotiate precisely what will (and won’t) transfer in a transaction. Furthermore, after the deal is closed, the valuator’s analysis can be used to allocate the company’s purchase price for tax and accounting purposes.

3. Is the cost approach right for your situation?

This method isn’t used in every valuation. A valuation expert can explain the strengths and limitations of the cost approach for your situation — and compare them with those of the income and market approaches. Discussing your intended use of a valuation will help determine if the cost approach is appropriate for your circumstances. ■

Using ESOPs to transfer ownership

An employee stock ownership plan (ESOP) can be an effective way to transfer a company to children or employees over time, while also offering meaningful tax advantages. Because ESOPs can be structured to allow owners to sell shares gradually and retain control during the transition, they've become a popular succession planning tool. However, an independent valuation is critical to maintain compliance and withstand scrutiny from the IRS and the U.S. Department of Labor (DOL). Owners considering this strategy should understand the rules and responsibilities involved.

ESOPs explained

An ESOP is a qualified retirement plan that invests primarily in employer stock and operates under IRS and DOL regulations, similar to those that govern 401(k) plans. Instead of transferring ownership all at once, an ESOP usually purchases shares over several years. During the transfer period, the shares sold to the ESOP are held in a trust. The trustees, who may be officers or other company insiders, exercise voting rights on most issues (other than mergers, dissolutions and other major transactions).

Generally, ESOP distributions to eligible employees are made in stock or cash. For closely held companies, employees who receive stock have the right to sell it back to the company (exercising "put" options, or an "option to sell") at fair market value during certain time windows.

Independent valuation

Under the Employment Retirement Income Security Act of 1974, the DOL prohibits ESOPs from paying more than "adequate consideration." So, hiring a qualified appraiser to determine fair market value is essential to support all major ESOP transactions.

Specifically, independent valuations are required when the ESOP initially acquires shares and at least annually thereafter (and for any other significant ESOP stock transactions). Typically, a private business owner also obtains an informal valuation before forming an ESOP to evaluate its feasibility as an exit strategy.

Limitations and considerations

ESOPs can be costly to execute and administer. In addition to routine plan administration, companies must budget for annual valuations, professional advisory fees and future stock repurchases triggered by employees who exercise put options. ESOP debt may also affect financial ratios and bonding capacity.

Furthermore, ESOPs can be established only by C and S corporations. Companies currently structured as limited liability companies, partnerships or sole proprietorships must be restructured before using this strategy. This step may have tax and financial implications.

Professional support is essential

ESOPs fall under the authority of both the IRS, which focuses on tax compliance, and the DOL, which reviews valuation and fiduciary practices. Working with qualified business valuation professionals and experienced legal counsel is vital to meeting these requirements and achieving a smooth, tax-efficient ownership transition. ■





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