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Litigation & Valuation

REPORT

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Start early, end strong

Tax planning in litigation

Tax planning at the beginning of a case can have a significant impact on the eventual financial outcome for your client. There's a substantial difference between an award or settlement that's subject to income tax and one that's not. The parties have a certain amount of control over the characterization of damages for tax purposes, but it's important to start planning as early as possible, preferably *before* the complaint is drafted.

Origin of the claim

Generally, the tax treatment of damages is based on the "origin of the claim." Thus, awards of lost wages in employment discrimination cases are taxable, while damages received "on account of personal physical injuries or physical sickness" are excluded from income under Internal Revenue Code Section 104(a)(2). Note that nonphysical injury damages are generally considered taxable income.



In commercial or securities litigation, lost profits are taxable, while damages for injury to a capital asset — such as physical damage to a building or the diminished value of a company's stock — are generally treated as part nontaxable return of capital and part capital gain. Punitive damages and interest are taxable.

Generally, the tax treatment of damages is based on the "origin of the claim."

Even if damages aren't excluded from income, the distinction between wage and nonwage damages is important. Suppose, for example, that an employment discrimination victim recovers damages for both back pay and emotional distress, but suffers no physical injury or physical sickness. The damage award is subject to income tax (except for medical expenses related to emotional distress), but only the back pay portion is subject to FICA and other employment taxes.

Laying the foundation

Most cases involve a combination of taxable and nontaxable claims; the ultimate tax treatment of an award or settlement depends on how it's allocated among those claims. The parties' characterization of the damages goes a long way, but it must have economic substance.

Suppose, for example, that an employer and employee settle an employment discrimination case for \$1 million, and the settlement agreement allocates half the proceeds to lost wages and half to emotional distress damages. By allocating \$500,000 of the settlement to nonwage damages (emotional distress), the parties save about \$14,000 each in employment taxes.

To support this allocation, however, the plaintiff should be able to show that he or she 1) sought

emotional distress damages in the complaint, and 2) sought and received medical treatment for symptoms of emotional distress. Otherwise, the IRS or a court may conclude that the party's allocation lacked economic substance and reallocate the entire settlement to taxable lost wages.

Plan ahead to benefit your client

The tax treatment of a damage award or settlement may not be your highest priority when developing litigation strategies. But it pays to give some thought to tax issues early in the litigation so you can secure the most tax-advantageous result for your client. ♦

The expert's role in accountant liability cases

In lawsuits involving business failures, it's increasingly common for shareholders and other plaintiffs to name the business's accountants or auditors as defendants. Whether you're representing the plaintiff or the defendant, expert testimony by accounting and other financial experts is crucial. These experts can help explain to the judge or jury whether an accountant carried out his or her professional responsibilities in a competent manner, analyze causation issues and compute damages.



What factors affect liability?

There are several reasons accountants and auditors are often named in lawsuits: One is that high-profile scandals involving financial statement fraud in the last decade have highlighted the potential liability of accountants; another is that plaintiffs suing over a failed business often view accountants as having deep pockets.

Perhaps the most common explanation, however, is the widely held misconception that, if fraud occurs or numbers in financial statements are inaccurate,

the accountant or auditor must have done something wrong. In reality, however, it's far more complicated than that.

An accountant's liability depends on several factors, including which professional standards apply, whether the accountant met those standards and, even if the accountant was at fault, whether his or her transgression caused the plaintiff's damages. Also, keep in mind that an accountant's liability may extend (beyond the client) to third parties who relied on or benefited from the accountant's work product.

Which standards apply?

It's impossible to evaluate an accountant's performance until you know the applicable professional standard, which varies from engagement to engagement. The highest level of engagement is the *audit*, which provides an opinion on whether financial statements are fairly presented in accordance with Generally Accepted Accounting Principles (GAAP) and are free of material misstatements. The auditor conducts certain testing and other procedures to assess the accuracy of information in the financial statements.

Public companies are required to file annual audited financial statements with the SEC. Private companies may need audited financial statements to satisfy lenders or other third parties. But in many cases, a review or compilation will suffice.

AUDITOR'S RESPONSIBILITY FOR UNCOVERING FRAUD

The American Institute of Certified Public Accountants' (AICPA's) Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, places additional responsibility on auditors for fraud detection. Among other things, it requires auditors to exercise "professional skepticism," brainstorm about ways fraud could occur in a company, discuss fraud risks with management, design unpredictable audit tests and check for management override of internal controls.

Despite these expanded responsibilities, however, an audit is no guarantee that financial statements are fraud-free. Frauds that are small in scope or that are carefully designed to avoid raising red flags may continue to escape detection even when an auditor has met the applicable professional standards.

A *review* determines whether financial statements are based on appropriate accounting principles, applied consistently. An accountant performing a review attests that information in the financial statements appears to be reasonable and that he or she is unaware of any material departures from GAAP. This conclusion is based on interviews with management and a review of the business's financial statements, but it involves no testing or other audit procedures.

In a *compilation*, the accountant compiles data from the company's financial records and places it into a financial statement format, assisting the company in correcting any obvious errors or omissions.

Accountants performing audits of public companies are governed by standards established by the Public Company Accounting Oversight Board (PCAOB) that follow Generally Accepted Auditing Standards (GAAS) with some enhancements. Private company audits are governed by GAAS.

What's the auditor's role?

In cases involving accountant liability for business failure, the plaintiff must establish that the accountant

failed to meet professional standards and that this failure caused harm from which the business couldn't recover. The defendant must overcome misconceptions about the auditor's role and help the trier of fact understand the accountant's level of responsibility for the financial statements.

For example, it's important to explain that GAAS doesn't require specific tests and procedures. Rather, it provides *guidelines* for designing an audit that, in the auditor's professional judgment, is appropriate based on the subject company's accounting system, internal controls and other characteristics.

Also, contrary to popular belief, auditors aren't guarantors of the accuracy of financial statements. On the contrary, a company's management initially prepares the financial statements and has primary responsibility for their accuracy. And many financial statement entries require management to make estimates or exercise judgment in determining, for example, whether certain receivables are collectible.

Based on *management's* representations, together with limited testing and other audit procedures, the auditor must obtain *reasonable* assurance that the statements are free of material misstatements. Even if, in hindsight, it turns out that financial statements contained material misstatements, it may have been reasonable, at the time of the audit, for the auditor to conclude that they were accurate.

Misconceptions about the auditor's role are especially dangerous when it comes to fraud. Contrary to what many people believe, performing an audit isn't a guarantee that all fraud will be uncovered. (See the sidebar "Auditor's responsibility for uncovering fraud" at left.)

What's the expert's role?

Accounting experts play several critical roles in accounting liability cases. They evaluate whether financial statements comply with GAAP and whether an auditor followed the requirements of GAAS.

They also address causation issues. For example, even if an accountant or auditor fell short of professional standards, and even if fraud or error resulted

in material misstatements, did this conduct cause the plaintiff's damages? The business may have failed for reasons other than the accountant's mistake, such as management's poor judgment or strategic errors, an economic downturn, or competitive pressure.

Or perhaps the plaintiff relied too much on the financial statements. After all, financial statements merely present a snapshot of a company's financial position at a particular moment in time. There are many other benchmarks and analytical tools used to evaluate a company's financial performance and predict future performance.

Deceptively complex

On the surface, accountant liability may appear to be relatively simple, but in fact it's an exceedingly complex area of the law. It involves multiple professional standards, many of which demand the exercise of professional judgment rather than outlining specific requirements. And even if a plaintiff can establish that an accountant violated those standards, determining whether a business failure was caused by an accounting or auditing mistake or one of the many other possible factors can be an enormous challenge. ♦

Gazing into the crystal ball

How contingencies affect a business's value

When a valuator is asked to define the term "fair market value" for a business, he or she would respond that it's typically 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.

The kicker is: A host of contingencies are often among the relevant facts, which means that valuers need to look into the future to arrive at fair market value.

Uncertain losses or gains are key

Uncertain losses or gains that will be resolved when one or more future events occur or fail to occur are often a part of business valuations. The accounting treatment of contingent losses (pending or threatened litigation, actual or possible

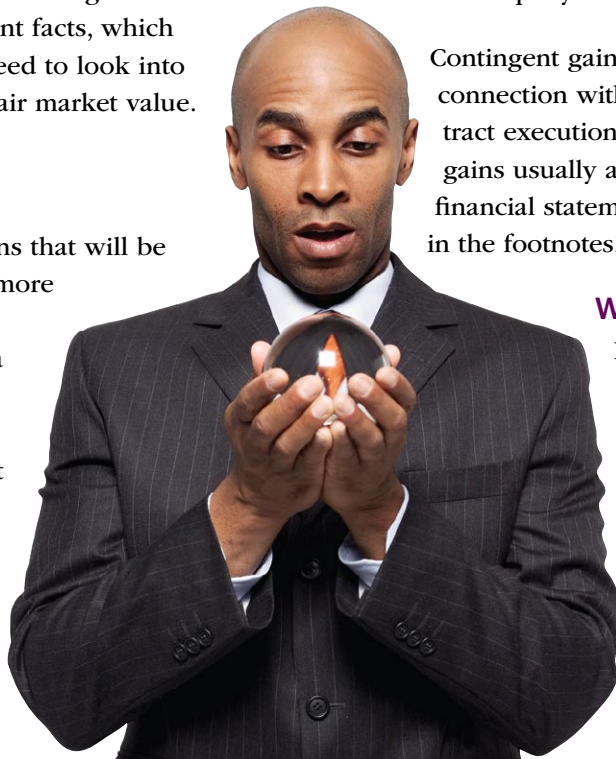
claims, product warranty obligations, debt guarantees) differs from that of contingent gains.

Contingent losses are classified as probable, reasonably possible or remote. When a contingent loss is probable and the amount can be reasonably estimated, it's accrued by a charge to income. If the loss is at least reasonably possible, it should appear on the company's financial statements.

Contingent gains might include damages recovery in connection with a lawsuit, patent approval or contract execution. For accounting purposes, contingent gains usually aren't recognized on a company's financial statements — though they may be disclosed in the footnotes.

Why they affect valuations

For an appraiser valuing a business, the treatment of contingencies gets a bit more complicated. Clearly, hypothetical willing buyers and sellers would consider contingencies in arriving at an acceptable purchase price. For a buyer, in particular, a



contingent loss increases investment risk and, therefore, reduces the price he or she is willing to pay.

For the valuator, the challenge is to quantify any contingencies and adjust the company's value accordingly. First, the valuator reviews the company's financial statements and other financial documents. He or she also talks with management to assess the probability that the contingencies will occur. If a contingency involves pending or threatened litigation, the valuator consults with counsel to evaluate potential outcomes (including settlement).

Bear in mind that, when litigation is part of the picture, the valuation report likely will be subject to discovery. Valuators and counsel should approach contingency issues carefully to avoid disclosing privileged or damaging information.

Hypothetical vs. real-life people

Fair market value may presume hypothetical buyers and sellers, but it's real people in real-life situations (who may be hesitant to accept a valuation based on uncertain future events) who rely on business valuations.

For example, Stephen and Joyce are getting divorced, and one of the principal assets to be valued in the property settlement is Stephen's ophthalmology practice. He's a defendant in a \$7 million malpractice suit and has \$5 million in malpractice insurance coverage.

The parties agree that, apart from the lawsuit, the fair market value of the practice is \$3 million. Stephen's malpractice attorneys believe there's about a 25% chance that the plaintiff will recover the \$7 million in damages.

One approach to valuing Stephen's ophthalmology practice for divorce purposes is to adjust the valuation to reflect the risk that he'll be liable for damages beyond the limits of his malpractice policy. Joyce objects to this approach because it would reduce the value of the marital estate based on a contingency that's unlikely to occur.

As an alternative, the parties agree to value the practice at \$3 million — its fair market value, without considering the contingency. They also agree to split any future liability Stephen incurs in connection with the lawsuit.

Adjust contingencies before or after

Whether it's better to determine a business's value before or after any contingencies are considered depends largely on the circumstances. For example, in an estate tax valuation, the likely impact of the contingency on the business's value must be considered. But parties involved in a divorce (such as Stephen and Joyce's example above) might choose to wait until the contingency has been resolved and then make adjustments accordingly. ♦

Nonpublic information considered in valuing securities

In *Highland Capital Management, L.P. v. Schneider*, the U.S. District Court for the Southern District of New York held that it was reasonable for a jury to conclude that material nonpublic information possessed by the defendants affected the fair market value of certain securities.

The case is significant because it seems to offer a novel interpretation of the phrase "reasonable knowledge of relevant facts" in the definition of fair market value.

Case background

The Schneider family sold their apparel company to Norton McNaughton. In connection with the

sale, Norton issued several promissory notes to the Schneiders, with a total face value of \$69 million, as partial payment.

The Schneiders engaged a broker to sell the notes. According to the plaintiffs, the Schneiders orally agreed to sell more than \$45 million in notes for 51 cents on the dollar to the broker, who in turn had agreed to “flip” them to Highland Capital Management for 52.5 cents on the dollar.

The defendants argued that, in awarding damages, the jury improperly took into account “postbreach” events.

Before the sale was consummated, however, the Schneiders learned, through nonpublic sources, that Norton would soon merge with another company and that the notes would likely be redeemed at face value (which in fact happened four months later). The Schneiders backed out of the deal, and Highland and the broker brought this lawsuit.

The jury found for the plaintiffs, awarding them more than \$40 million, plus prejudgment interest. In calculating damages, the jury valued the notes at their full face value. The defendants moved for judgment as a matter of law or, in the alternative, for a new trial. The court denied the motion, upholding the jury’s verdict.

Nonpublic information was relevant

The amount of the damages was a key point of contention. The defendants argued that, in awarding damages, the jury improperly took into account “postbreach” events: namely, the Norton merger and the subsequent payment on the notes at face value to the defendants. They also claimed that the only evidence of market value at the time of the breach was Highland’s offer to the broker of 52.5 cents on the dollar.

The defendants contended that “any material nonpublic information they possessed at the time of the breach was uncertain and should have no bearing on the notes’

market value.” The district court disagreed, finding that a jury could reasonably conclude that nonpublic information possessed by the defendants had an impact on the notes’ value at the time of the breach.

Interestingly, the court found that a jury could reasonably conclude that “it was irrelevant that the individuals who were actually negotiating the agreement did not possess this material nonpublic information.”

What do they know?

Fair market value is typically defined as the price that a willing buyer and seller would agree to, “when neither party is under any compulsion to buy or sell and *both* parties have reasonable knowledge of the relevant facts.” (Emphasis added.)

The *Highland Capital* decision suggests that even nonpublic information can be a “relevant fact” and that, in some cases, it’s enough for only *one* of the parties to have that information. The defendant apparently had at least reasonable knowledge of a fact that could be easily construed as material and very relevant. ♦

