

# National Litigation Consultants' Review

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Information, guidance, and resources from the nation's leading testifying, financial experts.

## UPCOMING APPEARANCES

by Members of the Editorial Board

NACVA's 13th Annual Consultants' Conference  
May 31-June 3, San Francisco, CA

Jim Atkins: *Using Excel Charts and Graphs, and PowerPoint for Courtroom Visual Testimony*

Michael Kaplan: *The Litigation Consultants' Forum: Building & Managing a Successful Practice*

Jim Lurie: *Valuation of Early Stage Technology Companies*

Lari Master: *The Valuation of Multi-Tiered Entities*

## FEATURE ARTICLE

### Walking the Line...Professional Opinion or Legal Conclusion?

BY THOMAS R. PORTER, CPA, ESQ., CFFA, CUA

This article is loosely based on a case I have just concluded; the case will probably be on appeal when you read it. Hence, the fact pattern has been changed to protect the innocent while preserving the issues that give rise to what I believe is an interesting discussion.

Assume you have been retained by plaintiff as an economic damages expert in a breach of contract matter. Further assume that the basis of plaintiff's complaint is not that defendant failed to meet contract requirements, but that defendant exceeded the requirements to such an extent that plaintiff was harmed by defendant's "excess" performance.

Let us cast the discussion in the universal language of widgets. Assume the underlying contract called for defendant to sell at least 1,000 of plaintiff's widgets per month over a three-year period. Plaintiff's maximum production capacity was 3,000 widgets per month, but the contract terms did not limit defendant's sales activity on the "upside." Both plaintiff and defendant had been in business for a number of years, but this was the first time they had worked together on a project.

Defendant was so effective in selling plaintiff's widgets that it sold 5,000 widgets per month for the first six months of the contract. *(continued on page 2)*

## BU FOR THE LITIGATION PRACTITIONER

### Valuation, Economic Damages and Causative Factors

BY EDWARD B. CORDES AND LARI B. MASTER

As the business valuation expert in litigation cases becomes more known and familiar to law firms in their area, it is not uncommon for attorneys to pass that expert's name along to other colleagues. At some point, the business valuation expert will be asked to perform an economic damages calculation for a business. There has to be a first time for everything, and in reality, this type of work is a good compliment to the already strong financial analy-

sis foundation that the valuation expert has established. In accepting this type of engagement, the business valuation expert should be aware of a few key nuances in a damages analysis that are not typical components of a business valuation analysis.

First, business valuation and economic damages analyses are not the same, but similar. Similarities include

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## WALKING THE LINE

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ise, and into areas in which we are not qualified to render opinion testimony. That could very well lead to the exclusion of our testimony in its entirety and the collapse of our client's case.

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<sup>1</sup> See, for example, Dunn, Robert L. Recovery of Damages for Lost Profits; 6th

edition; Lawpress Corporation, 2005.

- 2 Foreseeability is not a required element of economic damages analyses founded in tort.
- 3 Note there are two foreseeability standards: objective and subjective foreseeability. A discussion of these issues is beyond the scope of this article. The reader is referred to Dunn's Recovery of Damages for Lost Profits for a detailed analysis of these principles.
- 4 Example from Texas Government Code Section 38.123; see [www.wikipedia.org/practice\\_of\\_law](http://www.wikipedia.org/practice_of_law).
- 5 State rules of evidence regarding the qualification of expert witnesses typically mirror the federal rule.
- 6 Daubert v. Merrill Dow Pharmaceuticals, Inc. 113 S.Ct. 2786; Supreme Court of the United States; (1993).

## VALUATION, ECONOMIC

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analysis of the industry, the economy, the market share of the Subject Company, and financial forecasting. The entirety of the differences is outside the scope of this article, but one big difference is the premise of the engagement. Under most circumstances, a business valuation will use the going concern premise to determine the value of the business, whereas the premise of a business damages calculation relates to an allegation that the going concern concept has been compromised. To calculate damages, the business valuation analyst determines the value of an income stream by removing the effects of a particular claimed tort or breached contract action on that income stream. In theory, the difference in value between a valuation *after* the damaging event and the value *but for* the damaging event would be the same amount as the present value of the *lost* income stream, i.e., the damages.

### Proximate cause

Claims of damages/loss must have a proximate cause<sup>1</sup>. Statutes in various states require reasonably

proving a loss by directly linking that loss to the breach of contract or tort as well as differentiating the loss due to the action from other external factors. Causation becomes a 'but-for' analysis, wherein the claimant must show that 'but for' a causing action, the damages would never have occurred. Robert Dunn's treatise on damages<sup>2</sup> provides an excellent analysis of the issues, discussing foreseeability, differences between breach of contract and tort damages and the state statute nuances thereof. We would strongly suggest use of this resource to financial experts getting involved in economic damage cases.

It is the finder of fact's job to determine if a tort was committed or a contract defaulted in a damages case. The expert is not opining on IF the tort was committed, or IF the contract was defaulted, rather, the expert investigates whether the damage the plaintiff is claiming arose from the claimed action, or whether it reasonably arose from something other than the claimed action. The result of this investigation should have an impact on the expert's calculation of damages to the plaintiff caused by the claimed action. This investigative process is causative action analysis.

### Why an analysis of causative action should come first

A recent Texas appellate court case, *Wyndham Internat'l, Inc. v. Ace American Ins. Co.*, No. 05-04-01443-CV (Tex Civ. App. - Dallas, March 10, 2006), is a prime example of the necessity for the financial expert to address causative action early in the engagement. In this case, the defendant moved to exclude the plaintiff's expert witness testimony, which was the sole support for the plaintiff's claim of a \$66 million loss of business due to the 9/11 terrorist attacks on the United States.

In its opinion, the court noted that the unreliability of the plaintiff's expert<sup>3</sup> stemmed from several factors, including his failure "...to account for market factors affecting the hospitality industry in September and October 2001..." The expert "...instead conclud(ed) that the entire difference between the plaintiff's forecast for the period and the actual results for a fifty-one day period following September 11, 2001, was attributable to a covered loss..." stemming from 9/11.

On record were the plaintiff's 2001 annual report, citing economic downturn throughout 2001 as the

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cause of 83% of the loss of revenue, and Plaintiff's expert, CPA David A. Borghesi's deposition stating that he **did not try to segregate any other potential causes for the decline** in the Plaintiff's business such as the recession in the United State's economy in the 3rd and 4th quarter of 2001.

The damages claimed failed to clear the reasonable certainty hurdle, whereby the court was unable to link the action to the damages claimed and thus granted the motion to exclude the Plaintiff's expert witness and summary judgment in favor of the defendant due to a lack of evidence as to damages. Mr. Borghesi's testimony was not excluded because of causation, but this case is a good example of a failure to consider causative factors.

This article intends to give a practical discussion of the analysis and procedures to follow in determining the underlying premises and resultant causative analysis in damage claims cases performed by the business valuation practitioner.

## Evolution of a case

Plaintiffs and defendants are typically not experts in the specific business and economic matters of a damages analysis. As such, early involvement by the expert is a very cost effective approach for clients, allowing the expert an opportunity to:

- Analyze the claims before they are reduced to a specific complaint,
- Identify additional claims,
- Avoid the assertion of claims wherein the economic data does not support the claim or the causative action, and
- Tailor questions for discovery, interrogatories, and depositions to elicit direct responses about causation and their relation to claimed losses.

Engaging counsel often asks the financial expert to assume that a contract was breached or a tortious action was committed. While asked to assume the event of liability, the expert still needs to link the losses to the action, and separate any such losses whose causation may be different from the action.

## Evaluating Claims – Internal Data

As in most valuation and consulting cases, the process of evaluating claims by the financial expert usually begins with scouring the financial data for clues – in a damages case the clues sought are as to causation. Next, a thorough review of the complaint, response, and other motions will give the financial expert guidance as to the origins of the claims. As the case proceeds, an analysis of responses to interrogatories and discovery requests will often provide helpful information in the determination of causality. Throughout the analysis of these different forms of information, it is imperative that the financial expert be alert for inconsistencies in the testimony of the parties, documentation provided, and/or comments received during the interviews of the parties and others associated with the matter at hand. The inconsistencies noted invariably lead to the acknowledgement of indicated or actual causation, or manipulative tactics.

## Evaluating Claims – External Data

External corroboration is another key element to revealing

causative factors. Financial statement databases can provide financial information by SIC or NAICS classification. A comparative analysis can indicate industry trends, and whether or not the subject entity activity follows such trends. A review of industry trade association data and publications can give the financial expert insight into problems faced by an industry - which may suggest other causing issues for a loss than the alleged actions. Another good source of direction relevant to the claims can be obtained by scheduling a lengthy lunch with a competitor of the injured party. In addition, today's internet resources provide for almost infinite information – assuming the expert verifies that the source is valid.

## Practical Methodologies

Each and every claim for damages is unique, and there is no standard "checklist" for a causative factor analysis that will fit the needs of each case. When analyzing both internal and external data, it is important to cull out factors that are not germane to the case at hand. We have identified items in the following chart that could be the source of reduced profits, and which may be unrelated to the stated cause.

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| Affected Item    | Internal Factors   | External factors  |
|------------------|--|---|
| Sales/margins    | Lost sales personnel<br>Loss of key customer<br>Increase/decrease in raw materials<br>Lost customer/contract<br>Lost/sold a line of business<br>Closed a division/region<br>Patent/technology expire<br>Obsolete inventory | Entrance/Exit of competitor<br>Industry changes<br>Alternative product<br>Changed demographics<br>Customer access changed<br>Economy downturn<br>Regulatory changes |
| Production/costs | Labor dissent/scheduling<br>Training quality decline<br>Facility capacity<br>Equipment obsolescence<br>Utility usage   | Labor shortage<br>Input costs change<br>Process changes<br>Rental market<br>Product shortage  |
| Financial        | Operating losses<br>Extraordinary items in prior periods<br>Capital purchases<br>Excessive owner withdrawals   | Loss of credit facility<br>Economic changes   |
| Management       | Family/Emotional distress<br>Procedures & Policies<br>Change in management<br>Personnel conflicts<br>Resignation/death of key employee   | Head Hunters/competition  |

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### Successful Causation Analysis Examples

A grain dealer claimed damages against a railroad whereby the railroad failed to provide sufficient cars to ship the grain, thus causing the grain to spoil as a result of being stored on the ground. Just prior to the report becoming due, it was discovered that the grain had spoiled in the farmers' field due to an unseasonable early snowfall, rather than from being stored on the ground.

An auto body shop claimed that their sales were significantly down from the previous year due to an inability to use a portion of their shop stemming from alleged construction defects. This project was in a city some 75 miles away. After a chance conversation with a competitor of the shop, it turns out there had been a widespread hailstorm in the base year which artificially boosted auto body work in that city during that year.

In another circumstance, a grower of turf was claiming damages when his turf harvester was de-

stroyed. He alleged that the loss of his harvester caused a significant loss of customers; his proof was that several subsequent year losses indicated a marked decline in revenues. The real cause was a decline in housing starts.

In each of the foregoing cases, the analysis of the causation eliminated the need for developing the loss model, in as much as causation was not present.

Proper examination of causative factors will help identify the true amount of the economic damages related to the actions of the defendant, which is the ultimate goal of the financial expert in a case. It is the duty of the financial expert, and not counsel or the client, to perform this analysis in an unbiased manner. Doing so will serve the parties to the conflict, preserve professional reputations, and reduce the potential for malpractice.

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<sup>1</sup> Proximate cause is the initial act that sets off a natural and continuous sequence of events that produces injury. In the absence of the initial act that produces injury, no injury would have resulted.

<sup>2</sup> *Recovery of Damages for Lost Profits*, 6th Edition, LAWPRESS.

<sup>3</sup> David A. Borghesi, listed at [www.dauberttracker.com](http://www.dauberttracker.com) as a CPA and consultant.

### I SOLEMNLY SWEAR

## Developing a Theory of the Case: The Forensic Accountant's Role

BY JOHN R. MARKEL, ASA, CPA, ABU

My phone rings; Always a delightful sound. "John, this is Joe. I need your help on a case. It's a contract dispute, and there are economic issues."

(A conversation ensues about conflicts of interest, a promise of an immediate retainer, and other house-keeping matters.)

"So, Joe, what's your theory of the case?"

"It's evolving,"

"I know it's evolving, Joe, but what's your theory right now? Just so I might know what direction I'm headed into."

"The evidence you uncover in your investigation will probably strongly affect our ultimate theory, but from what we know now, our theory is:

- a. number one, *statute of limitations* (that is, the plaintiff has waited too long to assert his claim),
- b. number two, there was never a valid written contract, and
- c. number three..."

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