

The Witness Chair

Leading-edge Ideas for CPA Experts Providing Litigation and Dispute Resolution Services

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Lost Profits, Lost Business Value, and Janis Joplin

by Everett P. Harry, CPA

Forensic accountants continue to passionately debate two issues that could potentially have a significant impact on the amount of damages calculated:

- Should damages be determined as of the time of the alleged wrongdoing or as of the trial date?
- What is the relationship between damages calculated as lost profits versus lost business value? More specifically, can lost profits exceed lost business value?

Some practitioners declare certain answers to these questions as “right” and opposing solutions as just the exceptions for some fact sets.

CalCPA’s Litigation Sections Steering Committee recently appointed a task force to explore these and related topics, identify on-point literature, and develop means to communicate educational information to Litigation Sections members.

The following is a summary of the contested issues to help practitioners understand the possible implications of choosing or rejecting a given approach for a client assignment.

Damages Determined as of the Time of Wrongdoing

Damages may be determined at the time of alleged wrongdoing with subsequently available information ignored or given limited consideration. This is called the *ex ante* approach, which is explained by Franklin M. Fisher and R. Craig Romaine in “Janis Joplin’s Yearbook and the Theory of

Damages” (*Journal of Accounting, Auditing & Finance*, Winter 1990).

Assume Janis Joplin signed a high school yearbook before she became famous, the yearbook was stolen and destroyed, and the trial occurs years later after Ms. Joplin’s signature becomes worth a significant amount of money. Should damages be based upon the initial cost of the yearbook or the later elevated value, given the inclusion of the celebrity’s signature?

Fisher and Romaine argue that damages should be determined as of the date of loss with risk-free interest added to the date of trial and state “... hindsight should not be used.” They believe a plaintiff should not be compensated for risk it did not bear.

Damages Assessed as of the Time of Trial

Konrad Bonsack responded to Fisher and Romaine in “Damages Assessment, Janis Joplin’s Yearbook, and the Pie-Powder Court” (*George Mason University Law Review*, Fall 1990). Bonsack observed that damages should be measured on or about the time of trial and “hindsight should be used,” which is called the *ex post* approach.

Bonsack believes that a plaintiff cannot be restored to its but-for position with complete indemnity unless all information available to the time of damages analysis or trial is used, which returns both the intrinsic risks and rewards of asset ownership to the plaintiff. Thus, the defendant’s wrongdoing does not become a constructive forced sale of plaintiff’s asset at the time of the violation.

Lost Profits vs. Lost Business Value

Some practitioners assert that lost profits and lost business value damages should be essentially equal when measured upon the present value of a lost stream of economic income. For this result to occur, a number of conditions or premises must be in parity, such as:

- Standard of value, such as FMV or investment value.
- Valuation as of the same date.
- Use of the same available information and like interpretation.
- Equality of the magnitude and timing of the projected lost economic income.
- The same period of damages or loss (e.g., a perpetuity).
- The same discount rates.
- Consistent views on potential mitigation, if any is to be considered.
- Same measurement of the time value of money applied to the computed damages.

If for no other reason, computed lost profits and lost business value damages can vary, perhaps materially, when opposing experts disagree

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Section

ACTION

Business Valuation

by Scott T. Dye, CPA

The AICPA's new *Statement on Standards for Valuation Services No. 1* gives us all reason to reflect on Rule 201—General Standards of the Code of Professional Conduct.

These standards call for the CPA to comply with standards of professional competence, due professional care, planning and supervision, and sufficient relevant data.

Before accepting an engagement, the CPA or firm must ascertain whether they can perform the service with professional competence. This is especially critical with business valuation services. Simply being a CPA does not qualify one to perform valuation services. But being a CPA means the professional has the fundamental skills to assist them as they gain the knowledge and experience to perform competent valuations.

To perform business valuation services, a CPA should be trained in valuation theories, methodologies, and procedures. In valuation assignments, as in all types of engagements, CPAs must exercise due professional care in their performance of services.

The practitioner planning and supervising the work of others in a valuation engagement must keep in mind that these assignments require professional judgment throughout the process of estimating value. Thus, proper supervision demands sufficient communication with staff to successfully provide the professional judgment necessary for the valuation.

Obtaining sufficient relevant data is an important part of the valuation process and the new Standard will assist valuation practitioners in determining what documentation is relevant and sufficient.

As we become more familiar with the new standard, we must not lose

sight of the basic general standards that govern our practices.

Scott T. Dye, CPA, ABV, CVA is Business Valuation Section secretary and a shareholder with Stoughton Davidson Accountancy Corporation in Fresno.

Economic Damages

by Colin A. Johns, CPA

When we consider the dangers of the ever-more frequent *Daubert* challenge, the focus is generally on the expert's qualifications and the reliability of the expert's opinions.

Regardless of the potential for *Daubert* challenges, it is important to do what is necessary to ensure that adequate foundation for the expert's opinion is established at trial. This is typically considered in terms of factual testimony being elicited by counsel at trial to establish that foundation. Sometimes the foundation for one or more of an expert's opinions is the opinion of another expert.

In *Cardiovention, Inc. v. Medtronic, Inc.* (2007) 483 F. Supp. 2d 830, Medtronic challenged three of Cardiovention's damages experts. One of the experts, a CPA, was challenged on several grounds with respect to his calculation of damages, but the Court ruled that the CPA's testimony should not be excluded on those bases.

However, the testimony of another expert was excluded because it was based on recovery claims and theories dismissed by the Court.

The Court also held that, to the extent that the CPA's opinion was based on the excluded testimony of the other expert, that portion of the CPA's testimony was excluded.

This situation poses a dilemma for all experts. If the expert had the expertise to offer the necessary opinion without basing it on another expert's opinion, presumably they would have done so. If not, then the expert should advise counsel that their opinion is subject to the risk that the other expert's opinion may be excluded. Clearly, counsel must

be aware of the need to provide the required foundation.

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Family Law

by Tracy Farryl Katz, Esq., CPA

In *In re Marriage of Asfaw v. Woldberhan* (DJDA 2721, February 2007) the California Court of Appeal decided the first case addressing the issue of a depreciation deduction when calculating income available for support. In the case, the Appellant, Asfaw (mother) contended, among other things, that the trial court erred in calculating child support payments.

Asfaw argued that the depreciation of the father's rental properties should not have been used to reduce his business income. The Court reversed the trial court's conclusion and agreed "that depreciation is not properly deductible under the relevant Family Code provisions—Sec. 4058 ... and Sec. 4059."

Sec. 4058 defines "annual gross income" as income from whatever source derived. Sec. 4059 states annual net disposable income is derived by deducting from annual gross income the amounts actually attributable to certain specified expenses.

The Court, in reviewing both statutes, determined that neither statute specifically addresses the issue of depreciation expense. The Court then turned to the history of Secs. 4058 and 4059 to determine the legislative intent of the statutes.

The Court concluded that legislative history "point[s] toward disallowing depreciation as a deduction from income in calculating child support." The Court also looked at other states' treatment of depreciation and acknowledged that the treatment of depreciation varies from state to state and that reviewing other state law was not very helpful.

This holding raises several questions for family law practitioners. Would the result be the same if the

issue were spousal support or if the asset in question were declining in value, for instance, equipment, rather than appreciating, such as real estate in the instant case?

The forensic accountant should be aware of this holding and the issues it raises regarding “income for support.”

Tracy Farryl Katz, Esq., CPA is Family Law Section chair and a partner with Gursey Schneider & Co. LLP in Los Angeles.

Fraud

by B. Marie Ebersbacher, CPA

The recent conviction of Gregory Reyes, former CEO of Brocade Communications System, for stock options backdating brought investment fraud into the limelight. Stock options allow the option holder to buy shares at a future time at a fixed price. These are often used as incentives because the option price is typically fixed at the stock’s price the day that the option is granted.

Backdating allows for windfall profits because the “backdate” is one that precedes a run-up in the stock. In some cases executives have been accused of choosing the lowest price of the quarter. But there are more common schemes that can affect the rest of us, including Ponzi schemes, scams against seniors, and other investor frauds.

Ponzi schemes originated in the early 1900s and require only an ability to keep track of the pyramid. Investors are promised big returns and each level is paid by the one that follows. When there are no more new investors, fraudsters commonly tell investors that returns ceased because of government intervention.

The swelling senior population is increasingly being targeted by scams like charitable gift annuities, viatical settlements, and unregistered securities. Rising health care costs and increasing life expectancy, along with the distrust in the traditional stock market created by the accounting scandals of “safe” companies such as Enron, create a wealth of opportunities for fraudsters.

Holding a long-time spot on many Top 10 fraud scheme lists are short-



Message from the Chair

by Mark Luttrell, CPA

I am completing my term on the AICPA’s ABV Credential Committee, the second such AICPA committee that I have been a part of during the past 10 years. As I participate in the activities of our national association, I am consistently proud of our California CPA community and the unique opportunities our members have through our Litigation Sections.

We have the ability to learn, network, and professionally grow through these Sections in ways that most of our peers do not. We are frequently referred to as a “model state” and are the subject of discussions on how to emulate similar programs in other venues.

I am particularly impressed with the leadership and vibrancy of our Litigation Sections. Outstanding leaders continue to emerge, creating new projects and ideas that continue to raise the bar for our profession.

term promissory notes issued by highly speculative or non-existent companies promising high returns—sometimes upwards of 15 percent monthly—with little or no risk. They are sold by fraudsters masquerading as independent insurance agents when interest rates are low and investors are lured by the higher, fixed returns that promissory notes offer. However, the issuer of the note has no intention of delivering the promised returns.

State securities regulators still receive a high number of complaints from investors regarding brokers who use shortcuts or resort to fraud to increase commissions. Legitimate mutual funds and variable annuities are integral to the wealth of our nation. However, state securities regulators and federal investigations have uncovered mutual

Family Law is progressing on an analysis on the meaning of “income” in support cases. Economic Damages is moving forward on the dynamic and controversial relationship between lost profits and business value. Business Valuation is interpreting our new Standard and creating a practical tool for all of our members to use. The list goes on.

As I observe these activities I am reminded that it is the process from which I have benefited. Nothing compares to analyzing and debating complex issues with some of the best practitioners in the country. This opportunity is unique to our members in California and is the “fast track” for anyone serious about developing a career in litigation and valuation services.

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fund sales contests where investors are encouraged to move to funds that pay higher commissions to brokers, have abusive trading practices such as “market timing” and illegal trading practices such as “late trading by investors in our jurisdictions.”

Investors in variable annuities can be defrauded when they are not told about high surrender charges or steep sales commissions agents often earn when they encourage investors into variable annuities. Also, fraudsters make claims of guaranteed returns when, in fact, variable annuity returns are vulnerable to the volatility of the stock market.

B. Marie Ebersbacher, CPA, ABV, CFE is Fraud Section chair and a shareholder with CBIZ & Mayer Hoffman McCann P.C. in Bakersfield.



First Permanent Injunction Granted to a Non-practicing Entity Post-eBay

by M. Monica Ip, CPA

Judge Leonard Davis of the Eastern District Court of Texas granted Australia's Commonwealth Scientific and Industrial Research Organisation's (CSIRO) motion for a permanent injunction against Buffalo Technology, Inc. and Buffalo, Inc. (collectively Buffalo) June 15. Judge Davis's ruling is noteworthy as it is the first permanent injunction granted to a non-competitor since the Supreme Court's decision on *eBay v. MercExchange* in May 2006.

CSIRO is Australia's national science agency and one of the largest and most diverse scientific research organizations in the world. It conducts frontier scientific research for the benefit of the public. Part of its funding is derived from the licensing of its intellectual property.

In the early 1990s, CSIRO scientists solved the multi-path problem associated with indoor wireless networking and CSIRO was awarded U.S. patent No. 5,487,069 ('069 patent) Jan. 23, 1996. The multi-path problem refers to radio signals being reflected by materials such as walls and furniture in an indoor environment, causing the signals to arrive at the receiver from different paths at different times.

In 1999 and 2003, the Institute of Electrical and Electronics Engineers (IEEE), a standard-setting organization in the U.S., ratified the 802.11a

standard and the 802.11g standard, respectively. CSIRO alleged that these standards embody CSIRO's invention and, as a result, all 802.11a and 802.11g compliant products infringed its '069 patent.

CSIRO contacted companies that practiced the '069 patent and offered to license its technology, but its efforts resulted in no license agreements.

Texas-based Buffalo Technology, Inc. is engaged in the sales and marketing of wireless local area network products, which included 802.11a/g compliant access points, routers, and client adapters. Buffalo, Inc., a Japanese corporation, is a related entity that provided the products.

CSIRO filed suit against Buffalo in 2005 alleging infringement of the '069 patent. On Nov. 13, 2006, the Court found that the patent was valid, that it covered the core technology found in 802.11a and 802.11g compliant devices and that Buffalo had infringed multiple claims of the patent.

As a result of the judge's June 2007 ruling on injunction, Buffalo must cease selling its infringing products.

While the award of permanent injunction was not unexpected, it was considered a long shot. Prior to the Supreme Court's *eBay* ruling, injunctions were routinely granted to prevailing patent holders absent exceptional circumstances. However, in its *eBay* opinion, the Supreme Court stated that the traditional four-factor test for injunctions applies equally in patent cases.

A plaintiff seeking a permanent injunction must demonstrate that:

1. it has suffered irreparable injury;
2. remedies available at law, such as monetary damages, are inadequate to compensate for that injury;
3. considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and
4. the public interest would not be disserved by a permanent injunction.

Since *eBay*, but prior to Judge Davis's CSIRO ruling, generally, only patent owners who compete directly with the infringer had been granted permanent injunctions. Patent owners who practice their patents have

been able to cite factors such as loss of profits, loss of market share, loss of reputation and loss of brand recognition to support irreparable harm. In many cases, the court also found that a compulsory license was adequate to compensate a non-practicing patent owner for ongoing infringement.

In light of the four-factor test and post-*eBay* rulings, it was not difficult to conclude that it would be a challenge for non-practicing entities, such as universities and research institutions, to obtain permanent injunctions. While the Supreme Court specifically stated that patent holders, such as university researchers or self-made inventors, may be able to satisfy the traditional four-factor test, it provided no guidance as to how that could be accomplished.

In granting CSIRO its motion for a permanent injunction, Judge Davis provided a road map on the application of the four-factor test specifically for universities and research institutions.

Here is an overview of Judge Davis's analysis of the four-factor test:

Irreparable Harm Suffered by CSIRO

The Court concluded that CSIRO had been harmed financially and that the harm of lost opportunities was irreparable.

- "CSIRO competes with other research institutions and universities for resources, ideas and the best scientific minds. Having its patents challenged via the courts not only impugns CSIRO's reputation as a leading scientific research entity, but forces it to divert millions of dollars away from research and into litigation costs."
- "Delays in funding result in lost research capabilities, lost opportunities to develop additional research capabilities, lost opportunities to accelerate existing projects or begin new projects. Once those opportunities have passed, they are often lost for good, as another entity takes advantage of the opportunity."
- "Delays in research are likely to result in important knowledge not being developed at all or CSIRO

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AICPA Alert

by Christian Tregillis, CPA

With the increased demand for and interest in forensic accounting, the AICPA is considering the creation of an accreditation for forensic accountants. If introduced, the credential will first be available to CPAs who have obtained a combination of education and experience specific to forensic accounting, with minimum requirements of each.

The topic is being discussed by the AICPA's National Accreditation Commission and the AICPA's Forensic & Valuation Services Executive

Committee. Specific issues include the requirements to obtain the credential as well as the eventual addition of an examination to the process, continuing education, and insuring that the credential is supported by the AICPA with media for a successful launch and continuance.

Meanwhile, a market study has been expanded to evaluate the marketplace's interest in such a credential, including collecting feedback from practitioners, attorneys, triers of fact, and jury consultants.

Critical to the success of this credential is that it be earned and maintained by a sufficient number of practitioners, justifying necessary investments to build infrastructure and publicize the credential to enhance recognition. In evaluating the Accreditation in Business Valuation and other specialty credentials,

the AICPA found that a credential needs about 5,000 members to achieve critical mass. Above this level the credential is able to generate sufficient word of mouth and revenue to support advertising to the credential's relevant populations.

While the idea is still in its formative stages, the interest and opinions of practitioners will be important to the AICPA in the coming months. The plan is to collect input through the market study and develop a business plan, with meetings to occur in the first half of next year, and a launch thereafter. Information will be available on the website at <http://bvfls.aicpa.org/>.

Christian Tregillis, CPA, ABV is managing director of Kroll Financial Advisory Services in Los Angeles.

Permanent Injunction

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being pushed out of valuable fields as other research groups achieve critical intellectual property positions."

Adequacy of Remedies Available at Law

- It is the Court's opinion that monetary damages are not adequate to compensate CSIRO for its damages, which are not merely financial. As previously discussed, CSIRO's "reputation as a research institution has been impugned just as another company's brand recognition or goodwill may be damaged."
- The Court believed that a compulsory license "would not adequately compensate CSIRO as it would not contain other non-monetary license terms that are as important as monetary terms to a licensor like CSIRO."
- "The '069 patent is the core technology embodied in the IEEE's 802.11a and 802.11g standards and Buffalo's products are designed to specifically comply with these standards. Buffalo's infringement relates to the essence of the technology and not a 'small component' of

Buffalo's infringing products, monetary damages are less adequate in compensating CSIRO for Buffalo's future infringement."

- A compulsory license developed based on Buffalo's past sales, which were modest, may not adequately reflect the worth of the patent today to Buffalo.

The Balance of Hardship

- The Court concluded that "[the] balance of hardship favors CSIRO's motion for permanent injunction because the harm that continued infringement would likely cause CSIRO's research and development projects outweighs the harm that an injunction would cause Buffalo in being excluded from competing in the WLAN market."
- Since wireless products constitute only 11 percent of Buffalo Technology's business, an injunction would not be catastrophic to Buffalo.
- If an injunction is not issued, CSIRO will suffer financially and that harm would, in turn, impact CSIRO's "research and development efforts and its ability to bring new technologies into fruition."

The Public Interest

- The Court concluded that the public interest factor favors CSIRO's motion for permanent injunction.
- "Although research institutions' work may not always have immediate applications, the work of research institutions has produced enormous benefits to society in the form of new products and processes. Because the work of research institutions such as CSIRO is often fundamental to scientific advancement, it merits strong patent protection. ... [The] public interest is advanced by encouraging investment by research organizations into future technologies and serves to promote the progress of science and the useful arts."

Judge Davis's ruling demonstrates that permanent injunctions are still available to universities and research institutions and they can still use the threat of permanent injunction as leverage to drive settlement.

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H A P P E N I N G S

Litigation Sections Meetings

Business Valuation	Thursday, Jan. 31, 2008, LAX
Economic Damages	Wednesday, Feb. 6, 2008, LAX
Family Law	Friday, Feb. 1, 2008, LAX
Fraud	Tuesday, Feb. 5, 2008, LAX

Each section will send individual meeting notices.
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Education Foundation Course Offerings—(800) 922-5272 or www.educationfoundation.org

Business Succession Planning and Exit Strategies for Closely Held Businesses	Friday, Oct. 19, OC North
Business Valuation: A Review of the Essentials	Monday, Nov. 26, SFO
Business Valuation Overview	Friday, Oct. 19, SFO
Family Law Conference	Thursday, Oct. 25, LAX Friday, Oct. 26, SF
Finding and Evaluating Frauds: A Case Study Approach	Monday, Oct. 22, LV Wednesday, Nov. 7, SF/Pen Tuesday, Jan. 15, 2008, OC North
Fraud: Essential Audit Tools and Techniques	Monday, Nov. 12, Channel Counties Wednesday, Dec. 12, SJ Thursday, Jan. 17, 2008, LAX
Searching for Fraud: Assessing Risk and Addressing Red Flags	Thursday, Nov. 1, SLO Friday, Jan. 4, 2008, BUR
Tax Consequences of Divorce	Monday, Nov. 19, SFO Friday, Nov. 30, Palm Springs

Lost Profits

Continued from Page 1

about some or all of the factors and premises used in their respective computations. For example, information available after the purported wrongdoing date might reveal that the lost business opportunity was much better or much worse than envisioned at the date of loss, so *ex ante* and *ex post* damages amounts would be far apart.

The Challenge for the Damages Analyst

The damages analyst may have extensive academic training and experience in accounting, finance, and eco-

nomics, but that alone may not be sufficient to resolve the questions outlined at the beginning of this article.

Litigation services providers should appreciate that the courts do not necessarily accept universal application of academic principles or theories as “right” or “wrong,” but are adaptive to considering the applicable jurisdiction’s written decision history, the case facts in relation to the equity objective of making the plaintiff economically whole, and any social objective of deterring wrongdoing by the dollar magnitude of the damages award.

A discussion of such topics, at least with respect to the hindsight issue,

appears in “*Ex Ante Versus Ex Post Damages Calculations*” by Michael J. Wagner, Michael K. Dunbar, and Roman L. Weil (Chapter 8, *Litigation Services Handbook*, 4th edition, 2007).

Conclusion

By understanding the theories and points of view about the measurement of damages, including some of those expressed by courts through written decisions, CPA damages analysts will be better prepared to select and defend an approach that is best suited to the facts of the case considering the client-attorney’s input about relevant law.

Soon, the Steering Committee’s task force will disseminate useful information to help us all. I anticipate presentations and discussions about these topics at Economic Damages Section meetings, so consider joining the section and participating in the professionally enriching experience.

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