The Witness Chair

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

FALL 2004 ISSUE 36

# Common Mistakes in Personal Injury Loss Calculations

*by Miriam Culjak, Ph.D.*

Personal injury cases come in different guises. One type involves self-employed individuals, whose earnings losses resemble business loss cases. Another type, common in the construction industry, involves individuals injured while employed.

Regardless of the type of case, there are several common mistakes in personal injury loss calculations. Three mistakes are (1) projecting lost earnings based on insufficient data or ignoring relevant earnings history; (2) failing to establish a causal relationship between the injury and earnings loss projections, or alternatively, failing to rule out alternative explanations for declines in post-injury earnings; and (3) failing to account for opportunities to mitigate damages. Both plaintiff and defense experts are subject to these shortfalls.

### Earnings Loss Projections Based on Insufficient Data

A plaintiff's pre-injury earnings history is generally the best trend indicator of "but for" earnings, yet many experts project such earnings with a spotty pre-injury earnings history or ignore relevant historical information. The following illustrates a case where earnings projections were based on insufficient or ignored data.

The plaintiff was injured on the job after working at a particular employer for just a few months. Previously, the plaintiff had worked only part of most years and never stayed at any place of employment for more than a year. The plaintiff's expert projected approximately 35 years of earnings losses based on the plaintiff's "capacity," which was measured at his hourly earnings at the time of injury and a virtually full-time "but for" work schedule. The plaintiff's expert ignored the 10-year intermittent work history, particularly the frequent job turnover and less than full-time work.

In this case, the plaintiff's expert erroneously projected future lost earnings on the basis of insufficient or ignored data. It is incumbent upon the plaintiffs and their experts to assess historical hours and earnings information to project future earnings. Past earnings history often is the best indicator of future earnings, so trend departures, if any, should be evaluated and explained by the expert.

### Failure to Establish A Causal Relationship

The expert should evaluate the causal relationship between the injury and "but for" earnings projections, especially for cases involving self-employed individuals. The following examples illustrate failures to establish a causal relationship or to rule out alternative explanations for declining earnings.

1) The plaintiff owned a travel business that focused on European vacations and was injured in mid-2001. The plaintiff's claim failed to consider declines in travel to Europe because of the impact of Sept. 11 as well as general declines in use of travel agents as consumers turned to the Internet to reserve airline flights and hotel rooms. These factors better explained the plaintiff's declining earnings than did the injury.

2) A dry cleaning business owner was injured in an auto accident and subsequently blamed business declines on her impaired ability to work. Research revealed that three competitors opened nearby about the same time of the injury, and all three posted lower prices for their services than the plaintiff. The plaintiff's expert had not considered the increased level of competition as a factor in the plaintiff's declining post-injury earnings.

In both examples, the plaintiff's expert failed to consider the underlying economic forces in the plaintiff's industry and thus failed to establish a causal relationship between the injury and the lost earnings claimed. In many personal injury cases, it is important to consider the dynamics of the industry in which the plaintiff

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## In this Issue

# Section ACTION

## Business Valuation
*by Ted D. Israel, CPA*

Reading Tax Court cases over the last year reminded me of a Yogi Berra quote: “The future ain’t what it used to be.”

The challenge is having work completed five or more years ago evaluated now in light of current theories and trends.

For instance, in two separate cases, *McCord*, 120 TC 358 (2003) and *Lappo*, TCM 2003-258, the taxpayers’ experts were criticized for using IPO studies in support of their marketability discounts. Using sound reasoning, the Court adopted the position of the IRS expert, who said the IPO studies overstated the discount for lack of marketability and that restricted stock studies provided more compelling evidence.

In 1997 when the McCord and Lappo gift tax returns were filed, many of us were relying on IPO studies to support discounts for lack of marketability.

These studies generally resulted in larger discounts and were state of the art at the time. However, they may not measure up now because we operate in a rapidly evolving profession.

What can you do? Be progressive and open minded to new developments. Keep your library and subscriptions fresh. Invest in new tools and resources, such as restricted stock studies. Attend leading-edge conferences and seminars. Resist the temptation to settle into a “cookie cutter” approach to reporting. Incorporate the new knowledge you’ve gained into your reports as you go.

Your valuation report sits frozen in time while the progress train keeps thundering down the tracks. Minimize the gap by making sure you are as far down those tracks as possible when you complete and sign your report.

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## Economic Damages
*by Lynn Carl Jones, CPA*

CPAs enjoy acceptance as expert witnesses in part because our Code of Professional Conduct (Code) distinguishes CPAs from most other experts.

Our profession is unique in that we have responsibilities both to the public and clients. Consistent with dual responsibility, the Code requires CPAs to maintain objectivity and integrity in the conduct of all engagements. CPAs must remain free of conflicts of interest in all engagements and are prohibited from subordinating their judgment to others in all professional engagements. CPAs are obligated to perform all professional services to the best of their ability with concern for the best interest of the client and consistent with the profession’s responsibility to the public.

The profession’s high ethical standards require CPAs to exercise independence in thought and objectivity in reporting. Attorneys have different duties to their clients, including loyalty and zealous advocacy, and they recognize the advantage of engaging an expert whose testimony will ring true because of the objectivity with which the expert’s work is performed.

The duty of objectivity puts CPAs in the category of trustworthy advisers. Attorneys deserve an objective view of the relevant facts before going into court. Such timely information is good for everyone—attorneys who weigh settlement against trial costs and risks; clients who bear the cost of either; and the public, whose taxes support the court system.

CPAs have long enjoyed a high level of public trust. Maintaining that trust serves the profession, clients, and the public well.

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*Lynn Carl Jones, CPA, CFE is the Economic Damages Section chair and managing partner of Jones & Co. in Los Angeles and metropolitan New Orleans.*

## Family Law
*by Leslie O. Dawson, CPA*

Effective Jan. 1, 2005, Assembly Bill (AB) 205 gives registered domestic partners in California nearly all of the rights and obligations of married couples. Same-sex partners as well as opposite-sex partners over the age of 62 are eligible to register. While there are a number of procedural aspects and questions about what “marital” rights and obligations are affected, CPAs practicing in family law and tax should be aware of the tax complications raised by this law.

While AB 205 provides for equal treatment under California family law, it specifically states that for state income tax filing purposes, domestic partners must use the same filing status used for the federal returns. For federal purposes, the Defense of Marriage Act (P.L. 104-199), defines marriage as the legal union between one man and one woman. Thus, domestic partners cannot file jointly for federal or California purposes.

Another complication arises from the provision in AB 205 that specifies that earned income may not be treated as community property for state income tax purposes. However, upon dissolution, this income, and the property purchased with it, will presumably be considered community and subject to division between the partners. At what point does this income convert from one partner’s separate property to community property? Does this “conversion” constitute a taxable gift or other taxable event?

Also under AB 205, a registered domestic partner may be obligated to pay support to the other upon dissolution of the partnership. Since the parties were not “spouses” for federal tax purposes, Internal Revenue Code (IRC) Sec. 71, which allows for the deductibility of spousal support payments, will not apply and the payments will not be tax deductible. Further, since there is no specific exclusion, the payments may be taxable to the recipient spouse under the general rule of IRC Sec. 61.

This new law raises more questions than it answers. The impact of AB 205 on family law practitioners will continue to be monitored and addressed by the Family Law Section.

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*Leslie O. Dawson, CPA is Family Law Section chair and a partner in Glenn & Dawson LLP in Walnut Creek.*

## Fraud

*by Peter W. Brown, CPA and Wendy So*

Douglas Carmichael, chief auditor and director of professional standards of the Public Company Accounting Oversight Board, referred to Harvey Cardwell as the "father of fraud auditing" at the 2004 Association of Certified Fraud Examiners Conference in Las Vegas. Cardwell, author of *The Principle of Audit Surveillance* published in 1960, is a visionary who understood the significance of fraud and the need for specialized skills to help combat it.

Cardwell recognized that fraud auditing, which he called audit surveillance, and traditional financial statement audits were distinct and different services. In his book, Cardwell wrote, "[t]he public accounting profession has recognized the incompatibility of audit surveillance and financial auditing and is wisely, if belatedly, recognizing the two functions as separate services."

Today, while most accounting firms maintain separate practices for fraud audits and financial statement audits, the line between the two practices appears to blur with the introduction of auditing standards SAS 99 and PCAOB Standard No. 2. These standards make fraud detection a significant piece of the traditional financial statement audit.

In the May/June issue of *Fraud Magazine*, Carmichael was asked if an auditor would be liable for issuing a clean opinion on fraudulently misstated financial statements. Carmichael answered, "I believe there is no doubt that having the auditor responsible for expressing an opinion on both the internal control over financial reporting as well the output from that system really raises the stakes and puts real pressure on the auditor to do a better job in both areas."

Historically, financial statement audits were not designed specifically to detect fraud. However, the profession is clearly moving in this direction. SAS 99 states, "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Many are now reading this language as placing additional responsibilities to detect fraud squarely on the auditors' shoulders.

Carmichael points out that this "new" thinking is really not new at all. Cardwell did a good job of articulating these same concepts more than 40 years ago. With fraud detection playing a larger role in financial statement audits, the profession is realizing the valuable role forensic accounting knowledge can provide in assisting in an audit.

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# Message from the Chair

*by Andy Mintzer, CPA*

My, they've been busy! The powers that be have offered up a rash of possible rules and guidelines that could have far-reaching consequences for our practices. The Litigation Sections Steering Committee is busy tracking all of it.

Valuation practitioners should watch for the AICPA's exposure draft of the Statement on Standards for Valuation Services.

The Financial Accounting Standards Board is getting into the act by issuing its own exposure draft titled, *Fair Value Measurements*. The comment period for this standard has passed, but you can track its progress at *www.fasb.org/project/fv_measurement.shtml*. This standard will provide the GAAP definition of fair value for almost all accounting standards that require fair value—and the number of those standards is growing.

The AICPA's Forensic and Litigation Services Committee's discussion memorandum, *Forensic Services, Audits and Corporate Governance: Bridging the Gap*, raises many tough questions about the adequacy of auditing procedures and the role of forensic accountants in both audits and corporate oversight of financial matters. We may see the development of new auditing standards and the increased prominence for the forensic accountant in audits and as consultants for audit committees.

As we continue to see the profession change, we are saddened by the passing of Howard Sheppard in September. He was a pioneer, a great mind, and a consummate professional. We miss him dearly.

Get involved in the process by monitoring, responding, and tracking the recently issued exposure drafts and other professional papers … and stay tuned to *The Witness Chair* for more details.

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*Andy Mintzer, CPA, CFE is a sole practitioner based in Santa Monica.*

## Keepin' It Legal

# Cost-Shifting and Electronic Discovery: How Experts Can Help Clients Minimize Costs

*by Christian Tregillis, CPA and Rachel Laybourn*

Electronic discovery can be a costly part of litigation, but if experts know what to ask for, they can advise lawyers and clients in a way that may save clients both time and money. Parties producing requested documents traditionally have been expected to foot the bill for electronic discovery, but in the past couple of years, that trend has been shifting.

*Rowe Entertainment v. William Morris Agency*, 205 F.R.D. 421 (S.D.N.Y. 2002) (*Rowe*), established eight factors—known collectively as the Rowe Test—to be considered when federal courts evaluated who should pay the costs of discovery. In 2003, with *Zubulake v. UBS Warburg*, 216 F.R.D. 280 (S.D.N.Y. 2003) (*Zubulake*), the court changed the factors and then weighted them. This newer version includes the following seven factors, listed in order of importance:

1. The extent to which the request is specifically tailored to discover relevant information;
2. The availability of such information from other sources;
3. The total cost of production compared to the amount in controversy;
4. The total cost of production compared to the resources available to each party;
5. The relative ability of each party to control costs and their incentives to do so;
6. The importance of the issues at stake in the litigation; and
7. The relative benefits to the parties of obtaining the information.

Drafting broad discovery requests risks a determination that to respond would be overly burdensome, and, therefore, the request may be denied—or at least result in shifting the cost to produce to the requesting party. However, a request that errs on the side of specificity may yield too few results.

While experts occasionally may be able to offer testimony to support these factors (e.g., factor No. 3), an understanding of all seven factors can help experts support lawyers in preparing discovery requests related to financial and accounting issues.

### Requesting Electronic Documents

When it comes to electronic documents, requests can be limited by something as simple as a keyword search. If experts can limit discovery requests by creating lists of critical individuals and keywords, they can help protect clients from the threat of cost-shifting. *Rowe* and *Zubulake*, plus a more recent case, *Wiginton v. CB Richard Ellis*, 2004 U.S. Dist. LEXIS 15722 (N.D. Ill. Aug. 9, 2004) (*Wiginton*), have dominated the discourse on cost-shifting in federal courts.

*Rowe* set the standard for evaluating cost-shifting. In this case, concert promoters, were claiming discriminatory and anti-competitive practices by the booking agent defendants.

In their initial discovery requests, the plaintiffs asked for all communications by or between the defendants regarding the selection of concert promoters as well as any documents regarding the selection process. At that point, the judge created the Rowe Test used to evaluate the request.

He found that because of the overly broad (and therefore, costly) request and the fact that it was unlikely to result in a "gold mine," the costs should be shifted to the plaintiffs. Had the plaintiffs added keywords to their request for documents, the marginal utility factors (factors Nos. 1 and 2) and cost factor No. 3 may have swung in their favor and pre-empted them from having to bear the costs of the discovery.

In *Zubulake*, a case of alleged gender discrimination and illegal retaliation, the plaintiff went about her discovery requests in a more targeted way than did the plaintiffs in *Rowe*. Initially, Zubulake requested all communications by or between UBS employees that specifically referenced her. She later narrowed the request by limiting her results to include the communications of five specific individuals.

The court used this narrowed request to perform a "sample discovery" on five of 75 backup tapes containing e-mails. The purpose of the sample discovery was to allow the judge to better assess the costs and benefits of the search to determine a need for cost-shifting.

Of the 600 e-mails yielded by the sample discovery, the plaintiff identified 68 as being particularly relevant to her case. Since the e-mails only could be found on the backup tapes and there were 70 tapes remaining to be searched, the judge decided that the marginal utility factors weighed against shifting the costs to the plaintiff.

Additionally, despite the high cost of searching the remaining tapes (approximately $166,000), the potential damages at stake were in the millions of dollars, thus weighing against shifting the costs. After reviewing the remaining factors, the judge decided to shift 25 percent of the discovery costs to the plaintiff.

*Wiginton* had a far less favorable outcome for the requesting party. The plaintiffs, claiming sexual harassment in the form of widely circulated pornographic e-mails in the workplace, sought the discovery of e-mail communications nationally.

Though plaintiffs attempted to target their requests, they were unable to satisfy the marginal utility requirements that may have helped them avoid cost-shifting. In this sample discovery, the request by

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# AICPA Alert

*by Jeffrey H. Kinrich, CPA and Ronald L. Durkin, CPA*

The AICPA's new Business Valuation/Forensic & Litigation Services Membership Section is up and running. As its name implies, it is dedicated to serving AICPA members interested in the BV and FLS disciplines. You can find more information at *http://bvfls.aicpa.org*.

The BV standards saga continues as the AICPA has prepared another draft for review by interested AICPA committees and targeted outsiders. The most recent draft addresses nearly all the concerns expressed by FLS practitioners.

The draft and accompanying commentary make it clear that the standards only apply to BV engagements and do not apply to calculation of damages, lost profits, etc., unless the measure of damages is the value of the business. The mere use of certain business valuation techniques, such as present value calculations, does not by itself mean that the standards apply.

Further, the draft contemplates that litigation assignments will be exempt from the reporting standards (but not the substantive analytical standards) because the courts have their own reporting requirements and customs. The BV Standards Committee intends to release an exposure draft to the public soon. You are encouraged to read and comment on the public exposure draft. When the draft is finalized into standards, it will be applicable to all AICPA members.

The AICPA circulated a discussion memorandum dealing with the implementation of SAS 99, *Forensic Services, Audits and Corporate Governance: Bridging the Gap*, which was reviewed and commented on by CalCPA's Litigation Sections and Accounting Principles and Auditing Standards Committee.

Both groups believe SAS 99 is sufficient to deal with the issue of fraudulent financial reporting. They also believe that audits do not need forensic involvement to conduct the procedures contemplated under SAS 99. Major accounting firms, smaller accounting firms, regulators, and others recently participated in an AICPA-sponsored roundtable on the discussion memorandum. Those who commented at the roundtable seemed to confirm the fact that SAS 99 is sufficient if it is followed.

The AICPA Antifraud Programs and Controls Task Force, charged with developing guidance for audit committees and others in the areas of antifraud programs and controls, is working on a discussion paper, *Management Override: The Achilles Heel of Fraud Prevention*. The paper deals with potential methods management could use to override an otherwise effective system of internal controls. The document also discusses the legal responsibilities of the audit committee; programs that prevent, deter, and detect fraud; and other issues dealing with business and related financial statement risks.

California is represented on both the newly formed BV/FLS Executive Committee and the FLS Subcommittee. The Executive Committee includes chair Mike Ueltzen and member Ron Durkin, and the FLS Subcommittee includes Jeff Kinrich as the sole representative from California.

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## Injury Loss Calculations

*Continued from Page 1*

is employed because these factors may affect the plaintiff's future employment and earnings.

### Failure to Account for Opportunities to Mitigate Damages

In personal injury cases, the plaintiffs' experts often calculate "but for" earnings and subtract so-called mitigation earnings, so that the net difference results in lost earnings. However, these calculations still may overstate lost earnings because of the failure to consider opportunities to further mitigate damages, as the following examples show.

1) The plaintiff underwent vocational rehabilitation and explored possible alternative employment, going so far as to obtain a vocational rehabilitation loan to start a business. However, he did not follow through on his business plan. The analysis by the plaintiff's expert failed to cut off damages past the point where the plaintiff was given this opportunity to mitigate his damages and likely exceed pre-accident earnings.

2) The plaintiff was employed in the financial services industry at the time of the injury. He claimed his injury prevented him from making presentations to prospective clients because he was unable to travel and carry heavy equipment. His claim failed to account for opportunities to mitigate his damages by, for example, hiring someone to carry his equipment or shifting more of the presentation duties to his partner.

### Summary

Projecting lost earnings with insufficient data, failing to establish causality, and failing to consider mitigation are frequent mistakes in calculating personal injury losses. These mistakes often result in inflated personal injury loss calculations and may damage the credibility of an expert—whether representing the plaintiff or defendant. Experts who are faced with these issues should discuss them with their clients.

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# HAPPENINGS

## Litigation Sections Meetings

| | |
|---|---|
| Business Valuation | Thursday, Feb. 3, 2005, LAX<br>Thursday, May 12, 2005, SFO<br>Thursday, Aug. 4, 2005, LAX<br>Thursday, Nov. 3, 2005, SFO |
| Economic Damages | Wednesday, Feb. 2, 2005, So. Cal.<br>Wednesday, Apr. 20, 2005, LAX |
| Family Law | Friday, Feb.4, 2005, LAX<br>Friday, May 13, 2005, SFO<br>Friday, Aug. 5, 2005, LAX |
| Fraud | Tuesday, Feb. 1, 2005, LAX |

Each section will send individual meeting notices.
Download a copy at *www.calcpa.org/LIT*
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## *Education Foundation Courses—(800) 877-5897 or www.educationfoundation.org*

| | |
|---|---|
| Valuation Update and Case Studies for the Experienced Practitioner | Jan. 31, 2005, San Diego |
| Advanced Business Litigation Institute | May 5-6, 2005, La Quinta Resort & Spa |

## Keepin' It Legal

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plaintiffs yielded very few e-mail responses (between 4.5 percent and 6.5 percent).

Though it was determined that the backup tapes of the defendants were the only source of these e-mails, the extremely low rate of responsive e-mails led the judge to rule in favor of shifting the costs of this production request to the plaintiffs. The costs in this case were also exceptionally high in relation to the potential damages award. The plaintiffs were ordered to pay 75 percent of the costs of discovery.

### Cost-Shifting and California

The rules regarding cost-shifting in California Superior Court are significantly more flexible and leave the decision largely at the discretion of the court. Code of Civil Procedure (CCP) Sec. 2019(b) and Sec. 2031(f) give the court the power to restrict discovery that is determined to be obtainable from other sources or is unduly burdensome. CCP Sec. 2031(g) provides that cost-shifting is appropriate when the demanding party has to translate data into a form usable by the requesting party.

In *San Diego Unified Port Dist. v. Douglas E. Barnhart, Inc.*, 95 Cal.App.4th 1400 (2002), in dictum citing a federal case, the court endorsed cost-shifting to the party seeking discovery in the case of " … discovery involving significant 'special attendant' costs beyond those typically involved in responding to routine discovery."

In *Dodge Warren & Peters Ins. Serv. v. Riley*, 105 Cal.App.4th 1414 (2003), the trial court ordered that " … the reasonable cost to defendants to review the copied files for irrelevant and privileged documents was to be borne by [plaintiff], subject to reallocation by the trial court."

In *Person v. Farmers Insurance Group of Companies*, 52 Cal.App.4th 813 (1997), a case in which a doctor held records and refused to comply with a subpoena for documents, the court ordered that if the raw data exists and the preparation of the compilation is not unduly burdensome or oppressive, the doctor must compile and provide an itemized statement.

The rules surrounding cost-shifting have changed and may continue to do so. There may be a fine line between discovery requests that are too broad and costly and requests that are too specific to yield useful results. By being knowledgeable about the factors judges use to evaluate cost-shifting in both state and federal courts, experts have the potential to assist clients and counsel and to save them considerable time and money.

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