The Witness Chair

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

SPRING 2003 ISSUE 30

CalCPA Files Amicus Curiae Petition in *In re Marriage of Rosen*

by Donald Glenn, CPA, Terry Hargrave, CPA and Donald Miod, CPA

The California Society of CPAs (CalCPA), at the request of the Litigation Sections Steering Committee and the Family Law and Business Valuation Sections, recently filed an application for leave to file a petition for rehearing, modification or depublication of opinion and supporting declaration (Petition) as amicus curiae with the California Court of Appeal (Court). The Petition responded to *In re Marriage of Rosen* (2003 DJDAR 921), in which the Court overturned a trial court ruling finding of goodwill in Bruce Rosen's law practice. While CalCPA agreed with the Court's finding of no goodwill, it disagreed with the Court's rationale in arriving at that conclusion.

Two of the issues addressed in the Petition were: 1) the Court stated the appraiser "should have averaged Bruce's earnings" in his calculation of normalized earnings, and 2) the Court questioned the use of compensation surveys to determine reasonable compensation.

Mrs. Rosen's appraiser measured Mr. Rosen's income using the highest of his recent years' income. The trial court agreed, finding $42,500 of goodwill. The Court reversed, finding no goodwill in Mr. Rosen's law practice. The Court stated that earnings should be averaged over three years and was critical of the appraiser's work and commented that, "a reasonable trier of fact could not help but conclude the expert chose to use Bruce's net income from 1995—one of Bruce's highest earning years—solely to inflate the value of goodwill."

While it appears appropriate to use the average of the three years prior to the date of separation, in this case the wording of the decision may have precluded experts from exercising their judgment in deciding whether or not to use an average.

There are circumstances when the use of an average would not result in the best estimate of the normalized earnings, such as when the earnings have been steadily increasing and are expected to continue rising, or steadily declining and expected to continue declining.

The Court was also critical of the role of compensation surveys in determining reasonable compensation. The Court opined that the surveys used by Mrs. Rosen's expert (RMA and Altman & Weil) were not "statistically accurate" and should, therefore, not be used. The Court was on firm ground in its criticism of Mrs. Rosen's appraiser's lack of thoroughness and possible bias, and therefore reversed the trial court's conclusion.

The Court's wording on this point, however, was troubling to CalCPA. CalCPA believes that compensation surveys are valuable sources of evidence and if properly used can, and should, be allowed in business appraisals.

Although the Court denied CalCPA's petition for rehearing and depublication, it granted the petition for modification.

In response to CalCPA's comments, the opinion was modified to state, "[u]nder the facts presented in this case, the expert should have averaged Bruce's net earnings." This removed the requirement to average and allows appraisers flexibility in deciding the most appropriate estimate of normalized earnings.

The Court also modified its opinion regarding surveys. It removed its reference to statistical accuracy and added, "We do not disapprove of compensation surveys as a general matter. We realize they can be useful when used properly." The Court retained its question of "whether a *national* survey of lawyer compensation (such as the Altman Weil survey) is a proper basis for offering an opinion on

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In this Issue

ACTION

Business Valuation
by Robert Wallace, CPA

Does a marketability discount apply when valuing shares pursuant to a fair value appraisal?

It is well established that a minority discount does not apply when valuing an interest under the California Corporations Code, Sec. 2000 (Sec. 2000) fair value statute. But should a marketability discount be considered?

In a recent Colorado Supreme Court decision, *Pueblo Bancorporation v. Lindoe, Inc.,* (Colo., Jan. 21, 2003) the Court rendered the opinion that, as a matter of law, it is inappropriate to apply a marketability discount at the shareholder level in a dissenting shareholder action.

To support its opinion, the Court cited the national trend disfavoring discounts, the American Law Institute's 1994 interpretation eliminating discounts in fair value appraisals, and the 1999 amendments to the Model Business Corporation Act stating that discounts, both minority and marketability, do not apply in such valuations.

Does this help in assessing the applicability of marketability or liquidity discounts to fair value determinations under Sec. 2000? Probably not.

Sec. 2000 is unique in that it is a dissolution statute as opposed to a dissenters' rights statute. The statute at issue in the Colorado case was a dissenters' rights statute. If the purpose of the dissolution statute is to provide the shareholder with a price equivalent to dissolution, then many would argue that a marketability, or liquidity, discount applies in the

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Economic Damages
by William E. Simpson, CPA

While CPAs have long understood the dangers of document destruction—even before Enron—destruction of draft reports by experts has been a practice common to many CPAs engaged as expert witnesses. Justifications are many, including: elimination of confusion, reduction of storage requirements, and simplification of expert testimony as a result of the elimination of the conflicting and varying "opinions" which result from the existence of draft reports.

Two recent court opinions have made clear the hazards associated with destruction of draft reports. The courts in both cases ordered that draft reports of the experts be provided to the opposing parties.

Many CPAs believe that as long as the destruction of their draft reports is associated with their standard document retention policy, their practice of destroying draft reports would pass judicial muster. This belief has been undermined by *Trigon Insurance Company v. United States of America* [Civil No. 3:00cv365, 2001 U.S. Dist. LEXIS 18824 (E.D. Va., Nov. 9, 2001)]. In *Trigon* an expert destroyed his draft reports in accordance with his standard document retention policy. The court found " …the rather obvious effect, and perhaps even the purpose, of [the expert's] document retention policy was to eliminate this source of undeniably meaningful cross-examination resource about the substance of the expert opinions.... " The court also noted that " …document retention policies…do not trump the Federal Rules of Civil Procedure.... "

Trigon addressed draft expert reports sent between or among different experts and consultants, but it did not address draft expert reports sent to retaining counsel.

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Family Law
by David S. Cantor, CPA

In recent years there have been some case rulings addressing issues, which on the surface appear to make the jobs of expert witnesses less troublesome. Two such examples are *In re Marriage of Schulze* and *In re Marriage of Rosen* (pre-modification). But are these cases the detailed road map to be used in preparing our own assignment, or just a general set of directions? The answer to that question is simple: it depends.

Every case has its own set of facts and circumstances. Once the expert has unraveled the details of the case, they must then decide what to do with the facts learned. Without a doubt, the first areas to look toward for guidance are case law, the California Family Code (Family Code), and professional expertise. The expert must analyze the facts and circumstances of each specific case to see if case law and/or the Family Code are applicable. Many times it is that simple; there is case law on point or a Family Code section addressing specific issues. However, sometimes the facts and circumstances of a case are similar to, but not exactly on point with, existing case law.

Additionally, there may not be a Family Code section addressing the precise situation. If existing case law or the Family Code does not provide the appropriate guidance, the expert should confer with counsel to formulate a strategy for proceeding with the assignment(s). Keep in mind that if a case requires an atypical analysis, be prepared for rigorous cross-examination as well as questions from the judicial officer as to why established case law or the Family Code has not been applied.

David Cantor, CPA, ABV is incoming chair of the Family Law Section and a partner at Gursey, Schneider & Co. LLP in Los Angeles.

Fraud

by Karin Rohn, CPA

Results of a study by the U.S. General Accounting Office (GAO) of financial statement restatements due to accounting irregularities were recently released and have proven to be a great source of information regarding financial statement frauds. The study provides not only an in-depth analysis of recent frauds, but also important information related to restatement trends, impacts on financial markets, regulatory responses, and challenges that the SEC and other standard-setters now face.

Not surprisingly, the results of this study show that financial statement restatements have increased dramatically in the past five years (approximately 145 percent from January 1997 through June 2002). Although only a small proportion of public companies restate their financial statements on a yearly basis (approximately 2.5 percent), the number of restatements increased from 92 in 1997 to 225 in 2001, with another increase expected in 2002.

The study found that restatements have not only been frequent, but also financially significant. The GAO estimated that restatements eradicated approximately $100 billion in market capitalization in the past five years and that, on average, stock prices dropped almost 10 percent from the trading day before an initial restatement announcement to the trading day after the restatement.

Although the GAO found that companies restated their financial statements for many reasons, the study showed that restatements involving revenue recognition accounted for almost 38 percent of the restatements and was the primary reason for restatement each year. The study also showed that restatements involving revenue recognition led to greater market losses, and had an even greater negative impact on stock prices over periods than other types of restatements.

The GAO study placed blame for these restatements among

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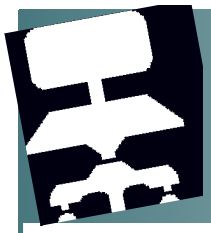

Message from the Chair

by D. Paul Regan, CPA

The Litigation Sections Steering Committee's meeting on Jan. 30–31 was packed with content and discourse, including analyses of significant cases and GAAP, GAAS, AICPA, and CalCPA issues.

There was one issue that was initiated during our meeting that made me proud to be a part of the Steering Committee and CalCPA. It also demonstrated the importance of the teamwork of the Steering Committee and CalCPA. The issue raised was a California Court of Appeal case that was filed on Jan. 23. The case is *In re Marriage of Rosen* (2003 DJDAR 921). The technical issues of this case are not the subject of my discussion. What was particularly impressive to me was the swift and effective action taken by the Steering Committee and CalCPA.

On Thursday morning, Jan. 30, the key details of the *Rosen* case were presented to the Steering Committee. It soon became apparent that, left unchanged, the case contained language that could lead to poor judicial decisions and troubling impacts on CPAs performing forensic accounting services. It was agreed that a task force of the Steering Committee would prepare a declaration to be filed with the Court of Appeal of the State of California, subject to the approval of CalCPA's CEO and Amicus Curiae (Amicus) committee.

After the day's meeting, Associate Director Maria Nazario and I called CalCPA CEO Susan Waters to discuss the process of hiring counsel and getting the Amicus committee's approval to file an application for rehearing, modification, or depublication of the opinion. Susan agreed to arrive at her office at 6 a.m. the next day to begin the process of gaining the Amicus committee's approval. Meanwhile, Don Glenn, Mark Luttrell, Don Miod, Terry Hargrave and other Steering Committee members began to prepare a declaration that would accompany the application and contacted Bernard Wolf, an attorney with substantial experience in these issues, to prepare the filing.

The following week was a blizzard of meetings, e-mails, and faxes. The Amicus committee met in Sacramento on Tuesday, Feb. 4 and I signed the declaration for a timely filing on Feb. 6. On Feb. 19, the Court of Appeal of the State of California accepted substantially all of the modifications suggested by CalCPA and ordered that the opinion be changed accordingly. In addition, the opinion expressly states the Court's appreciation for CalCPA's contribution and interest in these important issues.

This was clearly a job well done. Congratulations to all of the above-mentioned bright, caring, and dedicated individuals who practice the goal of protecting the public with their energy and commitment to our profession.

Paul Regan, CPA, CFE is president & chair of Hemming Morse, Inc., CPAs, Litigation and Forensic Consultants in San Francisco.

Keepin' It Legal

Prejudgment Interest: An Element of Damages That Must Not Be Overlooked

by Timothy J. Buchanan, Esq. and James W. Brody, Esq.

Expert damages analysis in both contract and tort cases should always consider whether prejudgment interest is available. Further, the attorney and expert should determine the appropriate standards for assessing prejudgment interest and determine the proper rate at which it will accrue.

Both state and federal laws have extensive provisions governing accrual of interest from date of violation forward. The key difference is that California, like most states, has enacted statutes that govern these issues, while federal law relies on the courts to develop fair rules to make the claimant whole in any damages award.

State Law

California statutes cover several situations in which prejudgment interest may be awarded as part of the plaintiff's damages:

1. *Mandatory* interest where the damages are "liquidated," that is, damages that are "certain, or capable of being made certain by calculation" and the right to them has vested in the plaintiff on a particular day [Cal. Civil Code, Sec. 3287(a)].
2. *Discretionary* interest, in the judgment of the court or jury, in contract and tort cases where the damages are "unliquidated," or when punitive damages are awarded [Cal. Civil Code, Secs. 3287(b), 3288].

Often, the plaintiff is seeking recovery for contract breach or other economic loss and asserts the sum is readily calculable. The test for what damages are "certain, or capable of being made certain" is whether the defendant knows the amount owed or could have computed the amount from reasonably available information [*Children's Hosp. & Med. Center v. Bonta* (2002) 97 Cal.App.4th 740, 774]. Where there is no factual dispute over the amount owed, but the defendant disputes legal liability, the damages meet the test and prejudgment interest is awardable. But where the defendant raises factual disputes about the amount owed and a verdict is required to resolve the conflict, the damages are treated as unliquidated and prejudgment interest is not mandatory—but still can be sought as a discretionary award.

California … has enacted statutes that govern these issues, while federal law relies on the courts to develop fair rules to make the claimant whole in any damages award.

Many cases in which expert assistance is needed are internal entity disputes, such as an action for partnership dissolution. If the complaint seeks an accounting, this by itself may show the damages are uncertain within the meaning of the test. But a court still may award prejudgment interest as a matter of equity, so it should figure in any damages analysis.

If the damages are unliquidated, the plaintiff may seek a discretionary award of prejudgment interest if the claim is founded upon a contract or a tort, such as negligence, fraud, or interference with business. On a contract claim, the court may decide the date from which to run the interest, but the interest cannot reach back earlier than the date the complaint was filed. In tort cases, prejudgment interest may only be awarded on economic damages. Thus, it cannot be awarded on claims of personal injury or emotional distress, but can, for example, be applied to damages for loss of use of funds or property. The amount of damages need not be readily ascertainable.

A final statute allows prejudgment interest in any personal injury case in which the defendant rejects a plaintiff's statutory offer of judgment (settlement) under Code of Civil Procedure, Sec. 998 (Sec. 998) and the plaintiff obtains a "more favorable" judgment at trial. In such a case the plaintiff is entitled to recover 10 percent interest on the judgment from the date of the Sec. 998 offer (Cal. Civil Code, Sec. 3291).

The rate of prejudgment interest depends on what type of claim is at issue. On a contract, the contract rate is used until the contract is superseded by a judgment. Otherwise, the rate is 10 percent on contracts entered into after 1985, and 7 percent for earlier contracts (Cal. Civil Code, Sec. 3289). For non-contractual claims, and in cases against public entities, the rate is 7 percent per annum from the date the claim arose (*Children's Hosp., supra).* In limited contexts, interest may be compounded, so consult with counsel on this issue.

Federal Law

There is no federal statute governing prejudgment interest. Case law has developed rules allowing such an award if necessary to make the plaintiff whole in a damages award. If federal jurisdiction is based upon diversity of citizenship, the federal court adopts the laws of the forum state on prejudgment interest. If

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AICPA Alert

by Ann E. Wilson, CPA

The AICPA's Litigation and Dispute Resolution Services (LDRS) Subcommittee met Feb. 27–28 in Miami. Topics of discussion included the following:

The Consulting Services Special Report, 03–01, *Responsibilities of Practitioners Providing Litigation Services*, has been published. If you are not a member of the AICPA's Consulting Services section, see the online *AICPA News Update* for information on how to order this publication. Many thanks to the members of CalCPA's Litigation Sections Steering Committee for their valuable input to this important publication. Extra special thanks goes to Mike Ueltzen for shepherding this document through the process from conception to final publication. This was a monumental effort by Mike and his task force.

A Strategic Plan has been developed for the LDRS to guide our efforts over the next 18 months. The plan focuses on educating litigation practitioners; providing tools to assist practitioners to acquire necessary skills and competencies; and increasing recognition of litigation services practitioners within the profession and in the "external world"—attorneys, the judiciary, and the general public.

A Competency Model is being developed for the Business Valuation/LDRS practice area. It is scheduled to be completed in the spring. The Fraud Competency Model has already been completed and may be obtained from CPA2Biz, Inc. The purpose of the competency models is to provide tools for practitioners to assess their level of skill in various practice area requirements and then to provide a list of resources where practitioners may acquire the skills they need to enhance.

The proposed *Statement on Standards for Valuation Services No. 1* (Standards) is undergoing some rewriting in response to the many letters of comment that were received during an informal comment period. There will be a formal public exposure period before the Standards are finalized.

A Family Law practice aid, focusing on divorce, will be published this summer.

As a follow up to an interactive session held at the Las Vegas Advanced Litigation Conference on Oct. 30, 2002, and as a result of recent SEC rulings, a white paper has been developed outlining key areas of the Sarbanes-Oxley Act of 2002 that will affect litigation practitioners.

Ann E. Wilson, CPA, CFE is a member of the AICPA's LDRS Subcommittee. She is a sole practitioner with offices in Solana Beach and Pasadena.

Business Valuation

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measure of fair value when determining the possibility, if any, of a sale as a going concern.

In a recently decided California case involving a valuation under Sec. 2000, *Bradley Mart v. Leland Severson* (2002) 95 Cal.App.4th 521, the Court of Appeal did not directly address the issue of a marketability discount—but the appraisers did. The appraisers unanimously concluded that fair value meant the price that would be received for the corporation in a liquidation sale under court supervision, assuming a tainted sale environment and a forced seller.

Whether labeled a marketability discount, a liquidity discount, or some other term, the potential impairment to value resulting from the conditions and costs of a forced sale is an appropriate consideration in a Sec. 2000 valuation.

Rob Wallace, CPA, JD, ASA and Business Valuation Section chair, is a principal with Wallace, Delury & O'Neil, Inc. in Sacramento.

Fraud

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corporate management, boards of directors, auditors, securities analysts, and credit rating agencies. The most important question that the study was unable to answer, however, was whether or not the recent actions taken by Congress, the SEC, and private industry will be able to reverse this damaging trend. For that, only time will tell.

Karin Rohn, CPA, CFE is a manager in KPMG LLP's Forensic Practice in Los Angeles.

Keepin' It Legal

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jurisdiction is based upon a federal claim, such as violation of federal securities or antitrust laws, the court adopts federal law, focusing primarily on whether interest is consistent with policies underlying the statute at issue. Courts generally apply market rates of interest, making expert analysis even more essential.

In summary, counsel and experts should not overlook prejudgment interest as a vehicle to maximize damages calculations and make the claimant whole for a loss.

Timothy J. Buchanan is a partner in the Commercial Litigation Practice Group of McCormick, Barstow, Sheppard, Wayte & Carruth LLP in Fresno.

James W. Brody is an associate attorney in the Commercial Litigation Practice Group of McCormick, Barstow, Sheppard, Wayte & Carruth LLP in Fresno.

Amicus Curiae

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average lawyer compensation in *Southern California*." This comment by the Court has merit, but the cited survey, Altman & Weil, in addition to national averages, contains compensation information describing industry specialty, geographic location, size of firm, billing rates, billable hours, years in practice, etc. In the modification, the Court reasoned, "[t]he expert did not attempt to relate the information in the surveys to an analysis of Bruce's law practice."

The lesson for the appraiser is to correlate survey data to the subject case. The Court's modified opinion now provides guidance and caution on the use of surveys, not their prohibition, which was one of the thrusts of CalCPA's petition.

Donald Glenn, CPA, ABV; Terry Hargrave, CPA, ABV; and Donald Miod, CPA, ABV are former chairs of the Family Law Section.

Economic Damages

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However, destruction of draft expert reports sent to retaining counsel was the main topic of *W.R. Grace & Co.,-Conn. v. Zotos International, Inc.* [No. 98-CV-838S(F), 2000 U.S. Dist. LEXIS 18096 (W.D.N.Y., Nov. 2, 2000)]. In *Grace* the expert discarded prior drafts, which included written comments by attorneys on them, two weeks prior to his deposition at the request of retaining counsel. The court stated, "[t]he availability of cross-examination at trial to thoroughly probe the basis and process of the reasoning underlying an expert's opinion as stated in his report is not an adequate substitute for pretrial disclosure and evaluation of the specific information received by the expert from an attorney."

Both *Trigon* and *Grace* are federal court cases, but neither is a Ninth Circuit case. However, the analysis of the law in the cases appears to be universally applicable. The main concern expressed in both cases was the opposing party's discovery right to obtain prior expert report drafts sent to third parties as well as the written notations received by the expert from the third parties regarding the drafts. Courts are concerned with whether the opinions expressed in expert reports have been influenced or changed as a result of input received from third parties, including, and perhaps especially, retaining attorneys.

While making it clear that draft expert reports sent to third parties should not be destroyed, the issue of draft reports prepared and not shared with third parties remains open. In *Trigon* the court stated, "[t]here is no need to decide in this case whether a testifying expert is required to retain, and a party is required to disclose, the drafts prepared solely by that expert while formulating the proper language in which to articulate that expert's own, ultimate opinion arrived at by the expert's own work or those working at the expert's personal direction. There are cogent reasons which militate against such a requirement but the issue is not presented here...."

William E. Simpson, JD, CPA, is secretary of the Litigation Sections. He is senior managing director of FTI Simpson.

HAPPENINGS

Litigation Sections Meetings

Business Valuation:	Thursday, May 29, OAK Thursday, July 17, LAX Thursday, Sept. 18, OAK
Economic Damages:	Wednesday, July 23, LAX October 2003, SFO
Family Law:	Friday, May 30, OAK Friday, July 18, LAX Friday, Sept.19, OAK
Fraud:	Tuesday, July 22, LAX Tuesday, Oct. 14, LAX

Each section will send individual meeting notices.

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Advanced Business Litigation Institute May 8-9, La Quinta, CA

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