Complimentary Copy • Volume 3 • 2015

National Litigation Consultants' Review

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

UPCOMING EVENTS

Annual Consultants' Conference
June 6–11, 2016
San Diego

Specialty Conferences:

- **Business Valuation and Healthcare Valuation Conference**
  September 19–24, 2016
  Washington, DC
- **Exit Planning and Transaction Advisory Services Conference**
  October 24–29, 2016
  New Orleans
- **Financial Forensics and Expert Witness Conference**
  November 14–19, 2016
  Chicago
- **Financial Consultants' SuperConference**
  December 5–10, 2016
  Las Vegas

INSIDE THIS ISSUE

Feature Article 1
Practice Tips 1
Business Valuation for the Litigation Practitioner 6
I Do Solemnly Swear 11

Data Sources for Expert Reports in Health Care Disputes

By Michael Heil, MHHSA, CVA, MAFF; Chris Fritz, MBA; and James Werner, CPA, CVA, MAFF

Introduction

This is the first in a four-part series. **Part 1** outlines the types of health care disputes that would benefit from the data sources and approaches outlined in the series, and identifies core principles. Although the dispute detailed in parts 2, 3, and 4 each require a unique approach, they share similar core principles and technical approaches. **Part 2** will focus on payment disputes between hospitals and commercial health plans, in particular those where determinations of reasonable value are required, and will provide information about effective data sources. **Part 3** will focus on payment disputes between physicians and commercial health plans, similarly requiring reasonable value determinations. **Part 4** will focus on disputes involving physician practices requiring determinations of economic damages in which the financial performance of a practice is important.

Part 1: Types of Disputes, Core Principles, and Data Sources

High-quality data are vital to effective expert reports. This series of articles focuses on data sources and offers guidance to those interested in preparing or engaging others to prepare expert reports in two categories of disputes between health care providers and commercial insurance plans: those involving hospitals and those involving physician practices. The series also covers disputes where economic damages need to be determined related to the financial performance of a medical practice.

Disputes between commercial health plans and hospitals or physicians frequently involve situations where an agreement does not clearly specify rates of payment.

Continued on Page 2

Practice Tips

The Income Tax Treatment of Economic Damages Awards

P. Dermot O'Neill, CPA and Michael D. Pakter, CPA

Part 1: The Income Tax Treatment of Personal Economic Damages Awards

Introduction

Financial experts are frequently asked about the tax impact of damage awards, both paid and received. The complexities of the Internal Revenue Code (IRC) and judicial interpretations thereof make determining the taxability of receipts or payments difficult. The same is true when dealing with the taxability of economic damages awarded to plaintiffs in civil actions. Nuances in the IRC and the judicial interpretations may make it difficult for a taxpayer to determine the taxability of his or her proceeds from a litigation award of

Continued on Page 4

National Litigation Consultants' Review

PUBLISHER
Litigation Forensics Board of NACVA
Sponsors of the MAFF Designation
5217 South State Street, Suite 400,
Salt Lake City, UT 84107-4812
(801) 486-0600 • www.NACVA.com

MANAGING EDITOR
P. Dermot O'Neill, CPA, ABV, MAFF, CVA
P. Dermot O'Neill, CPA, PC, Philadelphia, PA

ASSISTANT EDITOR
Michael D. Pakter, CPA, CFF, CGMA, CFE, CVA, MAFF, CA, CIRA, CDBV
Gould & Pakter Associates, LLC, Chicago, IL

EDITORIAL ADVISORY BOARD
Darrell D. Dorrell, CPA/ABV, MBA, ASA, CVA, CMA, DABFA
financialforensics®, Lake Oswego, OR
Karen B. Fortune, CPA, CFF, MAcc
IAG Forensics, Marietta, GA
Michael G. Kaplan, CPA, CVA, MAFF
Kaplan Abraham Burkert & Company, Calabasas, CA
Charles S. Lunden, CPA, ABV, CFF, CFE, CLU, FLMI
Bederson & Company, LLP, West Orange, NJ
Michael J. Molder, JD, CPA, CFF, CFE, CVA
AILA Limited, Wynnewood, PA
Megan Salehli, CVA, ASA, CFE
Asterion, Inc., Philadelphia, PA
Mark S. Warshavsky, CPA, ABV, CFF, MBA, CVA, CBA, CFE, DABFA, MAFF
Gettry Marcus, CPA, PC, Woodbury, NY
Ricardo J. Zayas, CPA, CFE, CVA, CFF, MS
Nihill & Riedey, PC, Philadelphia, PA

SUBSCRIPTION INFORMATION
The *National Litigation Consultants' Review* (NLCR) is published online by the Litigation Forensics Board of the National Association of Certified Valuators and Analysts (NACVA), 5217 South State Street, Suite 400, Salt Lake City, UT 84107-4812, sponsors of the Master Analyst in Financial Forensics™ (MAFF®) designation. The NLCR is free to the holders of the MAFF designation, complimentary for attorneys, and free to NACVA members. To find out how to receive the NLCR, contact NACVA's Member/Client Services at (NACVA1@NACVA.com). All other correspondence can be sent to the Managing Editor at the above address.

DISCLAIMER
"This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice, accounting, or other professional assistance is required, the services of a competent professional person should be sought." – From a Definition of Principles jointly adopted by a committee of the American Bar Association and a Committee of Publishers and Associates.

Continued from Page 1

Hospital–Health Plan Disputes

Hospitals or multi-hospital systems provide emergency care to patients insured by health plans with which the hospitals do not have a contract. When contracts do exist, the hospital is usually considered part of the health plan's selective provider network. The health plan directs routine and non-emergency services to network hospitals. In exchange, those hospitals agree to rates discounted from their standard charges.

The first dispute occurs when non-network hospitals expect to be paid their standard charges for emergency services when patients are taken to non-network hospitals. Disputes arise when health plans believe those standard charges are in excess of "reasonable value" and pay at lower rates that they determine.

The second dispute occurs when there is a network contract. Network contracts typically specify a simple set of rates for routine services and major disputes rarely arise. In many network contracts, less common services are covered by a provision requiring payment at a specified discount rate from the hospital's standard charges. The services covered by these provisions are typically for patients with extremely resource-intensive conditions, referred to as "stop-loss" cases, and for highly specialized services such as trauma center care and neonatal intensive care. Disputes arise throughout the term of the agreement when a health plan believes the hospital has increased its standard charges to an unreasonable level.

Physician Services

Cases involving payments by commercial health plans to physicians follow the same pattern as hospitals. Case types are variable for general contract disputes involving physicians when physician practice financial performance needs to be evaluated to determine damages.

Size of Disputes

In our experience, for disputes listed above, the economic damages awards in cases that reach state court or arbitration proceedings typically range between $3 million and $250 million. The higher levels are typically associated with larger, multi-hospital systems. The inclusion of pre-judgment interest, for a dispute spanning five years, is likely to bring the total to between $3.9 million and $300 million.

The resolution of the dispute—settlement or judgment—frequently determines or influences, future rates of payment. For example, even at current, low-risk cost-of-funds rates, the present value of a judgment of $40 million for a five-year dispute ($8 million per year) is likely to be at least an additional $34 million, depending on the cost-of-funds rate.

The size of disputes between physicians and commercial health plans is typically lower than for hospitals ($500,000 to $5 million), except in the case of very large, multi-specialty medical groups. The size of disputes in general damages cases involving physician practices is variable and appears to depend on specialty.

Central Task

The central task in each of these cases is to establish industry practices and market patterns compared to the subject organization. The first challenge is to find the best data sources.

Core Principles for Data Sources

In our experience, there are four core principles for selecting benchmark data sources:

1. Comparability
2. Validity
3. Transparency
4. Statistical stability

Comparability should be optimized by considering several key factors:

- The benchmark data should be comparable for a time period as close as possible to the subject matter in the dispute.
- For hospital charge and payment information, care should be taken to differentiate between inpatient and outpatient care.
- For hospital and physician charge and payment information, care should be taken to use an appropriate geographic area—small enough to reflect regional differences but large enough to be statistically reliable.
- For hospital and physician charge and payment information, data should be normalized for intensity. For inpatient hospital services, the best way to do this is to use Diagnosis Related Groups (DRG), the most widely used system for grouping hospital inpatient services according to resource requirements. DRG weights can be used to normalize; dividing charges or payments by the case mix index or by directly comparing a hospital's charge for a specific DRG to a benchmark charge for the same DRG. For outpatient hospital services, there are four options:

  i. Assume the finding on inpatients is applicable to outpatients (because many services provided in an outpatient setting are the same services provided in an inpatient setting, and the same price list is used in most hospitals).

Continued on Page 3

Continued from Page 2

ii. Compute average outpatient charges per outpatient encounter (taking care to interpret this highly aggregated approach).

iii. Use public-service-level price lists and build bellwether patient accounts.

iv. Use the Centers for Medicare & Medicaid Services (CMS) files for outpatients and normalize for intensity using the Medicare fee schedule (taking care to recognize that the service mix for Medicare patients will be somewhat different than for commercial health plan patients).

Validity should be assured by reviewing the "pedigree" of data, report publication, and breadth of its use in peer expert reports.

Transparency is best with public source information, such as inpatient, patient-level files from many state health departments and CMS Medicare claims data for inpatients and outpatients in hospitals. For non-public source information, it may be possible to disclose proprietary or attorneys-eyes-only data with the proper safeguards.

Statistical stability should be assured by evaluating sample size, studying year-to-year variability, and testing for significance in differences between means (using, for example, *t*-test).

Three Sources of Data for Disputes Between Hospitals and Commercial Health Plans

Three data sources are commonly used for disputes between hospitals and commercial health plans:

1. **Public Data on Inpatient and Outpatient Hospital Services (state and national):** These data are available in many states. Good examples include: (a) Florida Agency for Health Care Administration (AHCA); (b) Tennessee Department of Health; and (c) California: Office of Statewide Health Planning and Development (OSHPD), with patient discharge data sets, ambulatory surgery and emergency department data, and hospital-level data on utilization and financial performance. These data are excellent for charges and allow normalization for intensity with DRG weight. They do not include payment amounts at the patient or health insurance plan level. For inpatient services, there are also nationwide data from the CMS.
2. **Proprietary Data (Sources include: Compass Professional Health Services, FAIR Health, and OptumInsight):** These data are helpful for hospital and physician charges and payments. They contain county-level detail and DRG and CPT code-level detail with sufficient sample sizes. When large, independent data sources are not available, summaries of data from individual proprietary client work may be considered (see "Transparency" above).
3. **Paid Claims Files and Contracts:** In some cases, the parties will agree to (or the court or arbitrator will order) the exchange of "paid claims" files, which can be helpful to gain insight into confidential contract payment rates between the hospital and other health plans, and between the health plan and other hospitals. Care should be taken in interpreting these files, as discussed below.

Paid Claims Files Have Methodology Limitations

The question sometimes arises in similar analyses about the extent to which amounts accepted by providers from commercial health insurance plans (as reflected in paid claims reports) are useful in establishing reasonable value. Amounts accepted are of only limited value. The reason for this is that in some cases commercial health plans determine that a hospital's standard charges are unreasonably high and pay a lower rate based on an internal methodology. When a provider is paid less than its standard charges, the provider almost always seeks to be paid the higher amount through administrative review and appeal processes. However, when the parties do not reach agreement, the provider must make a choice between undertaking the cost of further efforts at adjudication, such as arbitration or litigation, or accepting the health insurance company's payment.

In many cases, the cost of further adjudication is high enough that the prudent decision is to "accept" the underpayment, in the sense that the provider relents in efforts to be properly paid, but does not truly accept the payment made by the health plan. Such underpayments should not be included when an analyst seeks to understand the true level of the amounts *accepted*. In a proper analysis, the overall amount shown in a paid claims file should be adjusted upward based on actual or estimated amounts disputed, amounts being adjudicated, and incremental lump-sum payments from completed adjudication proceedings that are not reflected in the account-level detail of the paid claims file as of the date of its production.

Another problem with efforts to analyze paid claims files is that when a provider succeeds in being properly paid after an extended adjudication process that may take years, the full amount paid across a large set of claims is rarely reflected in the paid claims file at claim-level detail. Rather, a lump-sum adjustment is made in the provider's aggregate financial statements years after the paid claims file was last updated.

Sources of Data for Physician Practice Economics

The following sources are useful in benchmarking physician practice economics:

1. **Medical Group Management Association (MGMA) Physician Compensation and Production:** 2014 report based on 2013 data[1]
2. **American Medical Group Association (AMGA) Physician Compensation Survey**: 2014[2]
3. **MD Ranger: Benchmark Reports** (Hospital-Based Groups, Call Coverage and Medical Administrative), 2009–2014: Published annually and most recently in May 2014, which was the fifth benchmark report published; comprehensive for all three categories of contracts between hospitals and non-employed physicians[3]
4. **MGMA Medical Directorship and On-Call Compensation Survey:** 2014 report based on 2013 data[4]

1 www.mgma.com/practice-resources/practice-solutions-topic-search.aspx

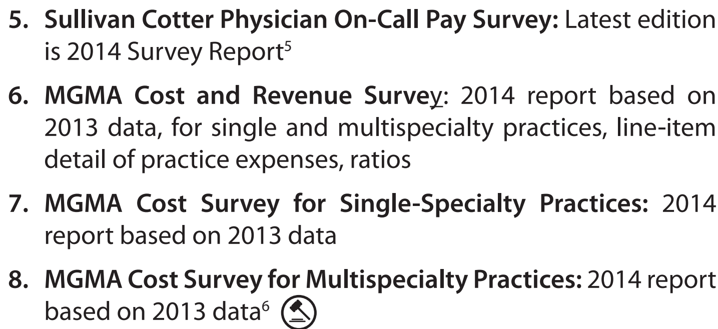
2 www.amga.org/store/detail.aspx?id=COMPSRV_2014

3 www.mdranger.com/products/standard-reports.html

4 www.mgma.com/store/surveys-and-benchmarking/mgma-summary-reports/mgma-medical-directorship-2014- report-data-key-findings-summary-report

Continued on Page 4

Continued from Page 3



5. **Sullivan Cotter Physician On-Call Pay Survey:** Latest edition is 2014 Survey Report[5]
6. **MGMA Cost and Revenue Survey**: 2014 report based on 2013 data, for single and multispecialty practices, line-item detail of practice expenses, ratios
7. **MGMA Cost Survey for Single-Specialty Practices:** 2014 report based on 2013 data
8. **MGMA Cost Survey for Multispecialty Practices:** 2014 report based on 2013 data[6]

Michael Heil is principal of HealthWorks, a management consulting firm in the health care industry that specializes in strategic and business planning, valuation, hospital-physician integration, and litigation support/expert witness services. He has 20 years' experience in senior management positions in hospitals on the East and West Coast. As principal of HealthWorks since 1992, Mr. Heil has focused on strategic and business planning, trauma centers and emergency services, valuation and emergency care, and litigation support/expert witness services in 66 litigation support matters. HealthWorks' expert engagements have been on behalf of hospitals, physicians, and commercial insurance companies. Mr. Heil earned his master's degree in hospital and health services administration from the Johnson School of Management at Cornell University and holds NACVA credentials as a Certified Valuation Analyst (CVA) and Master Analyst in Financial Forensics (MAFF). Mr. Heil can be reached at (408) 390-4683 or at msheil@hworksinc.com.

Chris Fritz is principal of HealthWorks. He has 15 years of executive management experience in hospitals and health systems, including seven years as CFO for an integrated health care system. Since 2009, Mr. Fritz has focused on hospital-physician integration, valuation, and litigation support/expert witness services for HealthWorks. He earned an MBA from California State University, San Marcos.

James Werner has been with HealthWorks since 2007. He leads the valuation practice (now with more than 2,000 FMV opinions) and litigation support engagements. He has owned and operated an accounting firm with clients throughout the U.S. He earned a Bachelor of Science in accounting from the College of Business and Management at the University of Maryland. Mr. Werner is a Certified Public Accountant and holds NACVA credentials as a CVA and MAFF, and he is Accredited in Business Appraisal Review (ABAR).

5 www.sullivancotter.com/surveys/physician-compensation-and-productivity-survey/

6 www.mgma.com/industry-data/survey-reports/mgma-surveys-cost-revenue-and-staffing-surveys

Practice Tips

The Income Tax Treatment of Economic Damages Awards

Continued from Page 1

personal economic damages. Whether or not such is taxable often depends on how the award of economic damages is categorized and/or described in the awarding documents.

Physical Injury and Sickness Awards

Under IRC Section 61, all sources of income are taxable, regardless of how they are derived, unless excluded in another section of the Code.[1] One such exclusion is IRC Section 104(a) that provides:

(a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include:

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

(3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness.

The tax status of any award of damages is based on the origin of the claim test. As stated in *Threlkeld*, "The law is well settled that the tax consequences of an award for damages depend upon the nature of the litigation and on the origin and character of the claims adjudicated, and not upon the validity of those claims."[2] Apparently, the theory excluding damage awards for personal physical injury is the absence of an "origin;" i.e., physical well-being is not a taxable activity.

The exclusion of personal physical injury and sickness awards from gross income under IRC Section 104(a) applies regardless of whether the injury or sickness damages were awarded through a verdict or a settlement, and whether the award is paid out in a lump sum or periodic payments. Any portion of the settlement or verdict attributable to medical expenses that had previously been deducted under IRC Section 213 is not excluded from taxpayer's gross income under IRC Section 104(a).

Illustration:

Sam slipped on some ice on his neighbor's sidewalk and injured his back. He paid $4,000 in medical expenses for the treatment of his injury and deducted $750 of that amount after application of the AGI limitation on the deduction of medical expenses. The following year, he sued his neighbor and was awarded $11,000 in damages, including $4,000 to reimburse him for his medical expenses. Roger may exclude $10,250 of those damages; however, he must include the $750 attributable to the medical expense deduction in his gross income.

1 IRC Section 61

2 *James E. Threlkeld, Petitioner v. Commissioner of Internal Revenue*, Respondent 87 T.c. 1294 (1986)

Continued on Page 5

Continued from Page 4

Awards for emotional losses may be excluded under IRC 104 if the losses are attributable to personal physical injuries. As stated in Regs. Section 1.104-1(c)(1):

> Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care… for emotional distress.

Awards in personal physical injury cases are, more likely than not, paid by an insurance company. The typical process is to pay the plaintiff's attorney the award amount as well as sending a 1099 to the attorney. Normally, the attorney will then reimburse the firm for out of pocket costs and remit the fee to the firm with the balance submitted to the client.[3]

Non-Physical Damages Awards

Damages awarded for lost profits, breach of contract, employment discrimination, and other types of non-physical damages claims are includible in gross income under the origin of the claim test.

Punitive Damages Awards

Awards of punitive damages are not intended to compensate the plaintiff, but rather to punish the defendant when his/her behavior is found to be especially harmful. Accordingly, awards of punitive damages are not excluded from gross income under IRC Section 104.

There is one narrow exception under which punitive damages may qualify for this exclusion. Punitive damages awarded in a civil wrongful death action can be excluded if the applicable state law in effect on September 13, 1995, provides that only punitive damages may be awarded in such an action [Code Sec. 104(c)].

Awards of Interest

If a civil damages case is affirmed, any interest allowed by law is payable from the date the judgment under review was entered.[4] The amount the court assigns as interest is taxable as interest income[5] even if the plaintiff's underlying claim is excluded under IRC Section 104(a)(2).

If a case is settled out of court, both parties could agree to exclude interest from the settled amount. However, if no understanding of the apportionment of the award is formally written into the settlement contract, the court may allocate a portion of the proceeds as prejudgment interest.[6]

Standard and Structured Settlements

If an economic damages claim is settled out of court, the taxability of the awarded damages is not affected by a plaintiff's decision to receive the amount in a lump sum or through a payment plan. The IRS may disagree with the apportionment of the lump sum settlement even if both parties were in agreement.[7]

In personal physical injury, wrongful death, and/or workers compensation claims, it is possible for a plaintiff to be paid through a structured settlement annuity,[8] whereby a defendant may pay an assignment company to take over his/her long term periodic payment obligation to the plaintiff.

Attorney Fees

To what extent is the legal fee deductible? If the award is wholly excludible from income under IRC Section 104(a), then Regs. Section 1.265-1(a)(1) indicates none of the legal fees are deductible. If part of the award is exempt and part not exempt, Regs. Section 1.265-1(c) indicates a reasonable proportion of the legal fee may be allocated to both exempt and non-exempt income in light of all the facts and circumstances in each case. The legal fee for non-exempt income will be included in the taxpayer's gross income along with the award and deducted as a miscellaneous itemized deduction.

In class action lawsuits (such as an employee group seeking lost wages), there is precedent that a successful member of the plaintiff group would not have to include the attorney fees as taxable income.[9]

Conclusion

The income tax consequences of a plaintiff's receipt of an award of personal economic damages may be difficult to ascertain. Generally, taxability varies based on the nature of the underlying claim (origin of the claim test), how the economic damages are apportioned, and/or whether plaintiff received the amount in a lump sum or structured settlement. This article does not provide legal or professional advice regarding the tax treatment of personal economic damages and it behooves all taxpayers to consult with knowledgeable tax professionals prior to agreeing to a settlement or award of personal economic damages.

P. Dermot O'Neill, CPA, ABV, CFF, CVA, MAFF, ABAR is President of P. Dermot O'Neill, CPA PC, Glen Mills, PA. His practice concentrates in the areas of forensic accounting, litigation support, business valuation, transaction consulting, financial analysis, and income taxation. He has provided consulting and expert witness assistance in cases involving oppressed shareholders, divorce, personal injury, wrongful death, accounting malpractice, and contract and tort issues. He has testified as an expert in Pennsylvania, New Jersey, Delaware, Florida, New York, Connecticut, Virginia, the Chancery Court of Delaware, as well as Federal Bankruptcy Court and Federal District Court. Mr. O'Neill is an adjunct instructor at Rider University College of Business Administration, Graduate Studies and has been an adjunct lecturer at Villanova University as well as a guest lecturer at the Widener University and Lehigh University Graduate Schools of Business. He has presented continuing professional education webinars and seminars sponsored by various state accounting institutes and societies, bar associations, professional organizations, and universities. He received his B.S. in Economics from Villanova University and may be contacted at damages@comcast.net.

3 The specific process in any case is defined by the agreement between the attorney and the client.

4 Rule 42 of the United States Supreme Court

5 IRC Section 61 (a)

6 *Delaney v. Commissioner*, 99 F.3d 20 (1st Cir. 1996)

7 *LeFleur v. Commissioner*, T.C. Memo 1997-312

8 IRC Section 130 (c)

9 *Eirhart v. Libbey-Owens-Ford Co.*, 726 F. Supp. 700 where the judge ruled that not all the plaintiffs were part of the suit at the time, and plaintiff agreed to pay lawyer fees, each plaintiff is not required to include the attorneys' fees on their individual income taxes.

Continued on Page 6

Continued from Page 5

Michael D. Pakter has more than 35 years of experience in accounting, financial analysis, financial forensics and investigations, including more than 15 years of experience in economic damages and business valuation issues. He is a Certified Public Accountant, registered and licensed in the State of Illinois. The AICPA has recognized him as additionally Certified in Financial Forensics and Management Accounting. He earned the NACVA's Certified Valuation Analyst designation having completed its business valuation specialty program and the Master Analyst in Financial Forensics designation having completed its business and intellectual property damages specialty program. The Association of Insolvency and Restructuring Advisors awarded him its Certified Insolvency and Restructuring Advisor certificate, recognizing knowledge and proficiency related to situations involving distressed and/or insolvent entities, and its Certification in Distressed Business Valuation, a certification focused on the valuation of distressed and/or bankrupt companies. Mr. Pakter is a Certified Fraud Examiner, which credentials denote proven expertise in fraud prevention, detection, and deterrence. Courts and arbitral bodies have recognized him as an expert in accounting, economic damages, business valuation, financial analysis, and business economics. Mr. Pakter was assisted by Dov S. Getz, a recent graduate of the Hebrew Theological College in Skokie, Illinois.

Business Valuation for the Litigation Practitioner

Forensic Analyst Caveats for Intellectual Property Bankruptcy Valuations

By Robert F. Reilly, CPA

Introduction

Forensic analysts ("analysts") are often called on to value debtor company intellectual property as part of a commercial bankruptcy dispute. First, this discussion summarizes types of commercial intellectual property that analysts may value within a bankruptcy context. Second, this discussion reviews some of the reasons why analysts may be asked to value intellectual property within a bankruptcy context. Third, this discussion focuses on analyst caveats and report writing guidelines for intellectual property valuations performed within a bankruptcy controversy.

Types of Intellectual Property

Typically there are four types of intellectual property that may be subject to a bankruptcy dispute:

1. Patents
2. Trademarks
3. Copyrights
4. Trade secrets

These four intellectual property types are a subset of the general category of commercial intangible assets.

Patents, trademarks, and copyrights are created by and protected by federal statutes. Trade secrets are created under and protected under state statutes. Nonetheless, most states have either completely adopted—or adopted the essence of—the Uniform Trade Secret Act within their state statutes.

For purposes of this bankruptcy controversy article/discussion, let's assume that the debtor company is either the intellectual property owner (and, possibly, the licensor) or the intellectual property non-owner operator (i.e., the licensee). Therefore, we will generally refer to the debtor company as "the owner/operator."

Within the context of a bankruptcy controversy, the four categories of intellectual property types are often expanded to include associated or contributory intangible assets.

The patents category may be expanded to include patent applications, the technology and designs encompassed in the patent, and the engineering drawings and other technical documentation that accompanies the patent or patent application.

The trademarks category may be expanded to include trademarks (both registered and unregistered), trade names, service marks, service names, trade dress, product labeling that includes trademarks, institutional advertising (including signage), and promotional materials that include trademarks.

The copyrights category may be expanded to include both registered and unregistered copyrights on publications, manuscripts, white papers, musical compositions, plays, manuals, films, computer source code, blueprints, technical drawings, and other forms of documentation.

The trade secrets category may be expanded to include any information or procedures that: (1) the owner/operator keeps secret, and (2) provides some economic benefit to the owner/operator. Such trade secrets include computer software source code, employee manuals and procedures, computer system user manuals and procedures, station or employee operating manuals and procedures, chemical formula, food and beverage recipes, product designs, engineering drawings and technical documentation, plant or process schematics, financial statements, employee files and records, customer files and records, vendor files and records, and contracts and agreements.

It is not uncommon for an owner/operator to have two or more related intellectual properties. For example, the same product can have a utility patent and a design patent. The same product can have a patent and a trademark. The same software can hold a copyright and be a trade secret. The same procedures manual can hold a copyright and be a trade secret. The same drawings and schematics can be in a patent, have a copyright, and be a trade secret.

Because the owner/operator can own two or more intellectual properties, the analyst may be asked to assign values to the individual intellectual property for bankruptcy, fair value accounting, income tax accounting, property tax accounting, and other purposes. In disputes related to infringement or breach of contract, it is often possible for two or more intellectual property assets to be damaged by the wrongful action. The analyst may be

Continued on Page 7

Continued from Page 7

asked to assign or allocate the damages amount among the affected intellectual property. The damages analysis should consider each of the affected intellectual properties, but the analysis should not double count the amount of damages by assigning the same damages to two or more intellectual properties.

Within multinational corporations, different business units in different taxing jurisdictions can own different intellectual property. For example, a product design could benefit from a utility or design patent in country alpha, the product could be manufactured with a trade secret in county beta, and a trademark could be assigned to the final product in county gamma. Such a multinational manufacturer may ask the analyst to analyze the intercompany transfer price considerations of each intellectual property application.

Bankruptcy Reasons to Value Intellectual Property

The following list summarizes many of the common reasons why analysts may be asked to value intellectual property within a bankruptcy dispute. Section citations refer to the United States Bankruptcy Code. The rule citations refer to the United States Bankruptcy Rules.

- Preference payment claims and assessment of debtor company solvency (under Section 547)
- Fraudulent transfer claims and assessment of debtor company solvency (under Section 548)
- Debtor in possession (DIP) asset sales and adequate protection for creditors (under Section 363)
- Determination of any decrease in the value of a secured creditor's interest in the debtor's property (under Section 361)
- Value of a secured creditor's interest with regard to the acceptance or rejection of a plan (under Rules 3012 and 3018)
- Determination of a creditor's status as either secured or unsecured (under Section 560)
- Assessing the reasonableness of a proposed plan of reorganization (under Section 1129)
- Assessing if a proposed reorganization plan is fair and equitable to all impaired creditor groups in a cram down (under Section 1129)
- Assessing a secured creditor's claim for relief of the automatic stay (under Section 362)
- Debtor property collateral valuations to secure DIP financing
- Assessing if the pre-filing debtor company is operating within the zone of insolvency
- Protection of intellectual property licensees from a license rejection by the DIP (under Section 365)

Analytical Issues in Intellectual Property Bankruptcy Valuations

Analysts who value intellectual property within commercial bankruptcy controversies should be familiar with the following analytical issues:

1. There is no Bankruptcy Code definition (or standard) for the term "value." Analysts who perform such intellectual property valuations sometimes use fair value, fair market value, market value, or other standards of value.

   Section 506 provides that "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." However, this statutory guidance does not provide an actual standard of value.

2. The analyst's use of hindsight in the bankruptcy valuation is discouraged. The courts generally adopt the so-called "known or knowable principle" with regard to the analyst only using information that was knowable as of the defined valuation date.

   Of course, in many bankruptcy controversies, there is usually a controversy among the opposing analysts over when actual events (favorable or unfavorable) would have been known or knowable as of the intellectual property valuation date.

3. The analyst's reliance on (and due diligence regarding) the debtor company management-prepared financial projections should be tested or corroborated. The questions the analyst typically considers with regard to the use of debtor management-prepared financial projections in the intellectual property valuation may include the following:
   - How contemporaneous are the financial projections to the valuation date?
   - Were the financial projections prepared after the valuation date but, if so, were they still prepared based on assumptions that were known or knowable as of the valuation date?
   - Were there various unreconciled versions of the management-prepared projections?
   - What was the purpose for which the debtor management projections were prepared?
   - How skilled has the debtor company management been historically in preparing financial projections?
   - How reliable is the selected set of management-prepared projections?
   - Should the analyst consider various projection scenarios?
   - Were the financial projections ever relied on by an independent party (e.g., auditors, regulators, financing source)?

4. The analyst should document a replicable and transparent selection of valuation variables. The questions the analyst typically considers with regard to the use of valuation variables in the intellectual property valuation may include the following:
   - Should the valuation variables reflect the current financial state of the debtor company?
   - Should the valuation variables reflect the reorganized financial state of the debtor company?
   - Should the valuation variables reflect a willing buyer/willing seller or an industry average set of assumptions?
   - How does the assumed financial condition of the debtor company affect the selected cost of capital components (e.g., the kd, ke, debt/equity ratio) and the concluded weighted average cost of capital (WACC)?
   - How does the assumed financial condition of the debtor company affect the terminal value expected long-term growth rate?

- Should the selected discount rate relate to the operating risk of the debtor company or to the performance risk of the specific financial projections?

5. The analyst should consider the fact that current interest rates are still at historically low levels. The questions the analyst might typically consider with regard to the selected interest rate in the intellectual property valuation cost of capital analysis might include the following:
   - How should the currently low risk-free rate of return affect the selection of the cost of debt capital?
   - How should the currently low corporate bond interest rates affect the selection of the cost of debt capital?
   - Can the debtor company actually obtain such low capital costs?
   - Does an understated WACC calculation overstate the debtor corporation business value?
6. The analyst should be prepared to explain and defend the reasonableness of the analyst's due diligence procedures. The questions the analyst typically considers in the due diligence process of the intellectual property valuation may include the following:
   - Does the bankruptcy assignment involve a contemporaneous valuation or a retrospective valuation?
   - Did the analyst have access to the debtor company management and/or to other relevant parties?
   - Did the analyst consider that the parties' memories and perceptions of pre-petition events and conditions often change over time?
   - Did the analyst recognize the fact that only a limited amount of debtor company documents may be available?
   - Could the analyst's industry research be subject to various interpretations?
   - Did the analyst appreciate the fact that hindsight is always "20/20" when performing a retrospective valuation analysis?
7. The analyst should consider all of the debtor company income tax effects on the intellectual property value. The questions the analyst typically considers in the income tax deliberations during the intellectual property valuation may include the following:
   - What is the debtor's effective income tax rate?
   - What is the amount of the debtor's cash income tax expense?
   - What is the value of the debtor company's deferred tax assets or tax liabilities?
   - What is the debtor's expected use of NOLs and other income tax attributes?
   - How will a possible change of ownership affect the debtor company's tax attributes?
   - How will a possible change of ownership affect the debtor company's asset tax basis?
8. The analyst should avoid the use of industry so-called valuation rules of thumb as a specific valuation method. The questions analysts typically consider with regard to the interpretation of industry valuation rules of thumb may include the following:
   - Are there any industry rules of thumb with regard to financial metric pricing multiples?
   - Are there any industry rules of thumb with regard to operational metric pricing multiples?
   - Are there any industry rules of thumb that may imply values of debtor company intangible assets/contingent liabilities (e.g., capitalization of debtor company operating leases)?
   - Are there any industry rules of thumb for consideration with regard to any of the individual financial projection variables?
   - Do the industry rules of thumb assume the average company in the subject industry?
   - If they are valid, how are the industry rules of thumb supported by any empirical transaction data?
9. The analyst will typically perform a cash flow test within a solvency analysis, and such a solvency analysis may be prepared for many bankruptcy purposes. The questions the analyst typically considers with regard to the solvency analysis cash flow may include the following:
   - Should the analyst include the company's raising of either new debt capital or new equity capital during the cash flow test projection period?
   - Should the analyst consider the debtor's current credit availability during the cash flow test projection period?
   - Should the analyst consider any debtor company asset sales during the cash flow test projection period?
   - Did the analyst adequately consider the longest term debtor company debt outstanding in the cash flow test projection period?
   - Did the analyst adequately consider any debtor company debt balloon payments later in the cash flow test projection period?
10. The analyst should consider the appropriateness of applying a market approach in an inactive intellectual property transaction market. The questions the analyst typically considers with regard to the use of the market approach in an inactive market may include the following:
    - Are there any sufficiently comparable public companies available for consideration in the market approach comparable profit margin method analysis?
    - Are there any sufficiently comparable uncontrolled transactions (intellectual property sales or licenses) available for consideration in the market approach relief from royalty method analysis?
    - Is there a sufficiently active current market for the debtor company intellectual property?
    - How reliable are any "backsolve" valuation method sale or license transactions of the actual debtor company intellectual property with regard to providing meaningful valuation guidance?

Continued on Page 9

Continued from Page 8

Analyst Caveats for Performing Intellectual Property Bankruptcy Valuations

Analysts may consider the following practical caveats with regard to the preparation of intellectual property valuations within a bankruptcy controversy:

1. The analyst should accept legal counsel's advice and instructions; the analyst should also:
   - Document all of the legal counsel's instructions
   - Document all of the legal counsel's definitions of technical legal terms
   - Not practice law without a license
   - Let the legal counsel take responsibility for all legal issues related to the bankruptcy
2. For many reasons (knowledge, skill, experience, etc.), legal counsel may not always be totally forthcoming with the analyst; the analyst should also:
   - Be aware of any "creeping commitments" (or unintended expansions) regarding the scope of work in the analyst's engagement
   - Be aware of any legal counsel-imposed limitations on the analyst regarding access to all of the documents in the case
3. The analyst should 'document, document, document' both in the intellectual property valuation workpapers and in the valuation report; in particular, the analyst may:
   - Document all debtor company management and other party interviews
   - Document all due diligence procedures performed
   - Document why the analyst selected or rejected each valuation method considered in the analysis
   - Document why the analyst selected or rejected each valuation variable considered in the analysis
   - Document why the analyst selected or rejected each set of financial projections relied on (or not relied on) in the analysis
   - Use contemporaneously prepared financial projections relied on by others (including debtor management), if possible, and not use financial projections prepared after litigation (if possible)
4. The analyst should use generally accepted intellectual property valuation approaches, methods, and procedures in the bankruptcy valuation; in particular, the analyst typically should not:
   - Use de novo valuation methods (or use de novo valuation method naming conventions)
   - Rely on "rules of thumb" pricing methods to achieve specific value indications to include in the final value conclusion
5. The analyst should use confirmatory intellectual property valuation approaches and methods in the bankruptcy analysis; in particular, the analyst may:
   - Explain the valuation synthesis and conclusion process
   - Explain the quantitative (or qualitative) value conclusion process so that it is replicable, transparent, and auditable
6. The analyst should use source documents, if possible; in particular, the analyst may:
   - Look for confirmatory source documents
   - Look for contradictory source documents
   - Explain the process and reasoning for selecting the specific source documents relied on
   - Look at and consider all source documents that are made available to the analyst in discovery or otherwise
   - Avoid wearing "hindsight blinders"—i.e., the process of excluding post-valuation date documents that contain pre-valuation date information that supports
7. The analyst should consider all debtor company general intangible assets in the intellectual property bankruptcy valuation analysis; in addition, the analyst should consider all debtor company contingent liabilities in the bankruptcy valuation analysis
8. The analyst should consider the expected income tax affects in all of the intellectual property bankruptcy valuation (and solvency, fairness, and related opinion) analyses; in that consideration, the analyst may:
   - Consult with an independent income tax expert, if one is needed
   - Consult with an income tax expert colleague, if one is available
9. In bankruptcy-related litigation, the analyst should be mindful that "your expert report is your best friend"; the analyst should be mindful of and determine that:
   - The valuation analyst's report should be clear, convincing, and cogent
   - The valuation analyst's report should be replicable and transparent
   - The valuation analyst's report should be adequately supported with source documents
   - The expert report caution: "If it's not in the report, you didn't do it"
10. The analyst should know his or her own technical limitations in performing the intellectual property valuation; that is, the analyst should rely on third party specialists for input into the intellectual property valuation, when needed; such third party specialists may include:
    - Industry experts
    - Tax accounting experts
    - Financial accounting experts
    - Real estate appraisal experts
    - Personal property appraisal experts
    - Other experts

Continued on Page 10

Continued from Page 10

Intellectual Property Bankruptcy Valuation Report Writing Guidelines

There are numerous objectives of the intellectual property bankruptcy valuation report. Of course, the analyst wants to persuade the report reader (whether the reader is a potential sale/license transaction participant, the debtor, a creditor, a judge or other finder of fact, etc.). The analyst also wants to defend the intellectual property value conclusion.

In order to accomplish these objectives, the content and format of the valuation report should demonstrate that the analyst:

- understood the specific intellectual property valuation assignment;
- understood the debtor's intellectual property and the subject bundle of legal rights;
- collected sufficient debtor financial and operational data;
- collected sufficient industry, market, and competitive data;
- documented the specific debtor's intellectual property economic benefits;
- performed adequate due-diligence procedures related to all available data;
- selected and applied all applicable income-, market-, and cost-approach valuation methods, and
- reconciled all value indications into a final value conclusion.

The final procedure in the intellectual property analysis is for the analyst to defend the value conclusion in a replicable and well-documented valuation report. The written valuation report should:

1. explain the intellectual property valuation assignment;
2. describe the debtor's intellectual property and the subject bundle of legal rights;
3. explain the selection or rejection of all generally accepted valuation approaches and methods;
4. explain the selection and application of all specific analysis procedures;
5. describe the analyst's data gathering and due diligence procedures;
6. list all documents and data considered by the analyst;
7. include copies of all documents that were specifically relied on by the analyst;
8. summarize all of the qualitative analyses performed;
9. include schedules and exhibits documenting all of the quantitative analyses performed;
10. avoid any unexplained or unsourced valuation variables or analysis assumptions; and
11. allow the report reader to be able to replicate all of the analyses performed.

In order to enhance the credibility of the intellectual property valuation report conclusion, the report should be:

- clear, convincing, and cogent;
- well organized, well written, and well presented; and
- free of grammar, punctuation, spelling, and mathematical errors.

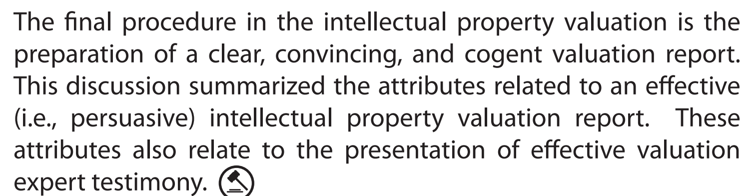
In summary, the effective (i.e., persuasive and credible) intellectual property valuation report will tell a narrative story that:

1. defines the analyst's assignment;
2. describes the analyst's data gathering and due diligence procedures;
3. justifies the analyst's selection of the generally accepted intellectual property valuation approaches, methods, and procedures;
4. explains how the analyst performed the valuation synthesis and reached the final value conclusion; and
5. defends the analyst's value conclusion.

Summary and Conclusion

Forensic analysts may be called on to value a debtor company's intellectual property for a variety of bankruptcy-related reasons. This discussion reviewed the general categories of debtor intellectual property and summarized the bankruptcy-related reasons for valuing commercial intellectual property. In addition, this discussion focused on the analyst caveats related to performing intellectual property valuation analysis.

The final procedure in the intellectual property valuation is the preparation of a clear, convincing, and cogent valuation report. This discussion summarized the attributes related to an effective (i.e., persuasive) intellectual property valuation report. These attributes also relate to the presentation of effective valuation expert testimony.



Robert Reilly, CPA, has been a managing director of Chicago-based Willamette Management Associates (WMA) for the last 23 years. WMA is a business valuation, forensic accounting, and financial opinion services firm. Mr. Reilly is a certified public accountant, chartered global management accountant, certified management accountant, chartered financial analyst, enrolled agent, accredited tax advisor as well as a certified business appraiser, certified valuation analyst, certified valuation consultant, certified review appraiser, certified real estate appraiser, and accredited senior appraiser. He is accredited in business valuation and certified in financial forensics. Mr. Reilly specializes in providing valuation and financial advisory services to ESOP sponsor companies, particularly with regard to annual employer stock valuations and ESOP transaction fairness opinions. He is the co-author of Guide to ESOP Valuations (the second edition was published in 2007). Mr. Reilly has co-authored 12 valuation textbooks, including Guide to Intangible Asset Valuation, published by the American Institute of Certified Public Accountants in 2013, and The Practical Guide to Bankruptcy Valuation, published by the American Bankruptcy Institute, also in 2013. He has authored over 300 articles that were published in various accounting, taxation, or valuation journals. Mr. Reilly has served as an editor or editorial referee for numerous professional journals. He currently serves as an editor for Valuation Strategies, The American Bankruptcy Institute Journal, and Construction Accounting and Taxation.

Continued on Page 11

I Do Solemnly Swear

Active/Passive Appreciation in Marital Dissolutions (A Valuators Perspective)

By Suzanne M. Trimble CPA, CVA, MAFF

Introduction:

In recent years, there have been a growing number of marital dissolutions that have been challenged with active/passive appreciation issues. In divorce cases, many attorneys will call upon business valuation appraisers to distinguish between "active and passive" appreciation when trying to decide how certain spousal assets should be allocated or divided.

Many states in our nation have available case law regarding the issue, but these cases share only limited information in respect to the approaches on how the active and/or passive appreciation element of the martial estate is calculated. States with case law pertaining to active/passive appreciation includes my home state of Alaska, in addition to Arizona, New York, New Jersey, Florida, Ohio, North Dakota, and Texas to name a few.

One of the most detailed approaches available is a publication by Mercer Capital Management, Inc. in 2006 called "*A Rate/Flow Model, An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions*." Furthermore, two formidable approaches that have been utilized by most community property states originated from the California cases of *Pereira v. Pereira,* 156 Cal. 1 (Cal.1909) and *Van Camp v. Van Camp*, 53, Cal. App. 17 (1921). (These two cases allocate active from passive increases and will be discussed later in this article.)

This article will share a comprehensive example, from a valuators perspective. The scope of this article will be to discuss how to allocate appreciation during a marriage between active and passive components once a business is deemed by the court to be separate property.

The basics of what constitutes active and/or passive appreciation is warranted before a discussion regarding an approach can be made:

Active appreciation occurs when marital funds or marital efforts cause a spouse's separate property to increase in value during the marriage.[1] Active appreciation recognizes that a separate asset can become partly marital by increasing in value during the course of a marriage. Active appreciation is included in the marital estate.

The asset's value at the inception of the marriage retains its separate character, but any subsequent increase in value is treated as marital property to the extent that it results from active marital conduct by either or both spouses: "Appreciation in separate property is marital if it was caused by marital funds or marital efforts; otherwise it remains separate."[2]

In order to find active appreciation in separate property, the court must make three foundational findings.

- First, it must find that the separate property in question appreciated during the marriage.
- Second, it must find that the parties made marital contributions to the property.
- Finally, the court must find a causal connection between the marital contributions and at least part of the appreciation.

Passive appreciation is not the result of active efforts of one of the spouses, i.e., the working spouse. Increased value attributable to other sources (passive appreciation) remains separate property. Examples of passive activities and external factors outside the control of the owner/managers that courts have recognized include:

- Significant barriers of entry restricting the growth of competition;
- Return on capital;
- Market factors, i.e., lack of competition in the market;
- Legislation enacted which creates an additional business opportunity;
- Financial changes (e.g., interest rate);
- Economic or industry growth;
- Increase in value can be due to efforts of third parties (management consists of hired employees); and
- Significant price increases or decreases over time.

Passive appreciation is considered as separate property that is not part of the marital estate.

According to *Cockrill v. Cockrill*, "…when the value of separate property is increased, the burden is upon the spouse who contends that the increase is also separate property to prove

1 *Martin*, 52 P.3d at 727 n.10; *Lowdermilk v. Lowdermilk*, 825 P.2d 874, 877-78 (Alaska 1992); *accord* BRETT R. TURNER, EQUITABLE DISTRIBUTION OF PROPERTY § 5.22, at 230 (2d ed. 1994).

2 TURNER, EQUITABLE DISTRIBUTION OF PROPERTY § 5.22, at 230. Supports finding of active appreciation. *See Martin*, 52 P.3d at 728; *Lowdermilk*, 825 P.2d at 877-78.

that the increase is the result of the inherent value of the property itself and is not the product of the work effort of the community."[3]

A typical approach to valuing an active separate business is to value the asset twice: first, at the date of marriage (or when acquired during the marriage); and second, at the date of filing the complaint, which often means date of separation. The difference between the two values (or appreciated value) is what is subject to equitable distribution arguments. Part of the growth may be passive and part may be active in nature.

The two approaches that are used by most community property states are the *Pereira Approach* and the *Van Camp Approach.*

In the *Pereira Approach,* the separate property claim is the value of the capital plus the annual rate of return on the capital. The key is to provide a reasonable annual rate of return for the separate capital investment in the business. If there is a community property claim, it is the value of the business at dissolution that exceeds the separate property claim. Most courts have applied *Pereira* by comparing the value of a business at the time of the marriage to the value at the time of dissolution by using a fixed rate of return.

The other method for calculating the enhanced value of a separate business is the *Van Camp Approach*. The *Van Camp* method looks at the community business and the difference between the compensation received and reasonable compensation for the effort performed. The courts have interpreted *Van Camp* to mean the allocation to the community property is an annual sum equal to the salary which would have to be paid to an employee rendering services equivalent to the business owner less the salary that would have been received by that employee.[4] For example, if the business owner's compensation is $150,000 per year and reasonable compensation is $200,000 per year, the difference of $50,000 is multiplied by the number of years of the marriage. This $50,000 amount is subject to community property and the remainder of the business would be separate property.

In either the *Pereira Approach* or the *Van Camp Approach*, each party must marshal all relevant facts related to the passive or active appreciation of a separate business subject to equitable distribution.

Valuations of the assets are based on the facts and circumstances of each case. Now that the discussion of active/passive appreciation and approaches has been made, let's analyze information of a hypothetical case. This case involves how much a sole shareholder's stock appreciation was due to his active performance in the corporation and how much appreciation was caused by other factors beyond his control, i.e., passive appreciation. The following are the facts and circumstances of this hypothetical case.

Case Analysis:

John Smith (H) owns the 100% interest in ABC LLC (the business). H was running the business as the CEO at the date of marriage (DOM). H was active in the business the entire marriage. The business more than quadrupled in value during the marriage. The marriage lasted six years. Date of marriage was November 5, 2006 and date of separation (DOS) was November 4, 2012. Besides the efforts of H, many external factors likely contributed to the growth of the business value.

Summary of Facts:

1. At the DOM, John Smith owned a separate property interest in ABC LLC with a fair market value of $550,000.
2. John Smith provided services to ABC LLC during the entire marriage for which he received reasonable compensation.
3. An analysis of the factors relative to the determination of passive and active appreciation in ABC's value during the marriage is consistent with the proposition that ABC's value increase during marriage can be attributed to the following passive appreciation factors:
   - ABC was an established business at the DOM;
   - Significant barriers of entry restricted the growth of competition;
   - There was lack of competition in the market;
   - There were significant price increases; and
   - Increase in the value can be attributed to third party management.
4. Assume a causal relationship between John Smith's marital contributions to ABC LLC and the active appreciation in the value of that business during the marriage is determined to exist.
5. Assume in this case that the court requires a marital interest subject to equitable distribution in the value of ABC LLC at DOS be awarded, and the amount of that award should be limited as follows:
   - John Smith should receive a rate of return on his separate property investment in ABC LLC. Assume using a 20-year treasury rate for October 31, 2006, the annual rate of return is 4.71%. (The use of a Treasury bond rate to compensate the separate property investment in a business operated during the marriage is a reasonable rate for this approach.)
   - A potential award to the marital interest should be limited to the increase in value of ABC LLC during 2006 (DOM) through 2012 (DOS). John Smith provided full-time services for which he was compensated during these years.

Business Valuation Approach and Methodology

The capitalized income approach was used to value the business as of DOS. (The date of separation was stipulated by the courts as the date utilized to value the business.) The following schedules allocate business appreciation during the marriage between active and passive amounts.

Schedule A—Summary of Conclusions

Illustrative Potential Values of Marital Interest in ABC LLC
During the Period of November 5, 2006
through November 4, 2012

Separate Property Rate of Return	Potential Value of Marital Interest	Schedule Reference
4.71%	$784,752	Schedule B

3 *Cockrill v. Cockrill*, 124 Ariz. 50, 52, 601 P.2d 1334, 1336 (1979).

4 *Cord v. Cord*, 94 Nev. 21 (1978).

Schedule B —*Potential Allocation of Increase in Value of ABC LLC Among the Parties' Marital Interest and Smith's Separate Property During the Period of November 5, 2006 through November 4, 2012*

			Potential Allocation to:		Potential Value to:	
Description	**Schedule Reference**	**Value**	**Marital Interest**	**Smith's Sep. Property**	**Marital Interest**	**Smith's Sep. Property**
Active Appreciation (to Marital Interest)	B-1	$784,752	100%	0%	$784,752	$-
John Smith's Separate Property	B-1	550,000	0%	100%	-	550,000
Return on Separate Property	B-1	154,972	0%	100%	-	154,972
Total		**$1,489,724**			**$784,752**	**$704,972**
					To Schedule A	

Schedule B-1—*Value of John Smith's Separate Property Investment in ABC LLC During the Period of November 5, 2006 through November 4, 2012*

	Date of Marriage: Nov. 5, 2006 **Date of Separation: Nov. 4, 2012** **Period:** Note B	**Smith's Interest in ABC During Marriage** Note C	**Smith's 4.71% Interest Plus Compound Growth** Note E	**Smith's Separate Property Investment** Note A	**Smith's Separate Return on Investment** Note D	**Residual Increase**
1	At Date of Marriage	$550,000		$550,000	$-	
2	DOM Increase in Value Year 1 through 6		$154,972		$154,972	
3	Increase During Marriage	$664,000				$664,000
4	DOS Increase in Value Year 1 through 6		$120,752			$120,752
5	Accumulated interest compounded	$275,724				
6	**Total Value**	**$1,489,724**	**$275,724**	**$550,000**	**$154,972**	**$784,752**
				To Schedule B	To Schedule B	To Schedule B

Schedule B Notes—*Value of John Smith's Separate Property Investment in ABC LLC During the Period of November 5, 2006 through November 4, 2012*

Note A
The 20-year treasury rate for October 31, 2006, the period prior to the parties marriage was 4.71%.

Note B
Date of Marriage: November 5, 2006
Date of Separation: November 4, 2012

Period	Beginning	Ending	Length (Years)
Year 1	11/5/2006	11/4/2007	1.00
Year 2	11/5/2007	11/4/2008	1.00
Year 3	11/5/2008	11/4/2009	1.00
Year 4	11/5/2009	11/4/2010	1.00
Year 5	11/5/2010	11/4/2011	1.00
Year 6	11/5/2011	11/4/2012	1.00
			6.00

Note C
The Value of John Smith's interest in ABC LLC was appreciated proportionally over the marriage as the following assumption at June 30, 2012 (date of valuation at DOS) states:

Value at Date of Separation (DOS)	1,278,000
Less: 5% Discount for Lack of Market	(63,900)
Fair Market Value of Subject Interest	1,214,100
Less: Value at Date of Marriage (DOM)	(550,000)
Increase During Marriage	664,100
Increase During Marriage (rounded)	664,000
	To Schedule B-2

Conclusion:

Distinguishing between active and passive appreciation of a business interest in a divorce can make a huge difference in the outcome of a divorce case. As you can see in this case example, the marital interest on **Schedule A** is $784,752. This amount of $784,752 would be divided equally. What this equates to is the amount of reasonable earnings on the business growth from the DOM to the DOS. Using the *Pereira Approach*, we have compared the value of a business at DOM to the value at the DOS by adding a fixed rate of return on capital. Using the *Pereira* Approach we have demonstrated how to allocate appreciation of a business ownership interest between active and passive components in a marital estate.

Suzanne Trimble CPA, CVA, MAFF Principal owner, Forensic & Valuation Services, Ltd. has over 25 years of experience in public accounting, financial analysis, and valuation. She has qualified as an expert witness to testify in court on business valuations and forensic matters. She has rendered litigation and forensic services in domestic marital issues, insurance claim matters, lost profits, personal injury, and asset misappropriations. She can be reached at her Anchorage, Alaska office at (907) 272-6522 or e-mail to info@smtcpa.com.

National Litigation Consultants' Review

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

Start or Renew Your Subscription Today!

The *National Litigation Consultants' Review*™ (NLCR™) includes feature articles offering practical analysis of contemporary issues; frank discussions and insights into how financial issues must be presented and defended in the courtroom; and war stories, horror stories, and hilarious stories from expert witnesses, attorneys, and judges who have been there. It also offers practical "how to" information on using technical tools and Web resources; independent, objective reviews of new litigation and business valuation publications and software; and analysis of efficiency tools, management ideas, and marketing tips specifically directed to the litigation support and financial issues practitioner. Historically aimed at the testifying expert, this online publication has now broadened its focus to cover the financial forensics disciplines found under the Master Analyst in Financial Forensics™ (MAFF®) banner and is free to all MAFFs, judges, and attorneys.

Name: _____________Designations: ___ Member # ________________________

Name of Firm: ________________________

Address: City: ___State: ZIP:________________________

Telephone: Fax: E-mail:________________________

❑ Yes, I would like to subscribe to the NLCR ($195) . . . . $__________

❑ I am a KVD subscriber and I would like to subscribe to the NLCR ($95). . . . . $__________

FOUR WAYS TO ORDER:

CTI c/o NACVA
5217 South State Street, Suite 400,
Salt Lake City, UT 84107-4812

Fax: (801) 486-7500

(800) 677-2009
(801) 486-0600

E-mail:
NACVA1@NACVA.com

PAYMENT OPTIONS:

❑ Check #: ________

❑ eCheck (ACH)

Financial Institution Information **Type of Account** ❑ Checking ❑ Savings

Bank Name: ______________________ (9) Digit Routing Number: ______________________

Account Number: ______________________

Card Information

❑ VISA ❑ AMEX ❑ MasterCard ❑ Discover

Type: ❑ Credit ❑ Debit

Card Number:______________________ Exp. Date: ______________________

Billing Address: (Same, or): ______________________

City:______________________ State:_______ Zip: ______________________

By signing, you authorize the NACVA/CTI or the IBA to charge your account for the amount indicated. NACVA/CTI or the IBA can also initiate credit entries to your account in the event a credit or correction is due. Your signature authorizes NACVA/CTI or the IBA to confirm the above information via e-mail and/or fax and to use either for future communication. NACVA/CTI or the IBA will not disclose or share this information with third parties.

Authorized Signature ______________________ Date: ______________

© Copyright 2015 NACVA, sponsors of the MAFF designation