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The rule has changed

Expanded work product protections win out in revised Rule 26

Absent congressional intervention, proposed amendments to the Federal Rules of Civil Procedure scheduled to take effect Dec. 1, 2010, will likely foster significant changes in expert witness practices — including the development and discovery of testifying witnesses' draft reports. If history is any indication, the changes to the federal rules may well trickle down to state and local rules of civil procedure as well.

Expanded protections

The proposed amendments, which were approved by the U.S. Supreme Court in April, make expert draft reports and most communications between an expert and the retaining attorney subject to work product protections — with three exceptions. Specifically, under Rule 26(b)(4)(C), discovery is allowed of communications that relate to:

1. Compensation for the expert's study or testimony,
2. Facts or data that the attorney provided and the expert considered in forming an opinion, or
3. Assumptions that the attorney provided and the expert relied on in forming an opinion.

A report by the Judicial Conference of the United States on the amendments asserts that the new work product protections won't impede effective discovery or examination at trial. Further, work product protections may be overcome in situations where the opposing party can establish need and hardship.

The amendments should mean that attorneys will have diminished need for consulting expert witnesses.

New rule for certain experts

Experts who aren't retained or specially employed to provide testimony or who aren't employees who regularly give expert testimony — such as certain physicians and coroners — generally aren't required to provide a written report. The amendments also address testimony from such experts.

Rule 26(a)(2)(C) requires attorneys relying on such a witness's testimony to disclose the testimony's subject matter. They must also summarize the facts and opinions on which the expert is expected to testify.



Impetus for the amendments

The Judicial Conference report discusses at length the reasons behind the latest amendments. It explains that the 1993 amendments to Rule 26 (the last revisions made to the rule's expert witness provisions) were interpreted to allow discovery of all draft expert reports and all communications between attorneys and expert witnesses.

The amendments were also read to require the production of reports from all witnesses offering expert testimony. The Judicial Conference concluded that this interpretation has created some major issues.

The report described the lengths that attorneys and experts have gone to in order to avoid generating any discoverable record themselves and to discover the opposing party's drafts and communications. Some attorneys, for example, retain two sets of experts: 1) consulting experts, who perform the work and develop the opinions, and 2) testifying experts. Attorneys may also go to great lengths to avoid having an expert take any notes, make any record of preliminary analyses or opinions, or produce any draft reports, so that the only record will be a single final report.

According to the Judicial Conference, these steps increase the costs and burdens of discovery, impede the efficient and proper use of experts by both sides, needlessly prolong depositions, detract from cross-examination into the merits of experts' opinions, and make some qualified individuals wary of serving as experts. They also can reduce the quality of the experts' work.

Practical implications

The Judicial Conference indicated that it believes attorneys spend too much time in depositions of the opposing party's experts trying to establish that the opposing attorney influenced the expert's opinions. The report suggests that this approach is inappropriate and unproductive.

Rather, it concludes, attorneys will have more success discrediting an expert's opinions by

The New Jersey influence

The Report of the Judicial Conference on the proposed amendments to Rule 26(b)(4)(C) of the Federal Rules of Civil Procedure (see main article) noted that the state of New Jersey has already enacted a similar rule that prohibits discovery of draft expert reports and limits discovery of attorney-expert communications.

In fact, the federal Advisory Committee on Civil Rules, which submitted the proposed Rule 26 amendments, gathered information from both plaintiff and defense attorneys in a variety of practice areas about their experiences with the New Jersey rule. The attorneys largely agreed that discovery had improved under the rule — with no decline in the quality of information about expert opinions.

cross-examining the substance of the opinions and offering evidence showing why the opinions are unsound. The amendments are designed to encourage this change in practice. As a result, expert depositions going forward should focus more on facts, data and methodologies, and trials may feature more intense grilling of experts by opposing attorneys.

Additionally, the amendments should mean that attorneys will have diminished need for consulting expert witnesses. And the protection for draft reports will free experts to more thoroughly and frequently revise their reports before producing final reports.

A matter of timing

The Judicial Conference emphasized that the amendments would continue to allow attorneys to explore what an expert considered, adopted, rejected or failed to consider in forming his or her opinion. But it also made clear that the best means for examining the merits of an expert opinion is through cross-examination on the substantive strengths and weaknesses of the opinion and the presentation of evidence. ♦

Devastating consequences

How appraisers estimate damages for new or unlaunched companies

In today's environment of economic uncertainty, launching a new business or keeping a fledgling company up and running isn't easy. As many lenders remain skittish about dealing with small to midsize businesses, it's difficult to procure the necessary financing. And competition is fierce among companies that have managed to, thus far, navigate the ups and downs of their various local economies.

For these reasons, a new or as-yet-unlaunched business that suffers economic damages can be subject to particularly devastating consequences right now. Under such difficult circumstances, appraisers can help these "green" businesses in court by using specific valuation techniques to calculate estimated damages.

Not much info

The problems when estimating damages for new or never-launched businesses stem primarily from a lack of data. To calculate lost profits, experts generally project the plaintiff business's lost revenues and adjust that amount by appropriate profit margins. They typically base revenue projections on data related to the company's own projections, its historical performance and its industry, as well as on larger economic trends and forecasts.

If company data is sparse, experts can determine market share and estimated penetration based on models and studies of new-product lifecycles.

With a new business, an expert may face inadequate or nonexistent performance data and insufficient business data that can be correlated with trend information. How then can he or she project revenues and profit margins?



Making projections

Fortunately, those calculating lost profits need only determine them to a reasonable certainty. Thus, an expert might be able to apply industry growth rate projections to individual company data to develop multiple revenue projections, varying the combinations of actual and projected data. If the results from the different projections fall within the same range, the expert can proceed to use company-specific data to develop cost structures.

If company data is sparse, experts can determine market share and estimated penetration based on models and studies of new-product lifecycles. They can validate revenue projections with data from governmental agencies, trade associations and other sources that track expected demand, prices and cost structures.

When determining profit margins for new businesses, experts again run into insufficient historical performance data or internal forecasts. In that situation, they may develop profit margins using internal data and reports, industry forecasts and other information sources.

Applying discounts

As with all calculations of this kind, experts apply a discount to projected lost profits. Courts recognize the need for such discounts on a couple of bases.

First, a discount is needed because a plaintiff can invest its award and earn an additional return on it. In other words, a plaintiff who receives an undiscounted amount of lost profits would stand to recover more than its actual damages.

Second, discounts logically follow the widely accepted belief that projected lost profits necessarily carry an element of uncertainty. In the case of a new business, the discount must reflect the increased risk usually associated with young ventures and the possibly unrealistic — and unreliable — nature of the company's own projections.

Quite feasible

When it comes to business litigation, lost profits are a common form of damages that are hotly

debated by both sides in court — especially when a new or unlaunched business is involved. Perhaps the primary reason these legal debates can get so heated is that, as mentioned, a new or unlaunched business has precious little data indicating how much or little profit it would have generated had the cataclysmic event prompting the lawsuit not occurred.

An appraiser can help gather and analyze what information is available to help build a defensible case. Moreover, he or she can take a wider view of the situation with the help of market surveys and analyses as well as business records of similar enterprises. Ultimately, an appraiser can transform a seemingly impossible task — appraising a very young company — into one that's quite feasible. ♦

FLP owners score yet another Tax Court victory

In addition to achieving other legitimate business purposes, holding discounted units in a family limited partnership (FLP) can result in a lower estate value than holding the underlying, undiscounted assets in one's estate.

Yet the IRS has successfully used Internal Revenue Code Section 2036 to persuade the U.S. Tax Court to eliminate discounts for lack of control and marketability in several FLP cases. The agency wasn't, however, successful in the recent case of *Charlene B. Shurtz v. Commissioner*.

Timber!

Charlene Shurtz owned interests in two FLPs between 1993 and 2002. First, she and 13 family members contributed 45,197 acres of undivided Mississippi timberland to C.A. Barge Timberlands LP in June 1993. In November 1996, Mrs. Shurtz created Doulos LP, to which she contributed

additional direct timberland holdings and her interests in C.A. Barge Timberland LP.

At the time of her death, Mrs. Shurtz owned a 1% general partner interest and an 87.6% limited partner interest in Doulos LP. In January 2002, the value of her estate was approximately \$8.8 million.

The IRS issued a \$4.7 million deficiency notice, contending that the values of the assets contributed to Doulos LP should be included in her gross estate because of Mrs. Shurtz's "retention of the control, use, and benefit of the transferred assets."

Sec. 2036 disallows discounts for lack of control and marketability on FLP interests if taxpayers retain real or implied possession or enjoyment of the partnership's property or its income. An exception is permitted if the estate demonstrates that transfers represent "bona fide sales for adequate and full consideration."



purposes. Although the court didn't address valuation issues in its opinion, *Shurtz* still reinforces the notion that an independent credentialed appraiser is a must-have for supporting valuation discounts.

Additionally, the case demonstrates that estate tax savings can be a legitimate reason for forming an FLP and won't necessarily preclude an estate from qualifying for the bona fide sale exception. The key is that those savings can't be a predominant factor in forming the FLP.

Tax Court findings

The Tax Court ruled that Doulos LP was created for the following legitimate nontax purposes:

- ◆ To protect the family's assets from Mississippi's highly litigious environment,
- ◆ To facilitate active and efficient management of the timberlands, and
- ◆ To preserve family holdings by restricting transfers.

The court also ruled that the asset transfers were bona fide sales because partners received FLP interests in proportion to the value of the assets they contributed. Moreover, partner capital accounts were properly credited for asset contributions and debited for distributions.

Ultimately, the Tax Court sided with the estate and accepted the taxpayer's valuation in its entirety — including the tiered discounts. The case doesn't, however, discuss valuation methodology or analytical procedures used to estimate valuation discounts.

Lessons learned

This case highlights the importance of proper partnership setup, funding and administration to help ensure an FLP is respected for estate tax

It's also noteworthy that, unlike FLPs in other taxpayer victories (such as *Samuel P. Black v. Commissioner*), Mrs. Shurtz's FLP wasn't administered perfectly. For example, the partnership delayed opening a bank account until four months after its creation, and partners sometimes paid disbursements from their personal accounts, though these payments were later reimbursed or credited to partners' capital accounts. And distributions weren't always proportionate to the partners' ownership interests, though unequal distributions were corrected in subsequent periods.

This case highlights the importance of proper setup, funding and administration when it comes to FLPs.

A glimmer of hope

Despite the minor indiscretions committed by the Shurtz FLP, the Tax Court ruled in the estate's favor. This provides a glimmer of hope for owners of less-than-perfect FLPs facing Sec. 2036 claims. Still, the safest practice is to follow FLP formalities as close to a "T" as possible. ◆

Fraud interviews: What to expect

When it comes to interviews with suspected fraud perpetrators, qualified fraud experts often can get the best results. They're well trained in how to best pursue suspicions of financial fraud, elicit new information and detect deception. Here's what to expect from the fraud interview process.

A rapport is built

To conduct a thorough and effective interview, even the most qualified expert will need assistance from the attorney involved. The attorney helps the expert obtain all of the relevant background information, including each interview subject's history, job duties and possible access to any common avenues of fraud.

In the opening stage of the interview, introductions are made and, ideally, a rapport is built. The interviewer explains the broad purpose of the meeting and may ask some questions with known answers to assess the interviewee's demeanor and honesty.



The discussion stage includes more specific questions. The interviewer makes clarifications where necessary but encourages the interviewee to do most of the talking. The closing stage is used to confirm the information obtained and request suggestions for other individuals to interview.

Driven by circumstances

To a large extent, the questions in a fraud interview are driven by the circumstances and any applicable standards (such as Generally Accepted Accounting Principles and Generally Accepted Auditing Standards). In general, though, the interviewer will ask company management about items such as:

- ◆ Their knowledge of any fraud or suspected fraud,
- ◆ Their knowledge of any allegations of fraud or suspected fraud,
- ◆ Their understanding of the risks of fraud in the company, including any specific risks the company has identified, and
- ◆ Any programs and internal controls the company has established to mitigate specific fraud risks or otherwise prevent, deter and detect fraud.

The interviewer may also need to interview employees at lower levels of authority, including operating staff who aren't directly involved in the financial reporting process and employees who are involved in initiating, recording or processing complex or unusual transactions.

Often, the most valuable information in a fraud investigation comes from the rank-and-file employees. These employees may be in the best position to notice fraud warning signs or suspicious behavior and to provide useful, ground-level insight on the company's fraud risks. But they may not recognize the red flags for fraud as such — and that's where the interview comes in.

Further investigation required

Bear in mind that it's rare for a fraud case to be tied up in a neat bow after a round of interviews. Further investigation will almost always be required. ◆



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Courts Discretion Limited to Statutes, Case Law and Potential Use of Trust

In a recent appellate decision (In re Marriage of Sonne, 48 Cal. 4th 118 [2010]) we are reminded that, even though trial courts have broad discretion in determining and allocating community and separate property, they need to follow the requirements of Family Code §2550 (equal division of community estate) and §2610 (each party to receive their full community property share of retirement benefits). The court also suggested potentially establishing a trust to receive the retirement benefits from which each party would receive their portion.

Gordon Sonne, a Monterey County law enforcement officer before and during the marriage, had a Public Employees' Retirement System (PERS) retirement benefit (he retired prior to his wife filing for divorce) that the trial court needed to allocate between his premarital separate property and the parties' community property. He had previously elected to receive a retirement allowance until his death and thereafter to his designated beneficiary (his divorcing wife) for her life. Both parties appealed the trial court's determination of what was community and separate property and how the retirement payments would be allocated. The California Supreme Court reversed and remanded to the Sixth District Court of Appeal who in turn reversed and remanded to the trial court with directions.

The District Court noted that the trial court failed to understand that Gordon's retirement allowance was made up of two parts. The annuity part was funded by the community but a separate property component existed, including from the use of reacquired service credits earned prior to marriage. The pension part was funded by employer contributions. The justices reversed and remanded for the trial court to use a proper apportionment method. Additionally, the justices directed the court to either (1) issue an order directing the establishment of a trust into which Gordon's survivor benefits would be paid, then his wife would receive her community share with the rest paid to Gordon or his heirs, or (2) select another method of apportioning the survivor benefit that complies with statutes and case law.

The court decisions and directives in this case are a reminder to all professionals practicing in this area: (1) to read the fine print and understand how an asset was created and how its value was determined, (2) where some separate property interest may exist, be alert for what might be community property, separate property, and/or a reimbursable claim, and (3) to not hesitate proposing a better alternative (even if it is an out-of-the-box idea) to the court if the result facilitates and/or simplifies future actions.

If we can be of assistance, please do not hesitate to contact us.

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