

LITIGATION AND VALUATION

ADVISER

In This Issue...

Physician Noncompete Agreements

Minimizing Taxes on Securities Damages

The Role of Valuation Analysis in Bankruptcy

Interesting & Helpful Statistics

Taking a Bite out of Electronic Discovery



The proliferation of electronic documents in recent years has dramatically changed the litigation playing field. Although the right to discover electronic data is well established, the sheer volume of electronic information available has made document production expensive.

Traditionally, the producing party bears this expense. But courts have begun to shift some or all of the cost to the requesting party – under certain circumstances.

The document explosion

According to some estimates, companies store 90% of their information electronically and conduct 80% of their communications via e-mail. These percentages are increasing daily. The large number of electronic documents is a result of more than just a change in format. Electronic documents are easy to create and store – and difficult to delete permanently. As a result, the number of documents even small organizations possess is staggering.

In the past, an employee might have a stack of files or even a file cabinet filled with papers. Today, it's not unusual for employees to use personal computers with 20 to 40 gigabytes or more of storage space. On average, one gigabyte holds the equivalent of about 65,000 Microsoft Word pages.

E-mail, in particular, has had an enormous impact. Busy executives dash off e-mails instead of picking up the phone or walking down the hall, creating a written record of informal communications that probably would not have been documented before.

At first blush, you might think electronic storage makes document production easier. After all, you can use keyword searches to quickly identify and retrieve relevant information, and you may even be able to produce documents electronically, saving the time and expense of printing and photocopying. That may be true of active files stored on computer hard drives or network servers, but extracting data from backup systems or from deleted, fragmented or damaged files can be a painstaking, expensive process.

Accessible vs. inaccessible data

As electronic discovery costs soar, courts are becoming more receptive to the notion that the requesting party should share the expense. Unfortunately, there are no uniform guidelines on when

(continued on page 2)

From Marty...

Welcome to the summer issue of our *Litigation and Valuation Adviser*. The articles are designed to give you ideas on novel issues.

The subject of non-competes can be applied to all professional practices. This legal form is often overlooked in valuation. To be successful, the agreement needs to be put in perspective of the law so that the appraiser can handle the valuation issues.

Meanwhile, the statistics on page 7 show T-Bills now over 5% – the economy's strong. Who can predict where the equities will go?

These are the "think about it" articles for your summer reading, with the hopes that they will **HELP YOU BUILD A BETTER CASE.**

Martin B. Lande

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Electronic Discovery

(continued from page 2)

cost-shifting is appropriate. The U.S. District Court for the Southern District of New York has issued a series of influential rulings (though of course they have no precedential value outside of southern New York) on electronic discovery in the landmark case of *Zubulake v. UBS Warburg*.

In *Zubulake*, an employment discrimination case, the plaintiff contended that e-mails exchanged among UBS employees were key evidence, and that these e-mails existed only on backup tapes and other archived media. According to the defendant, it would cost about \$175,000 to restore those e-mails.

The judge began her analysis by noting the legal presumption that the responding party bears the expense of complying with discovery requests. She then made a distinction between accessible data, which is always the responding party's responsibility, and inaccessible data, for which cost-shifting may be appropriate.

Accessible data includes active, online data – on hard drives or servers, for example – as well as near-line data, such as information on optical disks that store data in a readily usable format. Inaccessible data includes information on backup tapes and deleted or damaged files, which can only be retrieved through an expensive and time-consuming restoration or reconstruction process.

A 7-factor test

For inaccessible data, Judge Scheindlin outlined seven factors to examine to determine whether cost shifting is appropriate:

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

Because some of these factors were difficult to apply without knowing what was on the backup tapes, the judge ordered the defendant to restore documents from a small sample of tapes. Two months later, the court



reviewed the sample data and applied its cost-shifting test, shifting 25% of the restoration costs to the plaintiff.

Spoliation of evidence

A later ruling in *Zubulake* addressed the duty of litigants and their counsel to preserve electronic evidence. To avoid sanctions for spoliation (the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation), the ruling suggests that clients take steps to preserve relevant evidence.

In *Zubulake*, the court found that the defendant intentionally deleted certain e-mails and backup tapes. Sanctions included an adverse inference instruction - in other words, the court would permit the jury to infer that the destroyed evidence would have been unfavorable to the defendant.

The court pointed out that, although the spoliation in this case was intentional, some courts also impose sanctions for negligent destruction of evidence.

Preventive measures

It's a good idea to familiarize yourself with your clients' computer systems, backup procedures and document retention policies so you can anticipate electronic discovery issues. Estimating the cost of restoring documents from backup tapes and other archival storage systems will help you develop a reasonable budget and begin laying the foundation for cost-shifting arguments.

By taking steps such as preserving potentially discoverable documents in a readily accessible format, your clients may be able to reduce the possible future costs of complying with electronic discovery requests.

The Information Technology department at Holtz Rubenstein Reminick is in close contact with our Litigation and Valuation Consulting division; both are available to assist you with these and other litigation support issues. **h**

For information, contact Partner Joel Podgor at (212) 697-6900 or Podgor@hrrllp.com.

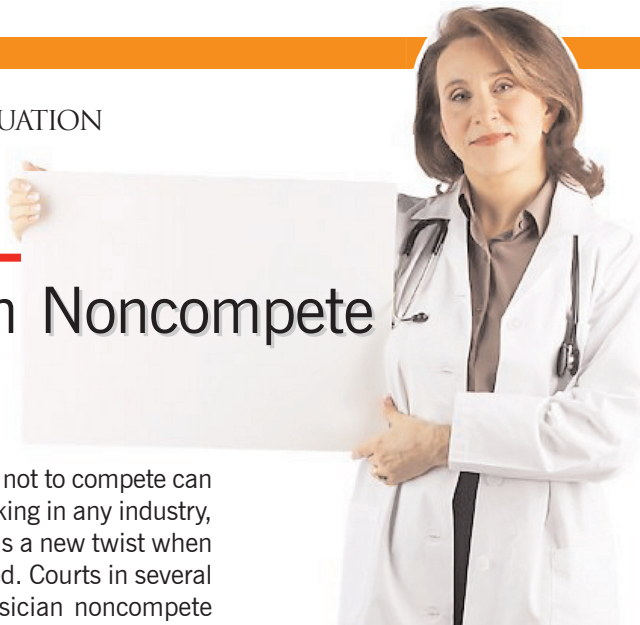


Proposed Rule Changes May Provide Uniform Guidance

The lack of consistent court rules concerning cost shifting, spoliation and other electronic discovery issues led the U.S. Judicial Conference's Committee on Rules of Practice and Procedure to propose amendments to the Federal Rules of Civil Procedure. Among other things, the proposed amendments would:

- Require the parties and the court to address issues involving electronic data preservation and discovery early in the proceedings,
- Provide that, absent a showing of good cause, a party need not produce electronic information that isn't reasonably accessible,
- Allow a party that inadvertently produces privileged information to assert the privilege and prevent further disclosure by notifying the other party within a reasonable time, and
- Bar sanctions against a party for failing to produce electronic information lost because of the routine operation of the party's computer system, unless the party violated a court preservation order or failed to take reasonable steps to preserve the information after it knew or should have known the information was discoverable.

If the proposed amendments are adopted, they will provide uniform guidance on electronic discovery throughout the federal courts and will likely influence a number of state courts as well.



Physician Noncompete

New Trend Affects Valuation

Valuing a covenant not to compete can be a complex undertaking in any industry, but a recent trend adds a new twist when physicians are involved. Courts in several states have held physician noncompete agreements to a higher standard than agreements in a commercial context. And one state's high court ruled that they're unenforceable in most cases.

When do noncompetes need to be valued?

The need to value a noncompete agreement can arise in many situations. In a divorce case, for example, a noncompete agreement may be relevant to the value of a business or professional practice for equitable distribution purposes. Many states treat the value of a noncompete agreement as the business owner's separate property, which isn't subject to division.

Noncompete values also play an important role in tax planning for a business sale or shareholder buyout. Depending on how the deal is structured, the portion of the purchase price allocated to a noncompete agreement can have significant tax implications for both buyers and sellers.

What's the method?

A noncompete agreement's value isn't added to the business value. Rather, it's a component of business value. If a buyer seeks to take advantage of the seller's workforce in place, for example, noncompete agreements between the business and its workers are critical to maintaining that workforce's value. If the owner will not stay with the business, his or her agreement not to set up shop

across the street is essential to preserve the value of the business being sold and transfer goodwill to the buyer.

Because a noncompete agreement's value is intertwined with business value, the most common valuation method is the "with and without" income method. To apply this method, the valuator:

1. Values the business by projecting its financial performance with the noncompete agreement in place;
2. Values the business by projecting its financial performance without the noncompete – that is, under the assumption the seller is free to compete with the buyer;
3. Probability-weights the second projection based on the likelihood the seller will compete;
4. Computes the present value of projected financial performance under each scenario; and
5. Subtracts the "without" value from the "with" value to arrive at the value of the noncompete agreement.

Step 3 is particularly important: The less likely the seller is to compete in the absence of a noncompete agreement, the less valuable the agreement is.

Factors that influence the probability of competition include the seller's age

Agreements

and health; the seller's plans to retire or relocate; the seller's other assets, business interests and sources of income; and industry factors, such as regulatory and market conditions that affect the seller's ability to compete.

How is it enforced?

Another important factor is the noncompete agreement's enforceability under applicable state law. Generally, the less likely it is a court would uphold the agreement, the less valuable the agreement is. But in making this determination, the valuator also considers the likelihood the seller would risk litigation by violating the agreement.

Given the impact of enforceability on a noncompete's value, it's important for the valuation to take into account applicable state law. Courts and lawmakers generally don't favor noncompete agreements because they interfere with free competition and a person's ability to earn a livelihood. Nevertheless, most states allow noncompete agreements that are reasonably designed to protect legitimate business interests.

States approach this issue in several different ways. Some states have passed laws permitting noncompete agreements provided they comply with certain restrictions. Others have banned noncompete agreements except in limited circumstances, such as the sale of a company's goodwill or the withdrawal of a partner from a partnership. (See sidebar "*The Reasonableness Test*" on next page.)

What about physicians?

Although many states treat physician noncompete agreements in the same manner as commercial agreements, courts and legislatures are increasingly applying a different standard to the health care profession.

In *Murfreesboro Medical Clinic v. Udom*, the Tennessee Supreme Court held that most physician noncompete agreements violate public policy and are unenforceable. Two exceptions - expressly permitted by statute - are agreements with a hospital or a medical school faculty practice plan.

The court compared the practice of medicine to the practice of law, noting, "Both professions involve a public interest generally not present in commercial contexts." Both involve relationships that are "consensual, highly fiduciary and peculiarly dependent on the patient's or client's trust and confidence in the physician consulted or attorney retained." Enforcing physician noncompetes would interfere with this relationship by restricting the right of patients to choose their physician.



Other courts continue to enforce physician noncompete agreements, but impose a higher level of scrutiny than with commercial agreements. For example, in *Intermountain Eye and Laser Centers v. Miller*, the Idaho Supreme Court declined to hold physician noncompete agreements unenforceable, but recognized that "doctor-patient relationships are different from most other relationships between service providers and their customers" and "require closer scrutiny."

In light of the public interest in protecting the highly personal relationships between physicians and patients, the court sent the case back to the trial court, noting the "reasonableness of a particular noncompete provision should be left to the finder of fact in light of the interests involved."

What's the impact?

As states continue to ban or restrict physician noncompete agreements, be aware of the impact this trend has on valuation. In some cases, noncompete agreements will lose some or all of their value, which may affect tax and equitable distribution issues.

But the appraiser's job is essentially the same: analyzing personal and industry factors to assess the probability that an individual will compete, and determining the impact of such competition on the value of a practice. If a noncompete agreement is enforceable, this exercise helps measure the agreement's value. If it isn't, weighing the likelihood of competition helps the appraiser identify and evaluate risk factors that affect the practice's overall value. **h**

The Reasonableness Test

Absent a statute that governs noncompetes, most courts evaluate them for reasonableness, looking at factors such as whether:

- The employer/buyer has a legitimate business interest in preventing competition by the employee/seller,
- The agreement is reasonably limited in terms of time, geography and prohibited activities, and
- Enforcing the agreement would harm the public.

In some states, courts are permitted to "blue-line" noncompete agreements - that is, edit out or circumscribe any unreasonable restrictions - and enforce the rest. The valuator should assess the probability a court would "rewrite" the agreement and determine the impact of a possible rewrite on the business's financial performance.

Minimizing Taxes on Securities Damages

Investors who prevail in securities litigation often lose a sizable portion of their damage awards or settlements to taxes. Plaintiffs can keep more of their winnings by considering tax consequences early in the case.

Tax treatment depends on the claim

As a general rule, damages and settlements are taxed based on the "origin of the claim." In other words, they're taxed in the same manner as the item or items the award was meant to replace. So, for example, an award of lost wages or lost profits would be taxed as ordinary income. But damages for injury to a building or other capital asset would be treated as a nontaxable return of capital up to the plaintiff's cost basis, and as capital gain to the extent the award exceeds the plaintiff's basis. Damages received on account of personal physical injuries or physical sickness generally are tax free.

In securities cases, damages typically are characterized as ordinary income, capital gains or nontaxable return of capital. Damages received for lost interest or dividends, for example, would be taxed as ordinary income (though "qualified" dividends would be taxed at long-term capital gains rates).

Damages based on injury to a capital asset - say, for management fraud that rendered the plaintiff's investment worthless - would be nontaxable up to the plaintiff's basis, with the excess taxed as capital gain.

Damages for injuries or illness usually don't arise in securities cases, though occasionally a plaintiff may claim that related emotional distress caused an ulcer or some other physical ailment. Punitive damages are taxed as ordinary income.

Punitive damages are taxed as ordinary income.



Damages allocation

Most securities cases involve various types of claims with different tax implications. The best way for a plaintiff to secure the desired tax treatment is to make sure the judgment or settlement agreement specifies what the damages are for. The IRS and the courts generally respect the parties' allocation of damages in a settlement agreement as long as it's reasonable.

An allocation stands a better chance of survival if it's negotiated at arm's length. The IRS and the courts are suspicious of allocations left entirely to the plaintiff's discretion.

It's important to consider tax issues early in the litigation. If the complaint and other documents focus on recovering lost interest income or punitive damages, for example, it may be difficult to defend a settlement agreement that allocates most of the damages to capital gains or nontaxable return of capital.

Addressing tax issues early also can help support a favorable tax allocation in the event the judgment fails to do so or the defendant won't agree to allocate damages in the settlement agreement.

A favorable result

Absent allocation in a judgment or settlement agreement, the IRS and the courts will determine the appropriate tax treatment based on all the "facts and circumstances." You can increase your chances of a favorable tax outcome by ensuring the complaint and other court documents support your characterization of the damages. **h**

The Role of Valuation Analysis in Bankruptcy

A federal district court decision, *In re Hechinger Investment Company*, illustrates the important role valuation analysis plays in bankruptcy matters.

Hechinger and its affiliates filed a Chapter 11 bankruptcy petition in June 1999. *Hechinger* was a related adversary proceeding brought by the Liquidation Trust of Hechinger Investment Company of Delaware, where the plaintiff made several claims against Hechinger and other defendants arising out of a 1997 business acquisition and combination.

Several of the claims were based on the plaintiff's assertion that Hechinger was insolvent at the time of the transaction and that some defendants - who knew or should have known of the company's insolvency - breached their fiduciary duties to Hechinger and its creditors.

Ruling on the parties' cross-motions for summary judgment, the court addressed, among other things, the issue of whether Hechinger was insolvent or "operating in the vicinity of insolvency" at the time of the transaction. The court observed that the Bankruptcy Code defines insolvency as a "financial condition such that the sum of [a corporation's] debts is greater than all of such entity's property, at a fair valuation."

The code doesn't define "fair valuation," but in this case the court found that, because bankruptcy was not "clearly imminent" at the time of the transaction, the company should be valued on a going-concern basis. But despite "thousands of pages of exhibits," it wasn't clear to the court whether any party had conducted such an analysis.

The plaintiff relied on an expert whose report "comprises an exhaustive recitation of data that allegedly was known or knowable at the time of the transaction." But none of the data was specifically referenced to the exhibits, and the expert's valuation analysis was contained in a one-page summary attached to his report.

The court denied summary judgment on this issue and sent it to trial. **h**

Interesting & Helpful Statistics

Treasury yields¹

30 day – 4.68% | 5 year – 5.10% | 20 year – 5.31%

Prime lending rate²

8.25%

Dow Jones 20 year bond yield²

6.27%

Barron's intermediate grade bonds²

7.44%

High yield estimate¹

Median – 10.51%
Mean – 11.77%

IBBOTSON: Total rate of return for years 1926–2005³

Small Cap – 17.4% | Large Cap – 12.3%

Dow Jones Industrials P/E Ratios²

On current earnings – 20.93
On 2006 operating earnings estimate – 14.80

S&P 500 Index P/E Ratios⁴

On current earnings – 18.74
On 2006 operating earnings estimate – 17.15

U.S. Equity Indexes – YTD Returns⁴

S&P 500 – 4.99% NASDAQ Composite – 5.32%
Dow Jones Industrials – 6.06% NYSE Composite – 9.25%
Dow Jones Transports – 11.16% Wilshire 5000 – 6.10%
Dow Jones Utilities – -1.89%

Long-term inflation estimate⁵

2.5%

Unemployment

US – 4.6%⁶ | NYC – 5.0%⁷

Average vacancy rates NYC⁷

Hotels – 12.0% this year | 10.0% last year
Office space – 6.6% this year | 6.8% last year

Zagat Survey

Most popular Long Island restaurants⁸

- | | |
|-----------------------|------------------------|
| 1. Peter Luger | 4. Bryant/Cooper Steak |
| 2. Cheesecake Factory | 5. Mill River Inn |
| 3. Coolfish | 6. Waterzooi |

1/Source: *Wall Street Journal* as of July 1, 2006

2/Source: *Barron's*, as of July 3, 2006

3/Source: Ibbotson, *S&P Valuation Edition, 2006 Yearbook*; Total returns for 1926–2005 Table 2-1, Arithmetic Mean

4/Source: *The CPA Journal*, June 2006, data as of April 28, 2006

5/Source: 10 year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, June 7, 2005

6/Source: United States Department of Labor, Statistics as of June 2006

7/Source: New York City Economic Development Corporation, *A Summary of New York City's Economy*; July 2006; rate as of May 2006.

8/Source: *Zagat Survey*; www.Zagat.com



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