

MAY/JUNE 2024

LITIGATION SUPPORT



Amended FRE 702 kicks off
What new rules mean for expert witness admissibility

Valuing a business that's in flux

3 recent business fraud schemes

Estate of Hoensheid v. Commissioner
Nonqualified appraiser costs client in court

Oscher  **Consulting, PLLC**

One Tampa City Center
201 North Franklin Street, Suite 3150
Tampa, Florida 33602
813•229-8250 FAX: 813•229-8674

Amended FRE 702 kicks off

What new rules mean for expert witness admissibility

The amended Federal Rules of Evidence (FRE) 702 regarding the admissibility of expert witness testimony in federal courts took effect on December 1, 2023. Although the amendments don't create a new standard, they do highlight some important points regarding the standard of evidence and the court's gatekeeping role that some district courts have previously misapplied. The changes could have significant implications for the role of expert testimony going forward.

Preponderance burden

The first amendment clarifies and emphasizes that expert testimony isn't admissible unless the proponent establishes that it's *more likely than not* that the testimony meets the rule's admissibility requirements. In other words, the same preponderance of the evidence standard that applies to most of the FRE's admissibility rules applies to the admissibility of expert testimony. In the past, many courts have mistakenly held that questions about the sufficiency of an expert's basis and application of the expert's

methodology are questions of weight rather than admissibility.

The amendment reiterates that the preponderance standard applies to FRE 702's reliability-based requirements. Many courts also have incorrectly evaluated these requirements under the more lenient FRE 104(b) standard instead of FRE 104(a).

The preponderance standard applies to FRE 702's reliability-based requirements.

The Advisory Committee on Evidence Rules criticizes courts for characterizing expert challenges as going to weight, not admissibility. But it acknowledges that some challenges do indeed raise matters of weight — even under the FRE 104(a) standard. For example, the fact that an expert with a sufficient basis to support an opinion hasn't read every study on the issue goes to weight. But arguments about the sufficiency of basis don't always go to weight.

More insight on the standard

According to the Advisory Committee, the amendment doesn't require a court to make a finding of reliability in the absence of an objection. When reliability is assessed, a proponent must demonstrate only



Early application of revised FRE 702 offers insights

The U.S. Court of Appeals for the Fourth Circuit relied on the amended Federal Rules of Evidence (FRE) 702 in 2021, even though they hadn't yet been finalized. In *Sardis v. Overhead Door Corp.*, the appellate court reversed a nearly \$5 million verdict in a product liability case. It explained that the lower court abdicated its "critical gatekeeping role to the jury" by allowing testimony from two experts without engaging in the required analysis.

The district court didn't perform any *Daubert* analysis and ruled that the issues of relevance and reliability affected only the weight of the experts' testimony. It recognized "legitimate concerns" with one expert's proffered testimony but deemed them solely a subject for cross-examination.

The appellate court found the lower court's error harmful because, if the court had satisfied its *Daubert* responsibilities, precedent would have compelled the exclusion of both experts' testimony. Without that testimony, the plaintiff failed to meet its evidentiary burden on each cause of action.

that expert opinions are reliable, not that they're correct. And, when experts come to different conclusions based on contested facts, the FRE 104(a) standard doesn't necessarily require exclusion of either side's expert. By deciding the contested facts, the jury can decide which experts to credit.

The Advisory Committee also rejected the requirement of some courts that expert testimony "appreciably help" the trier of fact. It deemed this standard of helpfulness "unnecessarily strict" and reinforced that the expert's knowledge is required only to "help" the trier of fact understand the evidence or determine a fact in issue.

Court gatekeeping duties

The second amendment to FRE 702 emphasizes that each expert opinion must stay within the bounds of what can be concluded from a reliable application of the expert's basis and methodology. It's up to the court to make this determination. Jurors who lack specialized knowledge may not be capable of meaningfully evaluating the reliability of scientific and other methods underlying expert opinions. They also might not be able to determine whether experts' opinions go beyond what their basis and methods reliably support.

The Advisory Committee stresses that this amendment is particularly relevant to the testimony of

forensic experts. These experts should avoid assertions of absolute certainty (or "to a reasonable degree of scientific certainty") if their methodology is subjective. Where possible, judges should receive an estimate of the methodology's known or possible rate of error — typically based on studies that reflect how often the method produces accurate results. Further, when expert opinion testimony includes evidence that a set of features corresponds between two examined items, the testimony must be limited to inferences that can reasonably be drawn from reliably applying principles and methods.

The amendment doesn't require new or specific procedures. It also doesn't require a court to "nitpick" an expert's opinion to attain a perfect expression of what the basis and methodology can support. Although the FRE 104(a) standard doesn't require perfection, it does prohibit experts from making claims unsupported by the basis and methodology.

A double-edged sword

Litigants should expect district courts to take a more stringent stance when it comes to expert witness testimony. So, take precautions to ensure your expert witnesses 1) are qualified, and 2) offer relevant and reliable testimony. On the flip side, with proper preparation, you may have greater success excluding opposing experts. ■

Valuing a business that's in flux

Current economic volatility — as evidenced by rising costs, upticks in interest rates, bank failures and geopolitical risks — adds an element of uncertainty when estimating business value. So, even established businesses can't necessarily count on historical profit margins and capital costs. Here are some ways valuers may adapt their analyses to account for uncertain market conditions.

Income approach

Under the income approach, value is based on expected future earnings (usually cash flows), which are then discounted to their present value. When market conditions are stable, historical financial statements are typically used to estimate future earnings. However, if a company's performance is expected to differ from previous periods, a valuator can't necessarily rely on historical data. Some changes in business operations may be only temporary, but others could continue indefinitely.

If a company's performance is expected to differ from previous periods, a valuator can't necessarily rely on historical data.

Short-lived changes may necessitate the use of a more complicated discounted cash flow analysis over a simpler capitalization of earnings method that's based on expected cash flows from a single period. Some changes will continue indefinitely, however. When considering a business's expected cash flows, a valuator must look at current sustainable cash flows. Valuers also may use more-sophisticated assumptions to develop expected earnings projections.

Likewise, experts typically use discount rates that reflect the risks associated with the operating



environment on the valuation date. Commercial interest rates have increased significantly in recent years. In addition, market and company-specific risks have intensified, which may increase a business's cost of equity. Many companies are currently experiencing labor shortages, rising prices from suppliers, exposure to cyber risks, and increased state and federal regulations. Investors generally demand a higher return to compensate for the added risk of operating in an uncertain environment, which usually decreases value.

Market approach

With the market approach, a business's value is derived from pricing multiples based on comparable (or "guideline") businesses or ownership interests that have been sold. Comparables may be:

- Sales of private or public companies under the guideline transaction (merger and acquisition) method, or
- Publicly traded stocks under the guideline public company method.

Pricing multiples — such as price-to-pretax earnings or price-to-revenue — may be applied to the subject company's historical financial metrics. However, when market conditions are

unstable, it may be appropriate to analyze only recent comparables. Additionally, valuers might make adjustments to pricing multiples to account for current market conditions or use forward-looking pricing multiples to apply to the subject company's projected financial results.

Cost approach

The concept underlying the cost (or asset) approach is that the value of a business equals the difference between the values of its assets and liabilities. Each item is valued using either the income, market or cost approach. Historical balance sheets are often the starting point for this valuation technique. However, balance sheets prepared under U.S. Generally Accepted Accounting Principles usually don't include intangible assets (such as brands, customer lists and goodwill) and contingent liabilities (such as pending litigation or an IRS audit).

The result may serve as a "floor" for a company's value or sanity check to compare to the results of the income and market approaches. After all, reasonable sellers typically won't accept less than net asset value in a merger or acquisition unless they're under duress to sell. In uncertain economic times, the cost approach may become increasingly relevant, particularly for distressed or insolvent businesses that aren't generating sufficient earnings to contribute to business value.

Exercise caution

When there's economic uncertainty, it's important for attorneys and business owners to carefully review business valuations. You should make sure your valuator takes steps to incorporate economic factors into his or her analysis. Note: Valuations shouldn't be recycled for unintended purposes, because a value that's accurate today may be inaccurate in a few months. ■

3 recent business fraud schemes

Fraud perpetrators are always finding novel ways to steal from businesses. Owners and managers need to stay atop the latest fraud schemes to fortify their companies' defenses against fraud losses. Here are three recent scams that you should be aware of.

1. Social media influencer shakedowns

It's common nowadays for so-called social media "influencers" to receive complimentary goods and services from businesses in exchange for free publicity on social media platforms. For example, a restaurant might offer free meals and drinks to an influencer in exchange for promoting the business on Tik-Tok posts. However, some less ethical influencers may rack up big bills, not pay them and fail to post anything about the businesses. Others may accept money for "exposure packages" (to place a

certain number of posts on various platforms) and then never deliver.

What should business owners do if influencers approach them for freebies? First, they should verify that the influencer has the number of followers claimed and that the person regularly publicizes local businesses on social media. In addition, they should consider asking influencers to sign simple contracts that specify what's agreed to be provided, what they promise to do in return and over what period. The company's attorney can draw up a basic influencer agreement for the business to use with social media influencers going forward.

2. Corporate impersonation

Most business owners are familiar with the dangers of phishing schemes and have warned employees not to



click links contained in suspicious emails. But savvy scammers have started using companies' names, logos and other intellectual property, making phishing emails hard to identify. For instance, a perpetrator might set up a website that resembles the company's site and use it to infect visitors with malware.

Thwarting these schemes can be especially challenging. If a business owner suspects that a con artist is impersonating the company, it should notify customers, vendors and other stakeholders immediately via email and social media channels. It's important to warn of fake messages and remind them that the business doesn't request sensitive information (such as credit card numbers) by email. An attorney can help draft these communications, so as not to alarm stakeholders, and help report the incident to the Internet Crime Complaint Center ([ic3.gov](https://www.ic3.gov)).

3. Compromised business emails

Fraudsters also may pose as supervisors or vendors and send compromised emails to workers to gain access to their employers' systems and data. Business email compromise fraud has become more

prevalent since the COVID-19 pandemic as more employees work remotely. Perpetrators typically ask recipients of compromised emails to initiate financial transactions, such as transferring money to an external account, and usually stress urgency. If employees can't quickly verify the request with the real person (as they might be able to do if they shared office space), they sometimes go ahead and transfer money to the crook.

It's important to educate employees about business compromise email scams. Employers should stress that workers should never assume a financial transaction request is legitimate. They should first speak face-to-face with the sender in person or on a phone call or video chat initiated by the employee.

Threats abound

Businesses are under frequent threat from fraud, and new schemes can emerge from places you might never have imagined. A forensic accountant can help employers identify vulnerabilities and establish policies and procedures that will help reduce fraud risks. ■

Estate of Hoensheid v. Commissioner

Nonqualified appraiser costs client in court

A business owner recently learned about the importance of using a qualified appraiser when claiming a deduction for contributions of private company stock to a donor-advised fund (DAF). Although presale charitable contributions may offer some valuable tax breaks for business owners who are planning to sell, *Estate of Hoensheid* demonstrates why owners should time contributions carefully and substantiate the fair market value of stock with a qualified appraisal.

Case facts

In April 2015, a business owner contemplated establishing a DAF for tax planning purposes. The taxpayer had hoped to avoid capital gains tax from an impending sale of the company by making a presale charitable contribution of some of his company's stock to the DAF. He transferred the shares in June 2015 and claimed a charitable contribution deduction of about \$3.3 million on his 2015 federal income tax return. To substantiate his deduction, the taxpayer used the transactional advisor who handled the business sale to appraise the stock for no charge.

The IRS disallowed the deduction and asserted a \$647,489 deficiency and \$129,498 accuracy-related penalty. These assessments were subsequently

increased because the contribution wasn't made until the sale was a virtual certainty, thus triggering the anticipatory assignment of income doctrine. Under this doctrine, a person with a fixed right to receive income from property can't avoid taxes by arranging for another to gratuitously take title before receiving the income.

Lost deduction

While the U.S. Tax Court agreed that the doctrine applied, it ruled that the taxpayer made a valid gift that might support a charitable deduction. To claim such a deduction on a gift exceeding \$500,000, a taxpayer must attach a "qualified appraisal" conducted by a "qualified appraiser."

The court found the taxpayer's appraisal flawed in multiple ways — beginning with the advisor's qualifications. The court noted that the transactional advisor didn't have any appraisal certifications or hold himself out as an appraiser. At trial, the advisor testified that he conducted valuations "on a limited basis" before joining the bank the year before the appraisal in question. Moreover, he performed business valuations for prospective clients only once or twice a year.

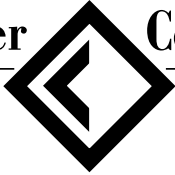
The court described the use of a qualified appraiser as the "most important requirement" for a qualified appraisal. Thus, it concluded that the taxpayer didn't show substantial compliance with substantiation requirements.

Double whammy

After being found liable for capital gains tax on the shares transferred to the DAF, the taxpayer might have still benefited from a hefty charitable deduction. But the donor lost that tax benefit, too, because he didn't use a qualified appraiser. ■



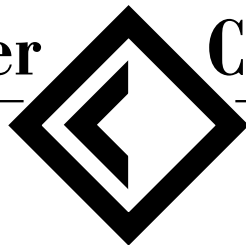
Oscher Consulting, PLLC



One Tampa City Center
201 North Franklin Street, Suite 3150
Tampa, Florida 33602
813•229-8250 FAX: 813•229-8674

PRSR STD
U.S. Postage
PAID
Permit #2880
Tampa, FL

Oscher Consulting, PLLC



A Certified Public Accounting firm providing litigation support services in the areas of Accounting, Finance, and Information Systems.

Areas of Expertise: Economic and financial analysis associated with:

- ▶ forensic accounting and fraud investigation
- ▶ contract disputes
- ▶ personal injury and wrongful death litigation
- ▶ bankruptcy issues
- ▶ environmental damages analysis
- ▶ family law issues
- ▶ business valuation
- ▶ securities fraud and manipulation
- ▶ employment law issues

Education/Training:

- Our consulting group includes:
- ▶ Certified Public Accountants
 - ▶ Accredited Business Valuators
 - ▶ Certified Fraud Examiners
 - ▶ Ph.D.s in economics, finance, accounting, marketing and information systems

The personal, professional and specialized service provided to our litigation clients demands the intensive involvement of people who understand the litigation process and who provide accessible, comprehensive service.

Working as part of your support team, Oscher Consulting presents innovative approaches and creative solutions to problems related to the development of successful litigation strategies. The result: responsive, accurate and confidential services that are highly valued by our clients.



The CPA. Never Underestimate The Value.