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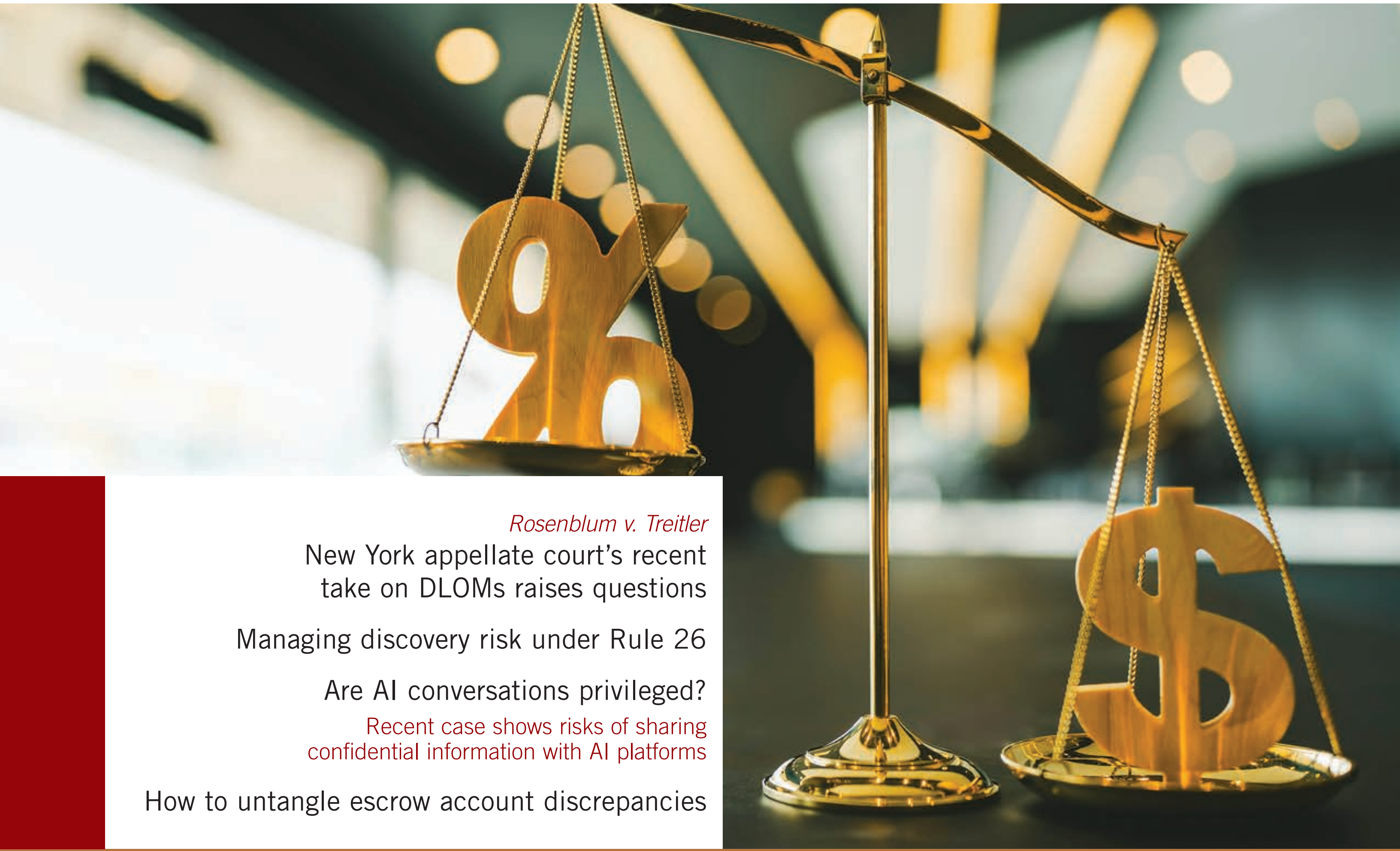

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Rosenblum v. Treitler

New York appellate court's recent take on DLOMs raises questions

The discount for lack of marketability (DLOM) is a frequently litigated business valuation adjustment. This discount is subjective and fact-specific and can significantly affect business value. Moreover, court decisions applying DLOMs are often inconsistent or even contradictory.

A recent New York appellate court case — *Rosenblum v. Treitler* — further muddies the waters. The court accepted the trial court's application of 15% DLOMs when determining the fair values of 50% interests in two limited liability companies (LLCs). The court implicitly acknowledged that, in New York fair value cases, the DLOM is analyzed at the entity level. But the factors it cited to support the discount suggested a member-level analysis.

DLOM basics

The International Glossary of Business Valuation Terms defines the DLOM as "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability." And it defines marketability as "the ability to quickly convert property to cash at minimal cost." Public stocks can be converted to cash quickly and inexpensively. However, noncontrolling interests in closely held businesses, which typically take longer to sell and generate high transaction costs, may warrant DLOMs. When quantifying these discounts, valuators consider various company-specific factors. (See "Determining the DLOM" at page 3.)

> Marketability refers to "the ability to quickly convert property to cash at minimal cost."

This discount is usually applied at the shareholder or member level to reflect the relative lack of marketability of the business interest being valued. Under a fair value standard, however, it works somewhat differently. In shareholder disputes, fair value is often defined as an interest's pro-rata share of the company's overall value, with no discounts for lack of marketability or control. The rationale is that noncontrolling shareholders may not relinquish their shares voluntarily, and these discounts allow the majority to unfairly suppress the value of noncontrolling owners' shares.

Some states, including New York, allow DLOMs when determining fair value. However, under New York law, it's generally accepted that a DLOM is determined at the entity level; a shareholder-level discount might provide a "back door" mechanism for controlling shareholders to reduce buyout payments to noncontrolling owners.

Protracted family dispute

Rosenblum involved a dispute over family-owned real estate holding companies. The instant litigation focused on two of the holding companies, organized as LLCs with ownership split equally between the plaintiff and his deceased mother's estate.

The plaintiff exercised his right under New York law to withdraw from the LLCs and receive the fair value of his membership interests. The trial court determined that the fair values of the plaintiff's interests were approximately $11.8 million and $10.7 million. These values included 15% DLOMs applied by the defendant's business valuation expert. The trial court explained that "a marketability discount is appropriate at the holding company level." However, the factors it cited in support of a DLOM included:

- The protracted litigation between the parties,
- The lack of an operating agreement and a set withdrawal process, and
- "The amount of time and money that has been wasted due to an unwillingness to compromise."

The appellate court upheld the trial court's valuations. It noted these factors highlighted "the difficulties a third-party investor would risk in purchasing the LLCs" and, therefore, supported the DLOMs.

Determining the DLOM

A common starting point for quantifying the discount for lack of marketability (DLOM) is the ranges provided by various empirical studies. Business valuation experts adjust the median discounts from these studies, upward or downward, to reflect the marketability of the interest being valued. Common factors valuators consider include:

- Expected holding period,
- The company's earnings volatility,
- The company's dividend policy,
- Size of interest being valued,
- Transfer restrictions on shares, and
- Prospects of an initial public offering (IPO) or sale.

Examples of empirical data sources may include:

Restricted stock studies. These studies compare freely traded public company stock prices with prices paid for restricted stock in the same company. The typical discount range in restricted stock studies is 20% to 45%.

Pre-IPO studies. These compare initial public offering (IPO) prices with pre-IPO prices of the same stock in private transactions. The typical discount range in pre-IPO studies is 30% to 60%.

LEAPS studies. These studies derive discounts from puts and/or calls on publicly traded stock options known as long-term equity anticipation securities (LEAPS). The typical discount range in LEAPS studies is 15% to 30%.

Questionable decision

Many commentators question the court's application of 15% DLOMs in *Rosenblum*. A DLOM in New York fair value cases should be analyzed at the *entity* level. However, the factors the defendant's expert considered (and the courts accepted) were arguably relevant only at the *member* level. After all, a hypothetical buyer of the LLCs wouldn't be affected by the protracted litigation, the lack of an operating agreement or the unwillingness of the current members to compromise. These issues would be irrelevant to someone who purchased the holding companies in their entirety.

The plaintiff asserted in his post-trial brief that a DLOM was inappropriate because a purchaser of his interests would have a statutory right to withdraw in exchange for fair value. What's more, applying DLOMs in this case would essentially give the estate more than its 50% share of the LLCs' values.

No clear-cut answers

The *Rosenblum* decision will likely generate greater uncertainty about an already contentious business valuation issue. Contact a valuation professional to discuss whether the DLOM applies in your situation and, if so, how to quantify it to reflect company-specific factors. ■

Managing discovery risk under Rule 26

Are draft expert reports — and the back-and-forth that goes into developing them — discoverable by the opposing side in litigation? The short answer in federal court is generally no, but the full picture is more nuanced and worth understanding before engaging an expert witness.

Rule 26 of the Federal Rules of Civil Procedure governs expert disclosures. Since its 2010 amendments, the rule has drawn clearer boundaries around what is and isn't discoverable. Those boundaries provide substantial protection, but not a free pass.

Two key protections

Rule 26 distinguishes draft reports from communications with experts, and each has slightly different protections.

1. Draft reports. Rule 26(b)(4)(B) protects drafts of expert reports or disclosures required under Rule 26(a)(2), regardless of the format. This includes marked-up PDFs, email attachments, notes and other working versions. The rule reflects how expert opinions develop over time. Drafts often contain incomplete analyses, alternative approaches or preliminary conclusions and are protected from disclosure.

2. Attorney-expert communications. Rule 26(b)(4)(C) generally shields communications between attorneys and experts who are required to provide a written report.

That protection is broad, but it doesn't extend to communications about the expert's compensation. It also doesn't apply to communications that identify facts or data provided by counsel and considered by the expert, or assumptions provided by counsel and relied upon by the expert.

What may be discoverable

Even with these protections, much of an expert's work remains subject to discovery. The rules don't shield the facts and data underlying the expert's opinions, the expert's analysis and methodology, or materials the expert considered in forming those opinions — even if those materials weren't ultimately relied upon.

Courts often interpret "considered" broadly. If an expert reviewed a document while forming an opinion, there's a good chance it may be discoverable.

Managing discovery risks

One way to mitigate discovery risk is to engage consulting (nontestifying) experts early in a case. Under Rule 26(b)(4)(D), the opinions and work of consultants are generally protected from discovery. This allows counsel to evaluate claims, test damages models and identify weaknesses without committing those preliminary views to a testifying record.

For instance, in business valuation and commercial damages matters, a consultant might explore alternative approaches, evaluate different data sets or stress-test assumptions before developing a final opinion. However, a consultant's protection can be lost if he or she is later designated as a testifying expert, or if the consultant's work is shared with and considered by a testifying expert.

Other practical tips to help minimize discovery risks when working with expert witnesses include:

- Be deliberate about what documents, data and assumptions are shared,
- Avoid unnecessary written commentary on draft reports, and
- Preserve the expert's independent judgment in forming opinions.

Experienced experts are familiar with these constraints and can help maintain appropriate boundaries throughout the engagement.

Where courts still draw lines

In recent years, courts have largely agreed on the core protections for drafts and attorney-expert communications. Most disputes now focus on what it means for an expert to have "considered" a document, or whether certain materials fall within one of the rule's exceptions.

Courts have also clarified that the 2010 amendments didn't create blanket protection for all expert-related materials. The protections are targeted, and they leave room for discovery into the *foundation* of an expert's opinions.

It's also important to note that these protections apply in *federal* court. State rules may differ significantly, sometimes expanding what's discoverable. In some jurisdictions, expert-related materials, including drafts, may be subject to broader disclosure requirements under state law frameworks.

Knowing what's protected

Draft expert reports and most attorney-expert communications are generally protected from discovery in federal court. But the facts, data and assumptions underlying an expert's opinion remain open to examination. Understanding where the lines are drawn — and structuring expert engagements accordingly — can impact how effectively expert testimony supports a case. ■

Are AI conversations privileged?

Recent case shows risks of sharing confidential information with AI platforms

The use of artificial intelligence (AI) tools has become increasingly common for various legal tasks, including research, data analysis, document review and even document drafting. Courts are just beginning to grapple with the implications of these game-changing technologies. In a recent case — *United States v. Heppner* — the U.S. District Court for the Southern District of New York faced a question of first impression nationwide: Do attorney-client privilege or the work-product doctrine protections extend to communications with a publicly available AI platform?

Defendant consulted Claude

In *Heppner*, the defendant was indicted for securities fraud and other crimes. Once he discovered he was the target of a government investigation, he used

Claude, a publicly available AI tool, to analyze his situation, develop defense strategies and outline potential legal arguments. The defendant did so on his own initiative; counsel didn't instruct him to use AI. After his arrest, the FBI searched his home and seized 31 documents that captured these conversations.

Defense counsel asserted that these documents were protected from discovery by attorney-client privilege and the work-product doctrine. The attorneys argued that the defendant 1) input information he learned from counsel, 2) created the documents for the purpose of obtaining legal advice, and 3) subsequently shared the documents with counsel.

Court finds no protections

The court found that the defendant's AI communications weren't protected by the attorney-client privilege, because:

- Claude isn't an attorney.
- There was no reasonable expectation of confidentiality. The developer's privacy policy allows it to use inputs to "train" Claude and disclose data to third parties, including government regulatory authorities.
- The communications weren't for the purpose of obtaining legal advice, because counsel didn't direct the defendant to consult Claude.

The court also found that otherwise nonprivileged communications don't become protected merely because they're shared with counsel. Additionally, it ruled that the AI documents weren't protected work product, because they weren't prepared "by or at the behest of counsel" and didn't "reflect defense counsel's strategy." While the government conceded that the documents "affected" defense counsel's strategy, they didn't "reflect" counsel's strategy when the defendant created them.

Unanswered questions

It's unclear how courts will rule in cases with different facts. For example, would the privilege have applied if counsel had directed the client or a consulting expert to use an AI tool? Under those circumstances, one might argue that the AI tool is analogous to a nonattorney agent of counsel, with whom communications may be privileged. Similarly, the defense might have had a stronger argument for work-product protection had counsel guided the client or a consultant on the use of AI, making it more likely that a court would find that the AI's output "reflects" counsel's strategy.

In terms of confidentiality, does it make a difference if the AI tool is used in "private mode" (meaning inputs aren't used for training purposes) or if the tool is privately hosted? Some commentators argue that there's a reasonable expectation of confidentiality even with public AI tools whose privacy policies allow disclosure to third parties. For instance, it's common for attorneys and clients to communicate or create documents using technologies that pose some disclosure risk — such as Google Docs, email services or cloud-based storage — without jeopardizing attorney-client privilege.

Develop an AI policy

As the courts continue to address these issues, the treatment of AI tools will become clearer. In the meantime, to preserve the attorney-client privilege and work-product protection, it's important to develop policies on the use of AI by clients, consultants and other participants in the litigation process. ■

How to untangle escrow account discrepancies

Escrow and trust accounts operate on a simple premise: Funds held on behalf of others must be accurate, segregated and fully traceable. When that premise breaks down — whether due to error, poor processes or suspected misconduct — the consequences can escalate quickly into legal disputes, regulatory scrutiny or litigation. In these situations, a forensic accountant may be called in to reconstruct and reconcile the account and identify what went wrong.

A puzzle that must fit

Escrow accounts are commonly used in legal practices, real estate transactions, mergers and acquisitions, construction projects, and other situations where funds are held on behalf of clients or third parties. An escrow account should function like a completed puzzle. The individual client or transaction balances are the pieces, and the bank balance represents the full picture. When everything is working properly, the pieces fit together perfectly; the total of all client balances matches the bank account exactly.

When they don't align, pieces may be missing, duplicated or in the wrong place. Escrow account discrepancies carry heightened risk because they involve third-party funds. Even relatively small variances can raise concerns about commingling or misallocation of funds and unauthorized disbursements.

Traditional vs. forensic reconciliations

Traditional reconciliations focus on whether escrow account balances tie; forensic reconciliations address why they don't. This typically involves reconstructing activity across three levels: 1) bank activity, including deposits, disbursements and timing differences; 2) general ledger balances, including adjustments and reclassifications; and 3) underlying client or transaction-level detail, where funds are tracked by matter, property or project. This can be especially challenging for high-volume accounts spanning multiple reporting periods.

When discrepancies arise, the objective is to trace transactions from source documentation through the accounting system to the bank and identify where breakdowns occurred. Discrepancies rarely stem from a single isolated error. Common issues include:

- Funds recorded in the wrong client or project account,
- Timing differences that were never properly resolved,
- Duplicate or unsupported disbursements,
- Adjustments made without adequate documentation, and
- Breakdowns in segregation of duties.

It's critical to quantify the magnitude and timing of discrepancies, reconstruct account activity where records are incomplete, and distinguish between errors, control failures and potential misconduct.

Seeking outside support

Escrow issues are often most efficiently resolved when addressed early. Delays can lead to further record degradation, additional transactions that complicate the analysis and increased costs to reconstruct historical activity. Engaging a forensic accountant at a dispute's outset can help preserve evidence, define the scope of the issue and establish a structured path forward.

Escrow discrepancies often signal deeper issues. A structured forensic review can trace transactions, identify breakdowns and establish a clear, supportable understanding of account activity. ■

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