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The Franchise Valuations Reporter

O Canada!

Toronto attorney, Ned Levitt, and I will be speaking on valuing franchise businesses at the Canadian Franchise Association National Convention, on April 3, 2012, in Niagara Falls, Ontario, at the Sheraton on the Falls Hotel.

More information is available from the CFA at www.cfa.ca.

Our Expertise

Within the franchise, distribution and dealership context, we are experts in:

- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security and E-discovery of Electronically Stored Information

We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

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Franchise Technology Risk Management

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The Care and Feeding of Expert Witnesses

The Three Stages of Using an Expert; Avoiding Exclusion For "Cherry-Picking"

As most litigators in the franchise, dealership and distributorship arena know, expert witnesses are often indispensable in proving damages, valuations and other aspects of cases. The retention and employment of such experts basically encompasses three stages: 1) the report; 2) the discovery phase; and 3) trial preparation and testimony.

The work at each stage is subject to Rule 26 in federal courts and the various rules applicable to expert testimony in the several state courts. In the report phase, the expert must review any and all relevant documents sent by counsel often including claims, answers, counter-claims, deposition transcripts, inside reports, outside reports, financial documents such as balance sheets and income statements and other relevant documents. Litigators who try to limit the expert's fees by limiting the information the expert is given will often end up having their expert excluded under a *Daubert* challenge for having relied on "cherry-picked" information.

For example, in *MDG International, Inc. v. Australian Gold, Inc*. (S.D. Ind. June 29, 2009) 2009 WL 1916728, although a federal district court stated that the expert had generally commendable qualifications to prepare a business valuation* the court warned counsel against stacking the deck:

> In challenging Wahlen's methodology and reliability, Australian Gold first contends that his opinions "rely on incomplete and inaccurate 'cherry-picked' facts." When an expert "ignores critical data" in forming his opinions, he fails to satisfy *Daubert.* (citations omitted). Australian Gold argues generally that Wahlen's opinions must be excluded because they rely solely on the information provided to him by counsel for MDG; because he did not review the record in preparing his report; and because he admitted that a review of the record would have impacted his opinions.

The court excluded the expert from testifying, saying:

> MDG defends Wahlen's opinion by maintaining that he relied on sufficient facts, including an overview provided by MDG's counsel, information gathered in a meeting with Mauricio and Diana Goldring, the owners of MDG, and a review of the Agreement between the parties and MDG's interrogatory answers. However, this information amounts to only a small fraction of the total data available in the record before the Court. Moreover, Wahlen's failure to consider the possibility that Australian Gold would and could terminate MDG's rights in any territory makes any opinion he offers on value and lost profits inherently incomplete and thus unreliable to a trier of fact. For this reason alone, the central testimony offered by Wahlen -- MDG's lost profits in Mexico and Puerto Rico -- is inadmissible. *See, e.g. Sun Ins. Mktg. Network, Inc. v. AIG Life Ins. Co*., 254 F.Supp.2d 1239, 1247 (M.D.Fla.2003) (excluding an expert opinion on prospective earnings for failure to consider risk that contract at issue was subject to termination).

The cost of preparing an expert report that will withstand *Daubert* challenges in most franchise, dealership and distributorship litigation can run from

and implementation of all aspects of cyber security, ESI management and e-discovery for franchise systems - from preparation of cyber security and ESI-related policies and procedures manuals through collection, preservation, processing, production and presentation.

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Links to Recent Articles on Cyber Crime

Cybersecurity Disaster Seen in U.S. Survey

Technology Companies Confront a Scourge of the Internet

Symantec Says Hackers Tried Extortion

Chinese Hackers Suspected In Long-Term Nortel Breach

DISCLAIMER

The information provided in this newsletter is for informational purposes only and should not be construed as legal or expert advice which can only be obtained from appropriate professionals. Franchise Valuations, Ltd. and Franchise Technology Risk Management provide such expert advice on the topics addressed herein.

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approximately $8,000 to $30,000 or more, depending on the amount of time required to review the record and prepare the report. This is why most cases settle after delivery of cogent expert reports and rebuttals.

In future editions of the newsletter we shall examine the discovery and testimony phases.

* MDG used the services of Professor James Wahlen, Ph.D., a professor of accounting and the chairman of the MBA program at the Indiana University Kelley School of Business.

Demand For Disclosure of Correspondence Between Expert and Counsel Foiled

Claim of Work Product Privilege Upheld on Appeal

In a recent case the Appellate Division of the New York State Supreme Court for the First Department* unanimously reversed, on the law, without costs, an order of the trial court which had granted defendants' motion seeking, *inter alia*, to compel the production of certain documents related to a third-party consultant's work. The action arose from the securitization of home equity lines of credit, which were aggregated into a "pool" by defendant and then transferred to a trust that was formed to issue securities to investors:

> When the loans began to default at what plaintiffs considered to be a high rate, they retained a law firm, which retained RMG Global (RMG) to conduct a forensic re-underwriting review of the loans in the securitization. Following plaintiffs' commencement of this action based on RMG's findings, defendants served demands seeking any and all records surrounding RMG's review. Plaintiffs provided defendants with RMG's conclusions and the raw data RMG used in its analysis of the loans at issue. However, asserting the attorney work product and trial preparation privileges, plaintiffs objected to the remainder of defendants' demands, including any correspondence between RMG and the law firm plaintiffs retained, and documents concerning the methodology employed by RMG in its review.
>
> Defendants moved to compel disclosure on the ground that plaintiffs had placed RMG's findings "at issue," and plaintiffs opposed, without providing evidence to establish the basis for their assertion of privilege. Defendants argued, in reply, that plaintiffs failed to meet their burden of establishing privilege in the first instance.

But the court would not buy Defendants' argument, holding:

> Here, plaintiffs did not waive privilege by placing RMG's review of the loans "at issue." All references to the "third-party consultant" in their complaint could be stricken and it would still stand. Mention of a third-party consultant was not made as an element of the claim, but as a good-faith basis for the allegations made. Since plaintiffs do not "need the privileged documents to sustain [their] cause of action," they have not "waived the attorney-client privilege by injecting privileged materials into the lawsuit" (citations omitted). Nor did plaintiffs waive the privilege by making a selective non-disclosure (citations omitted).

**Ambac Assur. Corp. v DLJ Mtge. Capital, Inc.*, 2012 NY Slip Op 00827 (Decided February 7, 2012)

Franchising in China and Russia: Seasoned Travelers Are Taking Precautions

As Andy Grove, Former Intel CEO, Said: "Only the Paranoid Survive"; Advice

On Avoiding Digital Espionage

When Kenneth G. Lieberthal, a China expert at the Brookings Institution, travels to the People's Republic, he follows a routine that seems straight from a spy film.

> He leaves his cellphone and laptop at home and instead brings "loaner" devices, which he erases before he leaves the United States and wipes clean the minute he returns. In China, he disables Bluetooth and Wi-Fi, never lets his phone out of his sight and, in meetings, not only turns off his phone but also removes the battery, for fear his microphone could be turned on remotely. He connects to the Internet only through an encrypted, password-protected channel, and copies and pastes his password from a USB thumb drive. He never types in a password directly, because, he said, 'the Chinese are very good at installing key-logging software on your laptop.
>
> What might have once sounded like the behavior of a paranoid is now standard operating procedure for officials at American government agencies, research groups and companies that do business in China and Russia - like Google, the State Department and the Internet security giant McAfee. Digital espionage in these countries, security experts say, is a real and growing threat - whether in pursuit of confidential government information or corporate trade secrets.

"If a company has significant intellectual property that the Chinese and Russians are interested in, and you go over there with mobile devices, your devices will get penetrated," said Joel F. Brenner, formerly the top counterintelligence official in the office of the director of national intelligence.*

*Nicole Perlroth, "Traveling Light in a Time of Digital Thievery," *New York Times* (February 11, 2012) .

Nexus - Income Tax: Call Center in Illinois May Create Nexus

Contracting Sales of Services in State May Trump Lack of Payroll, Inventory, Personal Property or Physical Presence

CCH reports that the Illinois Department of Revenue has issued a corporate income tax general information letter regarding potential nexus issues associated with running an out-of-state call center. The taxpayer asked whether it would owe Illinois income taxes as a result of operating a 24/7 call center for national retailers with multi-site locations. The taxpayer's business consists of coordinating contracted labor on an as-needed basis for its national customers, some of them located in Illinois. The contracted work is done by independent contractors, and the taxpayer does not have payroll, inventory, personal property, or a physical presence in Illinois.

The department clarified that the taxpayer's question of nexus was highly fact-dependent and as a general rule the department does not issue rulings regarding whether a taxpayer has nexus with Illinois. Such determinations can only be made in the context of an audit where a department auditor has access to all relevant facts and circumstances.

However, based on the limited facts presented, the DOR conceded that it seems likely that contracting sales of services in Illinois on a regular basis will subject the taxpayer to Illinois income taxation. General Information Letter IT 12-0001-GIL, Illinois Department of Revenue, January 12, 2012, released February 15, 2012.

SCOTUS Allows RICO Claim to Proceed

Basis of Claim Is Allegation of Tax Fraud by Competitor

According to CCH, the U.S. Supreme Court has denied a company's certiorari request to decide whether its competitor may bring a claim under §1962(a) of the federal Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§1961-1968, alleging that the competitor suffered losses because the defendant company was able to open a new store by investing funds derived from its failure to collect New York sales tax and underreporting of its taxable income.

In a previous trip to the U.S. Supreme Court in this case in 2006, the high court disallowed a separate RICO claim brought under a different subsection of the law. On remand, however, the U.S. Court of Appeals for the Second Circuit reversed a district court judgment and reinstated the claim brought under §1962(a). Therefore, as a result of the U.S. Supreme Court's denial of review, the RICO action against the company brought by its competitor may now proceed to trial. *Anza v. Ideal Steel Supply Corp.*, U.S. Supreme Court, Dkt. 11-659, petition for certiorari denied February 27, 2012.

IRS Releases Dirty Dozen Tax Scams

Top Scam in 2012 Is Identity Theft

The Internal Revenue Service issued its annual "Dirty Dozen" list of tax scams (IR-2012-23) advising taxpayers to use caution to protect themselves from being victims in a variety of schemes ranging from identity theft to return preparer fraud. The schemes peak during the filing season and they can be used in-person, on-line and by e-mail to mislead individuals with promises of refunds and free money.

The dirty dozen scams for 2012 include:

- identity theft
- phishing
- return preparer fraud
- hiding income offshore
- offering free money from the IRS involving Social Security
- false or inflated income and expenses
- using false Forms 1099 for refund claims
- frivolous arguments
- falsely claiming zero wages
- the abuse of charitable organizations and deductions
- the use of disguised corporate ownership
- the misuse of trust entities.

In an attempt to deal with identity theft, the IRS has stepped up its internal reviews to spot false tax returns before refunds are issued, as well as working with the taxpayers whose identity has been stolen.