Advocate's EDGE

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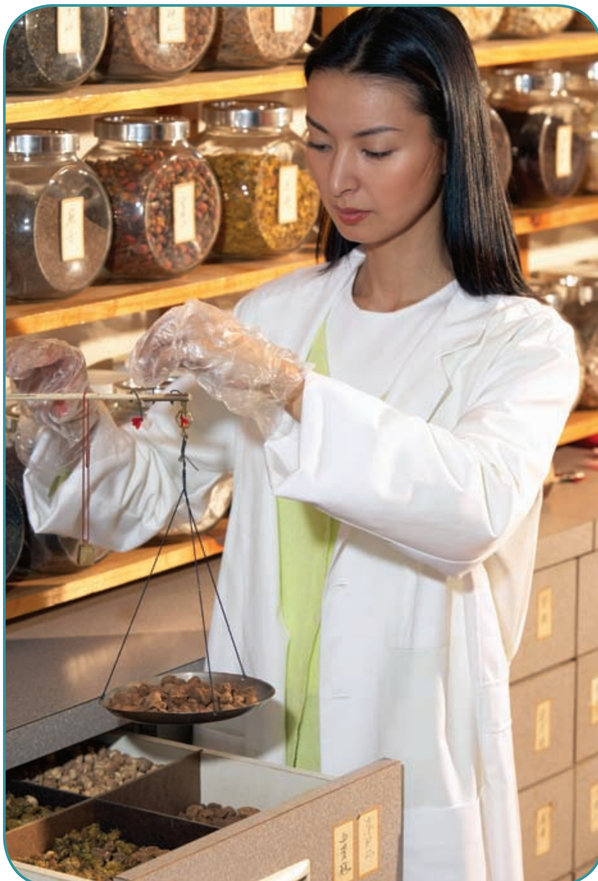
"Speculative" lost profits damages crumble in court

Lost profits damages may seem straightforward. However, they're anything but that when a valuator must base his or her calculations on the projected profits of a new business. One recent California case, *Beijing Tong Ren Tang (USA) Corp. v. TRT USA Corp.*, provides a striking illustration of how such a claim can crumble upon examination.

DISTRIBUTION DEAL DISINTEGRATES

Beijing Tong Ren Tang USA (BTRTUSA) entered into an agreement with Advantage United Corporation, predecessor of TRT USA Corporation (TRT), to cooperate in selling traditional Chinese medicine in the United States. Under the agreement, TRT was to be the general exclusive agent to distribute the main BTRTUSA products.



The parties' business relationship eventually soured. BTRTUSA sued TRT and three of its officers and directors, alleging violations of the Lanham Act. TRT and its three officers and directors filed a counterclaim against BTRTUSA and Chuanli Zhou, BTRTUSA's vice president, for fraud and breach of fiduciary duty.

A jury ruled against BTRTUSA on its claim. It ruled for TRT on the fraud claim against BTR and Zhou, and awarded $1.3 million in lost profits as compensatory damages. It also ruled in TRT's favor on the breach of fiduciary duty claim against Zhou, awarding another $741,450 in lost profits. BTRTUSA and Zhou asked the district court for a judgment as a matter of law on the basis that the jury lacked sufficient evidence for its decisions.

FRAUD DAMAGES ARE REDUCED

The district court determined that the fraud award was based on projected profits according to TRT's business plan. BTRTUSA argued that the lost profits damages were too speculative because the business plan projected profits for a new venture in an area where TRT had no track record.

The court explained that, although damages generally aren't awarded for anticipated profits of a new business, that presumption can be overcome by concrete evidence that allows a fact finder to establish the amount of damages with reasonable certainty. TRT, however, failed to provide such evidence.

According to the court, evidentiary support for a lost profits claim was totally lacking. The lost profits projection was made on the basis of a "speculative, grandiose business plan" making assumptions that were "totally unrealistic and unreasonably optimistic."

Projected profits in a business plan may — in some circumstances — provide enough certainty

regarding damages to overcome the absence of a proven track record. But the profits projected by TRT's business plan were too speculative to meet the legal standard of reasonable certainty necessary to support lost profits damages.

The court did allow some lost profits damages. It noted that TRT's damages expert testified on an alternative way of computing fraud damages based on monies that TRT paid but wouldn't have paid but for the wrongdoing by BTRTUSA and Zhou. This calculation included:

- Money paid for a product that wasn't delivered or couldn't be used,
- Consulting and label design fees paid to Zhou, and
- A deposit paid on a canceled order.

According to TRT's expert, damages totaled $141,168. The court found sufficient evidence to support the conclusion that they were caused by Zhou's fraudulent representations.

AS FOR PUNITIVE DAMAGES …

In addition to lost profits, the jury in *Beijing Tong Ren Tang (USA) Corp. v. TRT USA Corp.* (see main article) awarded punitive damages against Beijing Tong Ren Tang USA (BTRTUSA) and Chuanli Zhou. BTRTUSA and Zhou argued to the court that the awards were unconstitutional because they were grossly excessive.

The court found that the awards of $21,000 and $9,000 against Zhou were within constitutional limits and that his conduct was sufficiently reprehensible to justify the award. The awards against BTRTUSA did raise constitutional issues, though.

The court ultimately reduced TRT USA Corporation's punitive damages award against BTRTUSA from $750,000 to $21,000 and the co-plaintiff's punitive damages award from $23,000 to $9,000. The court noted that it couldn't justify awarding greater punitives against BTRTUSA than against the person responsible for the wrongful conduct without seeing any evidence of the company's net worth or financial condition.

FIDUCIARY DUTY DAMAGES FALL

Part of the lost profits awarded for the breach of fiduciary duty claim was based on Zhou's failure to ensure regulatory compliance and to provide exclusivity. The court held that those damages were too speculative.

> *The expert didn't explain how projected profits in the plan were calculated or why the figures were reliable estimates of anticipated profits.*

The court also considered the part of the award related to distribution of Gummy Bear vitamins in China. TRT's expert's testimony on those lost profits was based entirely on a business plan by IHI, a New York corporation, to sell such vitamins in China. TRT owned 50% of IHI, so the expert assumed TRT would have received 50% of its profits. The business plan involved the distribution of 50 products; thus, profits from the sale of the vitamins would constitute one-fiftieth of overall profits, according to TRT's expert.

The court, however, pointed out that IHI was an unestablished business that had never executed its plan to sell the vitamins in China. Because the expert didn't explain how projected profits in the plan were calculated or why the figures were reliable estimates of anticipated profits, the court found he wasn't a credible witness. The projected profits were also deemed as too speculative.

BOTTOM LINE

As a result of its weak supporting evidence, TRT saw its damages award slashed by more than 90%. Don't let this happen to your client. Work with credible experts who can prove lost profits to a reasonable certainty.

Finding and preventing procurement fraud

Purchasing departments can be fraud hotbeds. Without strong fraud control measures, your clients can easily fall victim to fictitious vendor, kickback and other procurement schemes. Although prevention is the best policy, companies at risk also need to know how to root out existing fraud.

FOLLOW THE CASH

If a client finds it's paying higher prices for lower quality products, the culprit could simply be marketplace fluctuations. But it's worth taking a closer look at procurement practices to determine if employee kickbacks are involved.

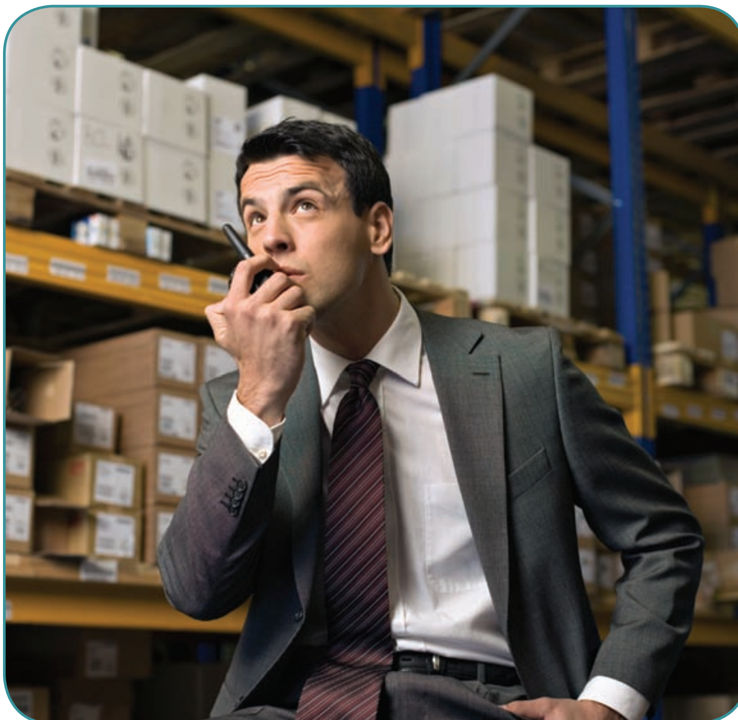
Cash payments to employees can be difficult to detect because those payments aren't reflected in the company's books. They probably are, however, reflected in higher pricing. Even fraudulent vendors must cover their costs. Suspicious companies should look for consistent shortages, informal communication (such as mobile phone calls or personal e-mails) between purchasing staff and suppliers, and poor record-keeping.

If the business involves contract bids for goods or services, it carries additional kickback risk. The person who approves those contracts could be receiving kickbacks from vendors. Red flags include fewer bids than expected, widely divergent bids on the same projects and unexplained deadline changes.

VENDORS TELL TALES

Companies also need to look for payments to vendors that have been invented by employees — alone or in collusion with individuals outside the organization. Warnings of fictitious vendors include invoices that are:

- Photocopied,
- Sequentially numbered,
- From companies that have only post-office box addresses, and
- For amounts that consistently fall just below sums that require approval for payment.



Connections between procurement staff and suppliers may also provide clues. Is an employee related to or otherwise linked with the owner or management of a supplier? If so, that employee shouldn't make purchasing decisions that involve the vendor.

PRACTICAL AND ETHICAL POLICIES

As with any type of fraud, the best way to avoid procurement department problems is to develop policies and take other preventive steps. For example, no one employee should be allowed to handle most or all of a company's purchasing procedures. The person who orders supplies and materials, for example, shouldn't check shipments or approve invoices.

Anonymous hotlines have proven to be one of the best ways to prevent and detect fraud. Public companies are required to offer one as part of Sarbanes-Oxley Act provisions. But businesses at risk may want to establish two hotlines: one for employees and a separate one for vendors to report any suspicious or questionable activities. Giving vendors a separate line makes them more comfortable sharing concerns, and allows them to ask questions about the business's ethical practices.

Companies also should state in writing how they expect employees — and vendors — to conduct business. This code of ethics should be reviewed and updated annually, and employees and vendors should be required to sign it every year, even if nothing changes. Annual reminders will reinforce the idea that the company considers ethical, professional business practices a priority.

GOING THE EXTRA MILE

Companies that are at higher risk for procurement fraud may want to consider additional measures, such as performing background checks on new vendors. Such checks can provide information on the vendors' affiliations, ownership, litigation, regulatory or legal violations or suspensions, and financial standing. This helps the business weed out vendors with dubious histories.

Companies might also periodically conduct random checks of their business records. They should look for vendor address and telephone matches that could indicate that two purportedly different companies are, in fact, the same or related. And it's a good idea to verify that supplies or services were delivered as ordered and that there are no billing and payment anomalies in amounts, invoice numbering or other red-flag areas.

WHEN FRAUD'S AFOOT

Preventive measures such as internal controls and ethics policies can help companies reduce financial losses by putting employees and vendors alike on notice that procurement fraud won't be tolerated. But if a client suspects that a scheme is already underway, engage the help of a forensic accountant. This expert is capable of finding fraud and its perpetrators, preserving evidence, and, if necessary, testifying in court.

Another one bites the dust

Tax court rules against FLP

A family limited partnership (FLP) can be a viable tax-advantaged method of handling assets — but only if it's established and administered correctly. That wasn't the case with an FLP the IRS successfully challenged in *Estate of Liljestrand v. Commissioner*, and the result was a tax deficiency of about $2.6 million.

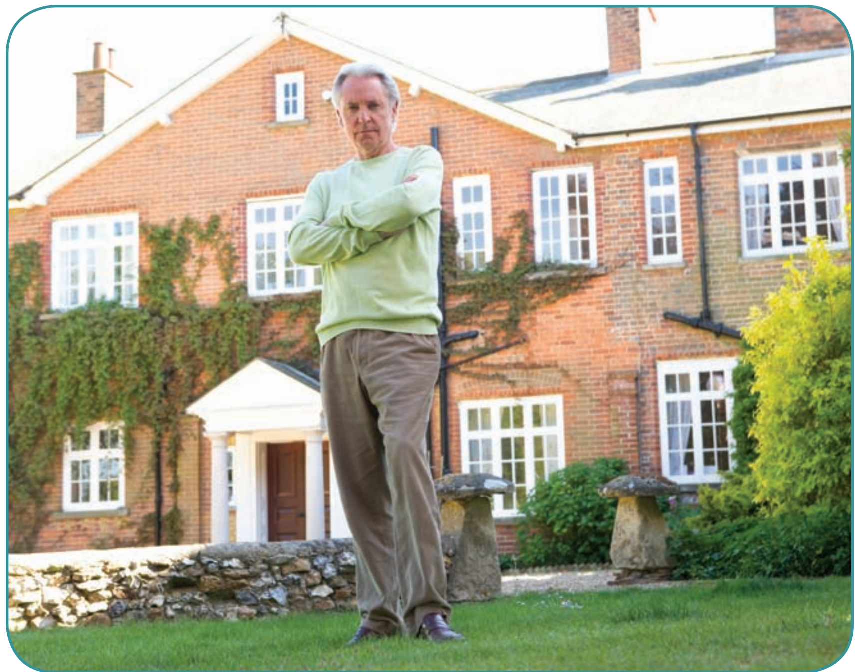
ASSET TRANSFER

Paul Liljestrand owned interests in several pieces of real estate through a revocable trust. His son Robert managed the real estate.

Liljestrand formed an FLP and transferred the real estate to it in exchange for a 99.98% interest, with Robert receiving the remaining interest. Liljestrand subsequently gifted FLP interests to trusts established for each of his four children. Although his estate planning attorney obtained an independent valuation of the interests, Liljestrand came up with his own estimates.

After Liljestrand died, the estate paid his taxes. However, the IRS issued a notice of tax deficiency. In its notice, the IRS included the value of the

real estate transferred to the FLP in the gross estate. The estate turned to the Tax Court for relief.

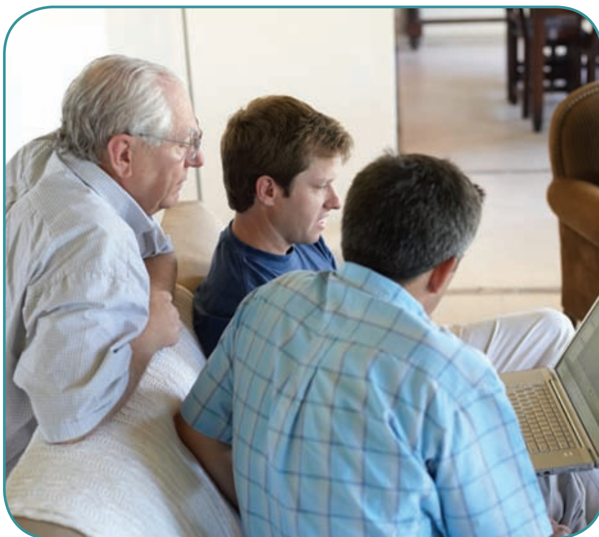


BONA FIDE OR NOT?

Under Internal Revenue Code Section 2036(a), assets that are transferred by a decedent during his or her lifetime are considered part of the gross estate if the decedent continued to derive a benefit from the assets or control the enjoyment of the assets. An exception excludes assets from the estate, though, if the transfer was a bona fide sale for full and adequate consideration.

The court determined that Liljestrand's transfers weren't bona fide sales, identifying several reasons:

Partnership formalities weren't observed. The FLP was in existence for two years before a separate bank account was opened for it. Prior to that, all of its banking was done through the trust's bank account, resulting in a commingling of partnership and personal funds. Only one partnership meeting was ever held, and no minutes were kept. Moreover, Liljestrand used FLP assets to pay for personal expenses and was financially dependent on his disproportionate partnership distributions.



The transfers weren't at arm's length. Liljestrand stood on all sides of the transaction. He formed and fully funded the FLP and received almost 100% of the partnership interests.

Contributions lacked full and adequate consideration. Interests credited to each of the partners weren't proportionate to the fair market value of the assets that each contributed to the partnership, because Robert made no contributions. Also, the assets contributed by Liljestrand weren't properly credited to his capital account.

The court found it "especially significant" that the FLP failed to even maintain capital accounts when it was first formed and used neither the values established in the independent valuation nor the fair market value of the real estate to establish the value of each partner's FLP interest. It ultimately concluded that Liljestrand did *not* contribute the real estate for full and adequate consideration.

FLP FAILURE

The *Liljestrand* case might seem discouraging, but the Tax Court has also upheld FLPs, allowing the exclusion of their assets from estates. It's imperative that your clients' FLPs be properly set up and administered to take advantage of the Sec. 2036(a) exclusion.

Are alternate estate valuation dates on the way?

The IRS has issued new proposed regulations on the election of alternate valuation dates for estates. If implemented, they could significantly affect the availability of alternate valuation dates when the value of an estate decreases after death.

SIX-MONTH RULE

Internal Revenue Code Section 2032(a) allows executors to elect to value an estate on the date that's six months after the date of death. Any estate property that's distributed, sold, exchanged or otherwise disposed of during the six months, however, is valued as of the date of disposition.

Also, any interest whose value changes due merely to the lapse of time is valued as of the date of death. An adjustment is allowed for any difference in value attributable to any factor other than the lapse of time.

TWO EXCEPTIONS

The IRS's proposed regs include two exceptions to the rule in Sec. 2032(a):

1. Transactions in which an interest in a corporation, partnership or other entity includible in the decedent's gross estate is exchanged for a different interest in the same entity or an acquiring entity (for example, in a reorganization, recapitalization or merger), and

2. When the estate receives a distribution from a business entity, bank account or retirement trust and an interest in that entity is includible in the decedent's gross estate. An estate may be able to use the six-month date to value, respectively, the interest received or the property held in the estate if certain conditions are met.

The proposed regs also feature an aggregation rule for calculating the fair market value (FMV) of each portion of property that's disposed of during the alternate valuation period but that remains in the gross estate on the six-month date. Further, the IRS has proposed a special rule for determining the portion of a trust that's includible in the gross estate as of the alternate valuation date by reason of a retained interest.

Finally, the proposal makes a few clarifications regarding: 1) when property is deemed to be disposed of where its title passes by contract or operation of law; and 2) the types of factors, including economic or market conditions during the alternate valuation period, that affect the FMV of property on the alternate valuation date.

WHAT'S NEXT?

The future of the IRS's proposal is unclear, but your financial advisor can keep you updated on any developments that might affect your clients. In the meantime, see http://www.irs.gov/irb/2011-51_IRB/ar11.html for details on the proposal.

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