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A Cross Jurisdictional Analysis of Derivative Corporate Litigation—Part 1 of 2

By Brett Larson, Esq.

Introduction

The concept of the derivative claim is rooted in the very foundation of corporate law, the distinction between the entity and the individual, and it has important practical implications. These implications clearly affect shareholders of corporations and also members of LLCs and, in some cases, partnerships.

Many lawyers and experts alike view the concept of the "derivative claim" as a foreign, technical nuance that they do not anticipate encountering. In reality, the distinction between a direct and derivative claim arises more frequently than one would think, and it has very real consequences for litigants, their attorneys, and damage experts. Any attorney or professional practicing in business or corporate litigation should understand this analysis or risk-significant strategic disadvantage including a dismissal of claims regardless of their merit.

Section One of this article defines derivative and direct claims. Different jurisdictions apply different tests to make this distinction and state law determines which test to apply. Section Two of this article describes the three most commonly applied tests. Section Three explains how this distinction applies in the context of corporations and limited liability companies. Section Four describes three procedural nuances applicable to derivative claims and Section Five explores the practical issues related to the recovery of damages and attorney fees. [*Sections Four and Five will be presented in Part Two.* Ed.]

Analysis

1. Derivative Shareholder Claims and Direct Shareholder Claims Defined

If a shareholder or member of an entity is damaged by the conduct of managers or operators of that entity, there are two avenues through which the equity owner may seek redress: a direct or a derivative cause of action. A direct action is a claim asserted by a shareholder to remedy a personal injury suffered by that shareholder. A derivative shareholder action is a claim brought by a shareholder on behalf of a corporation to remedy an injury suffered by the corporation when the corporation's directors or officers have failed to do so.

A. Derivative Shareholder Claims

Derivative shareholder claims allow shareholders to sue on behalf of the corporation in order to enforce a right of the corporation that the entity itself has failed to assert.[1] Through derivative litigation, shareholders have the ability to assert claims against directors, management, other shareholders, or even third persons.

Continued on Page 2

1 Andrew J. Sockol, *A Natural Evolution: Compulsory Arbitration of Shareholder Derivative Suits in Publicly Traded Corporations*, 77 Tul. L. Rev. 1095, 1096 (2003).

View From the Bar

Using Experts Effectively in State Tax Litigation

By Christopher T. Lutz, JD

Judges are rarely state tax experts. In most litigation requiring expert testimony, judges confront so much detail that it can be difficult for even the best state tax litigators to make their case, and the confusion rarely works to a taxpayer's advantage. All states courts presume that an assessment of tax is correct and confused judges tend to be quick to defer to the taxing authorities. Further, financial experts are often brought into litigation far too late and frequently to justify positions which arose during litigation. For that reason, consulting experts well in advance of litigation can make all the difference in how a court may view a particular issue. While few cases turn on a judge's analysis of tax litigants' experts, several cases across the country have

Continued on Page 6

INSIDE THIS ISSUE

Feature Article 1
View from the Bar 1
Practice Tips 10
Business Valuation for the Litigation Practitioner 12

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Continued from Page 1

Derivative shareholder suits theoretically serve two primary functions: (1) deterrence and (2) compensation.[2] Derivative suits have a deterrent effect because they allow shareholders to hold officers and directors liable to the corporation for their actions. Theoretically, at least, derivative suits also aid in compensating the injured corporation and shareholders by allowing shareholders a means to restore what the corporation has lost. Typically, courts hold that shareholders should bring a suit derivatively if a claim involves an allegation of "grossly negligent mismanagement, waste of corporate assets, excessive compensation, usurpation of corporate opportunity, and…general self-dealing."[3]

B. Direct Shareholder Claims

A direct shareholder action is a claim by a shareholder to redress a direct injury suffered by the shareholder. The purpose of a direct shareholder suit is to compensate a shareholder for suffering a harm that the corporation itself has not suffered.

Shareholders generally prefer direct suits for multiple reasons. First, unlike derivative suits, direct claims do not require compliance with strict pleading requirements related to making a demand on the board of directors.[4] Second, in a direct suit, the shareholder recovers damages personally rather than the court awarding damages directly to the corporation. If damages are awarded directly to the corporation, the shareholder may receive nothing directly except for reimbursement of his or her attorney's fees and costs.[5] Third, unlike a derivative claim, if a cause of action is direct, there is no threat that a special committee will decide to dismiss the claims regardless of their merits.[6]

In general, courts find that claims are direct when they involve the deprivation of shareholders' voting rights, denial of rights to inspect the corporation's books and records, suits to compel the declaration of dividends, claims that officers or directors induced a shareholder to sell his or her stock, or an attempt to compel the declaration of dividends. Although courts seem to generally agree on what constitutes the quintessential direct or derivative claim, the criteria courts use to determine whether a suit is direct or derivative varies, and the suit result can vary as well.[7]

2 Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball,* 77 Minn. L. Rev. 1339, 1345 (1993).

3 Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 Dick. L. Rev. 355, 360 (1994).

4 See Section 4A in Part 2 for detailed discussion.

5 See Section 5 in Part 2 for detailed discussion.

6 See Section 4C in Part 2 for detailed discussion.

7 See Section 2.

2. Determining Whether a Claim is Direct or Derivative.

Depending upon the jurisdiction, the court will apply one of three tests to determine whether a shareholder has the right to bring a cause of action as a direct, rather than a derivative, suit: (A) the direct harm test, (B) the special injury test, or (C) the duty owed test.

A. Direct Harm Test

Under the direct harm test, courts determine whether the corporation or the shareholder was harmed directly. If the shareholder was injured first, then the claim is direct and belongs to the shareholder; however, if the corporation is harmed first, then the claim is derivative. This analysis is rooted in the doctrine of standing.

If the shareholder alone is injured, then the shareholder is the correct party to bring suit to redress the harm. For example, if a corporate manager, acting for the corporation fraudulently induces a person to decrease or increase his or her ownership of the corporation, that conduct will give rise to the shareholder as a direct claim because the inducement caused an injury to the shareholder and not the corporation.[8] In contrast, if the claim alleges mismanagement of the corporation, which causes a decrease in share value, the claim would be derivative because the harm was to the corporation directly. Harm to the shareholders is an indirect result of the harm to the corporation.[9]

The American Law Institute (ALI) suggested that courts apply the direct harm test to determine whether a claim is direct or derivative.[10] The ALI states that a claim is direct if the shareholder can prove injury without having to prove damage to the corporation. [11] If the shareholder can recover only by showing that the corporation was injured, then the suit is derivative according to the ALI.[12]

B. Special Injury Test

Under the special injury test, a claim is direct if the shareholder suffered an injury that is separate and distinct from any injury suffered by the corporation. Courts in different jurisdictions apply this test in subtle, but significantly different ways. Some jurisdictions require that the special injury

Continued on Page 3

8 *Yudell v. Gilbert*, 99 A.D. 3d 108 (NY App. Div., 1st Dept. 2012) (Applying the two factor test articulated by *Tooley v. Donaldson*: "A court should consider (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually". However, the *Yudell* court ignored dicta in the *Tooley* decision related to the special injury test that Delaware courts have relied upon in developing their hybrid approach discussed below in Section 4D. *Yudell* states a true direct harm test.

9 *Id.*

10 A.L.I. P*rinciples of Corporate Governance: Analysis and Recommendations* § 7.01(a); Glen G. Morris, Shareholder Derivative Suits: Louisiana Law, 56 La. L. Rev. 583, 588.

11 A.L.I. Principles of Corporate Governance: Analysis and Recommendations § 7.01(a).

12 *Id.*

Continued from Page 2

be unique from any injury to the corporation.[13] Others require that the special injury is distinct from an injury suffered by the corporation *and* from any injury suffered by all other shareholders of the corporation.[14]

Under the more strict special injury test, harm to a shareholder caused by diminution in share value does not give rise to a direct cause of action because the harm affects all shareholders alike.[15] The most common examples of distinct and separate injuries affecting only one shareholder are injuries to a shareholder under a separate contract with the corporation or claims that a corporation singled out a shareholder specifically for oppression or dishonest mistreatment.[16]

The Delaware Supreme Court combined both special injury approaches by defining a special injury giving rise to a direct claim as an injury that is "not suffered by all stockholders generally or where the wrong involves a contractual right of the stockholders, such as the right to vote."[17] The Delaware Supreme Court has held that claims of stock dilution and reduction in voting power both give rise to direct causes of action by the damaged shareholder.[18] The ALI states that a shareholder's loss of wages or other income from the corporation is also an example of a special injury suffered by a shareholder that warrants direct action.[19]

In determining whether a claim is direct or derivative, the Minnesota Supreme Court determines whether the complained-of injury was an injury to the shareholder or member directly as opposed to an injury to the company.[20] In making this determination, the court will not "look to the theory in which the claim is couched, but instead to the injury itself." [21] Where the injury is to the company, and only indirectly harms the shareholder or member, the claim must be pursued as a derivative claim.[22] A plaintiff "cannot defeat the traditional derivative claim analysis by simply seeking personal relief."[23] Rather, the alleged injury must be separate, distinct, and independent from the company's injury to constitute a direct claim.[24]

Claims based on taking of corporate assets or usurping corporate opportunities are the most common category of derivative claims.[25] For example, in *Wessin v. Archives Corp.*, the Minnesota Supreme Court held that the alleged claims were derivative claims. In reaching that conclusion, the court reasoned, "[t]he injuries alleged by the Wessins hinge on the waste and misappropriation of corporate assets. The Wessins assert that the alleged wrongful waste and misappropriation 'effectively diminished the net income of Archives.'" [26]

In *PJ Acquisition Corp. v. Skoglund*, the court reached a similar conclusion by holding that claims for taking of corporate opportunity and assets under a theory of breach of fiduciary duty were derivative and subject to derivative claim pleading requirements.[27] In *Blohm v. Kelly*, the court similarly held that claims for breach of fiduciary duty were derivative where the damages were based on a shareholder paying himself excessive compensation and commingling his assets with the company assets.[28]

As a matter of comparison, the court in *Northwest Raquet v. Deloitte & Touche* held that the plaintiff's claims were direct.[29] In reaching this conclusion, the court noted:

> Northwest alleges very specific incidences of misrepresentation in Touche's audit report on which Northwest directly relied. Thus, although Northwest asserts that Touche's misrepresentation of the value of the FIR to Midwest indirectly affected Northwest, Northwest also alleges specific misrepresentations in the audit report that affected Northwest directly in its decision to purchase the debentures…It is this claim of direct fraud and the resulting injury that is separate and distinct from any fraud claim belonging to Midwest and from any injury to the debenture holders generally.[30]

In determining whether a claim is direct or derivative, the court will focus on the claimed injury. The claim is derivative if the injury is to the entity and causes the entity to be deprived of revenue or assets, but only indirectly damages the shareholders. If the claimed injury is unique to the particular equity holder and is separate from any harm caused to the entity, then the claim is direct.

C. Duty Owed

The duty owed test requires the court to determine whether: (1) a duty was breached, and (2) to whom that duty was owed. A claim is direct if the right asserted by the shareholder "flows from the breach of a duty owed directly to the plaintiff independent of the plaintiff's status as a shareholder, investor, or creditor of the corporation . . . ." [31] Put another way, a direct claim may be based on the infringement of a personal right belonging to the shareholder that is derived from "the corporation's articles of incorporation, state law, agreements among shareholders, or between the corporation and its shareholders."[32] Under the duty owed test, a shareholder may bring a direct action even if the same wrong injured the corporation as well. [33]

D. Hybrid Tests Applied in Delaware and Illinois

In Delaware and Illinois, courts use tests that are hybrids of the tests described above to determine whether a claim is direct or derivative.

Continued on Page 4

13 19 Am. Jur. 2d Corporations § 1939 (citing, Jones v. H. F. Ahmanson & Co., 460 P.2d 464, 470-71 (Cal. 1969); *Strougo v. Bassini*, 282 F.3d 162, 175 (2d Cir. 2002).

14 *John R. Behrmann Revocable Trust v. Szaloczi*, 74 P.3d 371, 374 (Colo. Ct. App. 2002).

15 *PricewaterhouseCoopers, LLP v. Massey*, 860 N.E.2d 1252, 1260 (Ind. Ct. App. 2007).

16 Jonathan Shub, Distinguishing Individual and Derivative Claims in the Context of Battles for Corporate Control: Lipton v. News International, PLC, 13 Del. J. Corp. L. 579, 593-94 (1988).

17 *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 330(Del. 1993); *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004) (Delaware courts no longer use the special injury test. Instead they apply a hybrid between the special injury and direct harm tests).

18 In *re Tri-Star Pictures*, 634 A.2d at 330.

19 19 Am. Jur. 2d Corporations § 1938.

20 *Wessin*, 592 N.W.2d. at 464; *Blohm v. Kelly*, 765 N.W.2d 147, 153 (Minn. Ct. App. 2009).

21 *Wessin*, 592 N.W.2d. at 464.

22 *Id.*

23 *Wessin*, 592 N.W.2d. at 465.

24 *Blohm*, 576 N.W.2d at 153.

25 *Wessin*, 592 N.W.2d. at 465; *PJ Acquisition Corp. v. Skoglund*, 453 NW 2d 1, 5-7 (Minn. 1990); *Seitz v. Michel,* 181 N.W. 102, 105 (Minn. 1921); *Blohm v. Kelly*, 765 N.W. 2d 147, 153-54 (Minn. Ct. App. 2009).

26 592 N.W.2d. at 465.

27 453 N.W. 2d at 5-7.

28 765 N.W. 2d at 153-54.

29 535 N.W. 2d 612, 619 (Minn. 1995).

30 *Id.*

31 *Branch v. Ernst & Young*, No. Civ. A. 93-10024-RGS, 1995 WL 791941, at *2, *4, *6 (D. Mass. Dec. 22, 1995)).

32 *Id*. at 106.

33 19 Am. Jur. 2d Corporations § 1940.

Continued from Page 3

In 2004, the Delaware Supreme Court adopted the direct harm approach in place of the special injury test.[34] In *Tooley v. Donaldson*, the court reasoned: "[i]n our view, the concept of 'special injury' that appears in some Supreme Court and Court of Chancery cases is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of 'special injury' as a tool in that analysis."[35] Delaware's direct harm test is based purely on, first, "who suffered the alleged harm," and second, "who would receive the benefit of any recovery or ...remedy."[36] Although in *Tooley* the court held that the special injury test was no longer applicable in Delaware, in its opinion, the court stated that "[t]he stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation." [37]

That same year, the Delaware Court of Chancery applied the holding from *Tooley* and found that a shareholder's claim was derivative.[38] In *In re Syncor International Corp. Shareholders Litigation*, a group of former shareholders sued the corporation claiming that they did not receive adequate compensation for their shares in the merger of Syncor and a company named Cardinal. The plaintiffs claimed that Syncor wrongfully renegotiated a merger agreement with Cardinal causing the Syncor shareholders to receive $83.9 million less than they should have for their shares.[39] The *Syncor* court determined that the defendants' conduct breached the duty of loyalty to the corporation and, therefore, the claim was derivative. In reaching this conclusion, the court reasoned that in order to make the determination of whether the claim is direct or derivative, it must consider (1) the nature of the wrong, (2) to whom the relief should go, and determine that the shareholder's injury is independent of any injury to the corporation.[40] The *Syncor* court purported to apply the direct harm test from *Tooley*, however, it seemed to apply a hybrid between the direct harm and special injury test.

In *In re J.P. Morgan Chase & Co. Shareholder Litigation*, shareholders claimed that their corporation paid too much for a merger with a target bank and their relative ownership was diluted by the merger.[41] The court acknowledged that the relevant inquiry post-*Tooley* must be, (1) who suffered the alleged harm, and (2) who would receive the benefit of the remedy or recovery.[42] However, once again, the court focused on the special injury language from *Tooley*, requiring that the shareholder demonstrate a personal injury without showing any injury to the corporation.[43] This analysis was upheld in *Gentile v. Rossette*[44] and *Gatz v. Ponsoldt*.[45] Although the Delaware Supreme Court clarified that the direct harm test is the appropriate test to apply, the language used by both the Supreme Court and the Court of Chancery clarifies that the test is actually a hybrid between the special injury and direct harm tests.[46]

34 *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004).

35 *Id.* at 1035.

36 *Id.* at 1033.

37 *Id.* at 1039.

38 *In re Syncor Int'l Corp. S'holders Litig.*, 857 A.2d 994, 997-98 (Del. Ch. 2004).

39 *Id.* at 994-996.

40 *Id.* at 997.

41 *In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 812 (Del. Ch. 2005).

42 *Id.* at 817.

43 *Id.*

44 *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006).

45 *Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007).

46 *Id.* at notes 70, 84, 89-90, 103 and accompanying text.

In Illinois, courts apply the special injury test, defining a special injury as one that is separate and distinct from that suffered by other shareholders. [47] The Illinois courts have also defined a special injury as a wrong involving a contractual right of the shareholder, such as a right to vote or to assert majority control.[48] This definition seems to combine the special injury and duty owed tests because the focus is also on whether the claim is based on a contractual duty owed to the shareholder. Illinois courts have held that when the injury is to the corporation, and only indirectly to the shareholder (such as through a diminution in share value), the claim is derivative.[49] While Illinois courts apply the special injury test, the court will still consider whether the entity or the individual is harmed first and whether the breached duty is owed directly to the entity or the individual.

3. The Distinction Between Direct and Derivative Claims in Shareholder/LLC Member Litigation

A. Corporations

It is well established that the direct/derivative distinction applies in the context of a corporation. Courts have long adhered to the general principle that an individual shareholder may not directly assert a cause of action that belongs to the corporation. [50] "When a shareholder asserts a cause of action belonging to the corporation, the shareholder must seek redress in a 'derivative' action on behalf of the corporation rather than in a direct action by the individual shareholder." [51]

B. Limited Liability Companies and Partnerships

Case law concerning the direct/derivative distinction is still overwhelmingly based on case law regarding corporations although some jurisdictions have recognized that the distinction applies to LLCs as well. Courts look to the law governing claims on behalf of corporations for guidance in LLC litigation. [52] The analogous treatment makes conceptual sense given that the uniform limited liability company acts adopted by most states follow the same corporate governance precepts and separate entity characteristic as their corporate counterpart.[53] An LLC is an entity separate from its members just as corporations are a

Continued on Page 5

47 *Spillyards v. Abboud*, 662 N.E.2d 1358, 1363-64 (Ill. App. Ct. 1996).

48 *Id.*

49 *Hamilton v. Conley*, 827 N.E.2d 949, 955 (Ill. App. Ct. 2005).

50 *Wessin v. Archives Corp.*, 592 N.W.2d. 460, 464 (Minn. 1999) (citing, *Singer v. Allied Factors, Inc.*, 13 N.W.2d 378, 380 [Minn. 1944]).

51 *Wessin*, 592 N.W.2d. at 464 (citing, *Northwest Racquet Swim & Health Clubs, Inc. v. Deloitte & Touche*, 535 N.W.2d. 612, 617 [Minn. 1995]).

52 *Safety Techs., L.C. v. Biotronix 2000, Inc.*, 136 F. Supp. 2d 1169, 1172 n.3 (D. Kan. 2001); *Glod v. Baker*, 2002-988, 2003 WL 21804398, at *6 (La. 3d Cir. Aug. 6, 2003); *Giuliano v. Pastina*, 793 A.2d 1035, 1036-37 (RI 2002); *Paclink Communications Int'l, Inc. v. Superior Ct.*, 109 Cal. Rptr. 2d 436 (Ct. App.-2d Dist. 2001); *Taurus Advisory Group, Inc. v. Sector Management, Inc.*, 1996 WL 502187 *2 (Conn. Super. Ct. Aug. 29, 1996); *Taurus Advisory Group, Inc. v. Sector Mgmt.*, Inc. No. CV 960150830, 1997 WL 241153 at *2 (Conn. Super. Ct. May 6, 1997); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1070 (Del. Ch. 1985), aff'd, 500 A.2d 1346 (Del. 1985)); *Ayres v. AG Processing, Inc.*, 345 F. Supp. 2d 1200, 1209 (D. Kan. 2004); *Brock v. Baskin-Robbins USA Co.,* 5:99-CV-274, 2000 WL 1357711 at *13 (ED Tex., Sept. 18, 2000); *Beaver Constr. Co., Inc. v. Lakehouse, L.L.C.*, 742 So.2d 159 (Ala. 1999); *Dawson v. Atlanta Design Assocs., Inc.*, 551 S.E.2d 877, 880 n.1 (N.C. Ct. App. 2001); *Energy Investors Fund, L.P. v. Metric Constr. Inc.*, 525 S.E.2d 441 (N.C. 2000); Minn. Stat. § 322B.01 Reporter's Notes; 20 Minn. Prac. Business Law Desk book § 3:1 Limited Liability Company Act (2011 ed.).

53 *Bailey v. United States*, 53 Fed. Cl. 251, 257 (2002) (injuries to the corporation's property are "recoverable only by the corporation in a direct action or by the shareholders in a derivative action") (*quoting Crocker v. Fed. Deposit Ins. Corp.*, 826 F.2d 347, 349 [5th Cir. 1987]); *Moore v. Simon Enters., Inc.*, 919 F. Supp. 1007, 1012 (N.D. Tex. 1995) ("Under corporate law, a corporation is a legal entity distinct from its shareholders and not even a person owning all of a corporation's shares can represent the interests of the corporation in a lawsuit."); *Sabey v. Howard Johnson & Co.*, 5 P.3d 730, 735 (Wash. Ct. App. 2000) ("Ordinarily, a shareholder cannot sue for wrongs done to a corporation, because the corporation is a separate entity: the shareholder's interest is viewed as too removed to meet the standing requirements. Even a shareholder who owns all or most of the stock, but who suffers damages only indirectly as a shareholder, cannot sue as an individual.") (footnote omitted).

Continued from Page 4

separate entity from their shareholders.[54]

As explained in Section 2, the direct/derivative case law can be divided into three general subcategories, depending on which of three approaches the court has used to make the direct/derivative distinction. In general, the LLC-corporate parallels apply regardless of the approach for making the threshold distinction. Where the corporate rule is direct harm, that rule will typically apply to LLCs as well.[55] When the corporate rule is the special injury, or duty owed, or rights infringed, the same rule will apply for LLCs.[56]

Courts understand that the direct/derivative distinction is rooted in the concept that the entity has an identity that is separate from the identity of its owners.[57] An LLC is an entity separate from its members,[58] and so it follows that the corporate approach to the direct/derivative distinction should carry over into the law of LLCs.[59] Courts have applied the same analysis in the context of partnerships.[60]

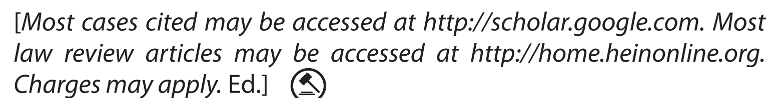
The Eighth Circuit held that the Minnesota Supreme Court would conclude that the similar corporate governance structure between corporations and limited liability companies, the recognized distinction between the entity and the individual, support such a distinction in the context of a limited liability company. [61] "Although the Minnesota limited liability company statute does not expressly provide for derivative suits, it is likely that such suits would be recognized by the Minnesota courts… It is therefore appropriate to look to the law governing claims on behalf of corporations for guidance in this case." [62]

In reaching this conclusion, the Eighth Circuit reasoned:

> Senior Cottages is a limited liability company, not a corporation. However, Minnesota limited liability companies share many of the properties of corporations. *See* Minn. Stat. § 322B.01 note (Overview Comments, Relevance of Chapter 302A in Interpreting and Applying Chapter 322B) (most of governance and management provisions of limited liability company statute drawn from business corporation statute). Limited liability companies can sue and be sued in their own name, Minn. Stat. Ann. § 322B.20 subd. 3; their directors and managers owe the company duties of care and loyalty, Minn. Stat. Ann. §§ 322B.663 subd. 1, 322B.69; a limited liability company is an entity distinct from any of its members, Minn. Stat. Ann. § 322B.88 note; members are not subject to liability for the company's debts, Minn. Stat. Ann. § 322B.303 subd. 1; and the limitation of liability may be forfeited under the same conditions that would warrant piercing the corporate veil, Minn. Stat. Ann. § 322B.303 subd. 2. Although the Minnesota limited liability company statute does not expressly provide for derivative suits, it is likely that such suits would be recognized by the Minnesota courts.[63]

It is therefore appropriate to look to the law governing claims on behalf of corporations for guidance. At least one district court in Hennepin County, Minnesota, has observed this distinction in the context of a LLC and was not challenged.[64] As the *Senior Cottages of America* Court recognized, the similarities between corporations and limited liability companies support an application of the distinction in these cases. Any other result would require the court to ignore the distincion between the limited liability company and its members.

[*Most cases cited may be accessed at http://scholar.google.com. Most law review articles may be accessed at http://home.heinonline.org. Charges may apply.* Ed.]



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54 *SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props., LLC,* 375 F. Supp. 2d 238, 243 (S.D.N.Y. 2005) ("Under Delaware law, a limited liability company...is a 'separate legal entity' distinct from the members who own an interest in the LLC."); *Bubbles & Bleach, LLC v. Becker*, No. 97 C 1320, 1997 WL 285938, at *4 (N.D. Ill. May 23, 1997) ("[I]t is this characteristic of limited liability companies—their distinct legal existence as an entity apart from their constituent members—which allows them to shield their members from personal liability and distinguishes them from both general and limited partnerships."); *In re Watson*, 322 B.R. 740, 747 (Bankr. E.D. Va. 2005) ("[T]he individual who establishes a corporation or a limited liability company for the purpose of business operation and asset ownership has created a wholly separate, legally identifiable entity apart from his individual legal existence."); Del. Code Ann. tit. 6, § 18-201(b) (stating that "[a] limited liability company formed under this chapter shall be a separate legal entity").

55 *PacLink Commc'ns*, 109 Cal. Rptr. 2d at 438, 440 (applying direct harm rule for corporations to LLCs); *Jones*, 460 P.2d at 470: *Godfrey v. Lafavour*, No. J05-005 CV JWS, 2005 WL 2340714, at *4 (D. Alaska Sept. 12, 2005); *Dawson*, 551 S.E.2d at 877.

56 *Giuliano v. Pastina*, 793 A.2d 1035, 1036-37 (R.I. 2002); *Lawton v. Nyman*, 327 F.3d 30, 50 (1st Cir. 2003) ("violation of a duty owed directly to shareholders, they may sue on their own behalf").

57 *Wessin*, 592 N.W.2d at 465; *PJ Acquisition Corp. v. Skoglund*, 453 N.W.2d 1, 5-7 (Minn. 1990); *Seitz v. Michel,* 181 N.W. 102, 105 (Minn. 1921); *Blohm v. Kelly*, 765 NW 2d 147, 153-54 (Minn. Ct. App. 2009).

58 Minn. Stat. §§ 322B.20 reporter's notes (West 1999); 322B.88 reporter's notes (West 1992).

59 *See Stoker v. Bellemeade, LLC*, 6l5 S.E.2d 1, 7 (Ga. Ct. App. 2005) ("Because the LLCs at issue are all closely held entities with some corporate characteristics, we address this issue by looking to the analogous situation presented under similar circumstances in the context of closely held corporations."); *see also In re Real Marketing Servs., LLC*, 309 B.R. 783, 788 (Bankr. S.D. Cal. 2004).

60 *Lenz v. Associated Inns & Rests. Co. of Am.*, 833 F. Supp. 362, 379-80 (S.D.N.Y.1993) ("In both the corporate and partnership context, the determination of whether a suit is derivative or direct turns on the nature of the injury alleged and the entity which sustains the harm."); *see also Abeloffv. Barth*, 119 F.R.D. 332, 334 (D. Mass. 1988) (requiring the procedures of Federal Rule of Civil Procedure 23.1 to be followed in a derivative suit filed by limited partners against general partners); *Strain v. Seven Hills Assocs.*, 75 A.D.2d 360, 371 (N.Y. App. Div. 1980) (finding that a limited partner could bring a derivative lawsuit against a general partner: "By logical extension it appears that a limited partner's power to vindicate a wrong done to the limited partnership and to enforce redress for the loss or diminution in value of his interest is no greater than that of a stockholder of a corporation."); *Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'1 Fund, L.P.*, 829 A.2d 143, 149-50 (Del. Ch. 2003) ("The test for distinguishing direct from derivative claims in the context of a limited partnership is substantially the same as that used when the underlying entity is a corporation…The test looks to the nature of the injury and to the nature of remedy that could result if the plaintiffs are successful.") (footnotes omitted).

61 *In re Senior Cottages of America, LLC*, 482 F.3d 997 (8th Cir. 2007)(citing Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* ¶ 10.07[2] (2007) (treatise by the Chair and the Reporter of the Limited Liability Company Joint Committee of the Business Law, Tax Law and Real Property Sections of the Minnesota State Bar Association)).

62 *Id*; *see generally* Daniel S. Kleinberger, *Direct versus Derivative and the Law of Limited Liability Companies,* 58 Baylor L.Rev. 63, 66-67 (2006)).

63 *In re Senior Cottages of America, LLC*, 482 F.3d 997, 1001 (8th Cir. 2007).

64 *Aboud v. Dyab et al.,* 27-CV-03-17490 (Hennepin County District Court, July 28, 2008).

Continued from Page 1

recently demonstrated the importance of expert testimony. A review of some of these cases illustrates how taxpayers can use experts effectively and intelligently.

In *Sysco Corp. v. Commissioner of Revenue*, 83 Mass. App. Ct. 1127 (2013), the taxpayer certainly would have benefited from consulting an expert well before litigation began. In that case, the taxpayer characterized the transfer of funds between its parent company and its wholly owned subsidiaries as true indebtedness. The state disagreed and re-characterized the transfers as taxable dividends rather than loans. At the Massachusetts Appellate Tax Board, the taxpayer presented three expert witnesses whose qualifications were unquestioned by all parties. Specifically, the taxpayer presented a transfer pricing expert, an economic expert, and a tax policy expert. Each of these experts discussed from his or her perspective why the transfers constituted true indebtedness. In addition to the testimony of the experts, the taxpayer presented a number of company executives who indicated that it was the company's intent to repay all indebtedness.

The court rejected all of the testimony presented to it, indicating that the objective evidence of intent to repay was insufficient. Manuals, which characterized the transfers as loans or the fact that the company purported to charge interest on the transfers were similarly insufficient, as there was no evidence that the transfers established an enforceable obligation to repay, and there was in fact no evidence that interest was actually paid. Further, as one expert acknowledged, Sysco repaid the subsidiaries only to the extent they required funding to pay expenses, retaining the excess as profits. Consequently, the appellate court affirmed the Appellate Tax Board's conclusion that the transfers were taxable dividends.

What is noteworthy about *Sysco Corp.* is that the expert testimony presented by the taxpayer was impressive. Indeed, taken as a whole, it would be difficult to read the expert testimony and conclude that the transfers made by the parent company did not create true indebtedness. This is a perfect example of a taxpayer explaining its actions after the fact. While the taxpayer's accounting system did characterize the transfers as loans, if the taxpayer had made efforts to actually repay the loans and pay interest, the Appellate Tax Board might have found it impossible to reject the expert testimony. Because this objective evidence did not exist, all the expert testimony in the world would not have saved the taxpayer's position. Indeed, as the court noted, the taxpayer's state tax expert "defined debt as an unconditional and legally enforceable obligation to repay[.]" Had the taxpayer consulted the expert prior to filing the returns in which it characterized the transfers as indebtedness, he surely would have stressed the importance of objectively demonstrating that Sysco was required to repay the loans.

It is important to note that the taxpayer was not necessarily wrong when it considered the transfers as loans rather than dividends. The court acknowledged that the company's cash management system certainly had a business purpose and economic substance, and there was reliable evidence that the loans were made pursuant to arm's length transactions. Nonetheless, once a taxing authority assesses a tax against a taxpayer, there is always a presumption in favor of the assessment. In such cases, where the question falls on the taxpayer's intent, courts will almost always side with the taxing authority absent compelling evidence to the contrary.

Unlike *Sysco Corp.*, which fundamentally hinged on intent, the taxpayer in *Powerex Corp. v. Department of Revenue*, TC 4800 (Oregon Tax Court, 9/17/2012) utilized its experts to prove a concrete fact rather than to persuade the court of its intentions. At issue in *Powerex Corp*. was whether electricity is tangible personal property. In Oregon, sales of tangible personal property are sourced where the purchaser is located. Receipts from sales other than of tangible personal property, however, are sourced where the income-producing activity that generates the sale occurs. Thus, if electricity were tangible personal property, the taxpayer's sales to Oregon customers would have been sourced to Oregon. If, however, the sale of electricity constituted a sale other than a sale of tangible personal property, the receipts would have been sourced to the out-of-state location where the taxpayer performed the income producing activity.

The Department of Revenue contended that electricity is tangible personal property and therefore should have been sourced to Oregon to the extent the taxpayer had customers in Oregon. The taxpayer, however, proffered two physicists who testified as to the nature of electricity. These experts described how the "transmission of electricity involves the transmission of force occurring by reason of the operation of 'virtual photons,' which have no mass." As there are as many electrons in the system after the point of transmission of energy to the purchaser as there was before, the sale of electricity did not involve the transfer of electrons and did not involve the transfer of tangible personal property.

The Department of Revenue's expert did not dispute the taxpayer's experts' conclusions. Instead, the expert concluded that the analysis would be different if the court reviewed the electricity grid as a whole rather than at the level of particle physics. The court stated that "[t]he problem with the approach of the witness for the department is that there is no indication in the statute that the answer to the question of whether a sale is of tangible property changes depending on the level of analysis." Because the department's expert did not contest the conclusions of the taxpayer's experts, the court found receipts from the sale of electricity constituted sales other than sales of tangible personal property.

Although the *Powerex Corp.* case involved separate experts for both parties, the court concluded that their testimonies were not necessarily in conflict and therefore gave more weight to the taxpayer's expert. However, taxpayers should be wary of "dueling experts." Indeed, in light of the presumption in favor of a taxing authority, where experts from opposing sides disagree, taxpayers will generally have the more difficult time making their case.

In *Tesoro Corp. v. Alaska Dep't of Rev.*, S-14326 (S. Ct. Alaska, 10/25/2013), both the taxpayer and the Department of Revenue presented expert testimony over the issue of whether the agreed upon facts in the case showed that the taxpayer's business activities and organization indicated that the taxpayer's business segments were unitary. According to the administrative law judge's findings, to which the Alaska Supreme Court gave significant weight, the Department of Revenue's experts were very persuasive, demonstrating "an impressive understanding of [the taxpayer's] organization and business activities during the audit period and were able to provide strong, but objective, opinions about where there was and was not centralized management, functional integration, and economies of scale between Tesoro's business segments and the extent to which these factors created significant unquantifiable flows of value between [the taxpayer's] parts." *In the Matter of: Tesoro Corp. f/k/a Tesoro Petroleum Corp., et al.*, 05-0155-TAX (Alaska Office of Admin. Hearings Decisions, 4/22/2009). Conversely, the Alaska Supreme Court noted that the administrative law judge found the taxpayer's

Continued on Page 7

Continued from Page 6

witnesses unconvincing and concluded that the taxpayer's experts ignored relevant facts and law to reach their conclusions. The administrative law judge finally concluded that "it is fair to say that the Division and its experts focused on, while [the taxpayer's] experts tended to divert the focus from, indicators of a unitary business that the Alaska Supreme Court determined to be significant." *Id*. In short, the state's expert testimony pummeled the taxpayer's experts.

Unlike the expert testimony in *Sysco Corp.*, the taxpayer in *Powerex Corp.* utilized its experts to prove an objective fact—that electricity is not tangible personal property. There was nothing more that Powerex could have done prior to litigation to solidify its position prior to litigation that electricity is not tangible personal property. Conversely, Sysco could have put in place more objective indicia that the transfers from its subsidiaries were in fact legally enforceable loans. In addition, *Tesoro Corp.* shows the importance of developing a business and tax planning model, rather than a litigation model, formed by a state tax expert's opinion.

Businesses will not always be able to consult with experts or state tax attorneys before taking a position on a particular tax return. Moreover, there will be plenty of situations where a strategy with significant state tax benefits will not make sense from a business perspective. However, such consultations will allow taxpayers to better structure their business activities to align with advantageous state tax positions. Consulting with experts can help businesses to better anticipate tax controversies, and the benefits can extend far beyond the courtroom. A proactive taxpayer that has considered its litigation strategy before the auditor has even picked up its tax return will have more opportunities to reach a swifter and more favorable conclusion than any unprepared taxpayer.

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Case Study: Employee Fraud or Prosecutorial Misconduct?

By: Zisl Taub Edelson, JD, MBA

Introduction

Something was clearly wrong from the start of this employee theft case. XXX Corp[1] had accused "Sally," its long-time, loyal bookkeeper, of check forgery and theft. After losing at trial, defense counsel was especially concerned because the bookkeeper's immigration status was at stake over the felony conviction. I joined the case as appellate counsel specifically because of my background in finance, accounting, and business operations. Sally needed to prevail on appeal to safeguard her immigration status and help rehabilitate her reputation and career. This was a young woman supporting a child with her whole life ahead of her.

An initial review of the public record and trial transcripts showed that the police and prosecutors had little knowledge of how companies actually operate day-to-day or basic accounting and bill payment methods such as QuickBooks ™ software. Without that knowledge, the police and prosecutors could not possibly have made an adequate investigation. They did not know what to ask or where to look.

After thoroughly reviewing the case file and trial transcripts, it was hard to understand why she was arrested in the first place. The prosecution's evidence was very weak, especially with respect to the financial and accounting issues related to the alleged crimes perpetrated at XXX Corp.

The Common Problem of Employee Theft

Employee theft is a significant problem for all sizes of businesses. However, smaller companies tend to have greater problems of increased fraud because they have inadequate staff to maintain sufficient internal controls over various business functions. A common lack of internal control in small businesses is the failure to segregate duties among staff members. Typically, this occurs when the same employee both processes payments to vendors and signs the checks for payment; performing both functions creates a situation where one employee can easily make fraudulent payments without the boss knowing. Increased supervision by the owner or manager would rectify this situation.

1 To protect individual privacy, all names referenced in this article are fictitious.

According to the Association of Certified Fraud Examiners', 2012 Report to the Nations, companies can, on average, expect to lose 5 percent of revenue annually as a result of employee theft or fraud. Employees use various schemes to steal from employers, including altering accounting books and records, falsification of company checks, invoices, receipts and/or other accounting records. In addition, most employees who steal from their employers exhibit certain changes in their behavior or lifestyle, including:[2]

- Living an extravagant lifestyle well beyond their salary
- Personal financial difficulties, such as divorce, addiction, or large medical expenses
- Unusually close relationships with company vendors or customers
- Excessive control issues

Facts of the Case

Sally's work as the company bookkeeper included managing accounts payable, entering vendor invoices into the company's QuickBooks accounting software system, printing checks using QuickBooks, and presenting the operations manager, "Joe," with checks to sign.

The prosecution accused Sally of using company checks she produced with the QuickBooks system to pay her personal utility bills, without proper authorization. Sally's defense was that the company routinely paid employee overtime "off the books" to avoid paying employment taxes and that payment of her utility bills was authorized by management in lieu of direct payment for overtime.

Although XXX Corp. was a small business, it had implemented good internal controls and segregation of duties. Sally prepared the company checks, but was not authorized to sign them. Joe reviewed the QuickBooks ledgers prepared by Sally each week, before signing checks. XXX Corp.'s accountant checked the accounting books and records twice weekly. The company's owner also reviewed the books on a regular basis.

Continued on Page 8

2 Association of Certified Fraud Examiners, *2012 Report to the Nations*.

Continued from Page 7

Sally's personality and work habits, as described in the trial record, did not fit the profile of a typical corporate fraudster. Sally had worked at the company for many years without any issues or warning signs. Five months after leaving XXX Corp. to have a baby, Sally realized that the company had wrongfully paid her straight time for overtime, instead of time and a half, as required by law. She filed a complaint with the Labor Department. Shortly after she filed the labor complaint, her former manager called police and accused Sally of improperly writing company checks to pay her utilities bills. Coincidental? Likely not. Retaliation is often a strong motivator in business and personal disputes.

Unfortunately, these facts were not highlighted or explained at trial. Sally's trial attorney apparently had failed to grasp the critical timeline of events for the five-month gap in time after Sally left the bookkeeping job, such as the labor disputes and her good conduct during her employment, factors that could play a critical role in mounting a defense.

Legal and Financial Analysis

An appellate lawyer's most important contribution is often the ability to take a step back and view a case from a new perspective. By taking a broad view and carefully developing a timeline of events that included every significant action taken by the defendant and her employer, the case took on a completely different complexion than what the prosecution presented at trial.

For criminal matters, the best starting point for case analysis is usually the police report. Joe was the person who initially contacted the police to make a report. Joe was an experienced businessman. He had a close relationship with the XXX Corp.'s owner and had run operations at the company for over 20 years. According to the police report, Joe stated that Sally had improperly written XXX Corp. checks and deposited the funds into her personal checking account. The police report also noted that Sally had left the company five months prior.

The theft indictment was vague and merely alleged that Sally, "without authorization," took control of the company's assets. There was no mention of improper use of company checks or where the money wrongfully went.

What really jumped out was the forgery indictment. There was no allegation of false signatures and no mention of funds going into the bookkeeper's personal bank account. Instead, the indictment stated that the bookkeeper "altered" a company check and paid it to her utilities account—not to her personal bank account. Joe's accusations in the police report did not coincide with the indictment. The operations manager changed his story along the way, a strong indication that his story was not credible.

Further analysis of the case documents and the applicable theft statute showed that whether and how Sally obtained "unauthorized control" of company funds *by improperly using the company's QuickBooks software* was the central legal issue in the case and should have been the focus at trial. However, the trial record contained no QuickBooks statements or other accounting records of XXX Corp. The main trial exhibits were pages upon pages of Sally's utilities statements from ComEd and People Gas, which shed no light on the issue of "unauthorized control." Sally did not deny that the company paid her utility bills. The factual issue was whether the company "authorized" those payments, or whether Sally had improperly issued company checks without proper authorization by anyone from XXX Corp.

In opening statements at trial, both the prosecution and defense attorneys showed a limited understanding of basic accounting and bookkeeping procedures, and particularly the QuickBooks software program, which is commonly used in thousands of small businesses across the country. A bookkeeper that used QuickBooks to prepare company checks in her daily work was accused of theft by preparing unauthorized checks. But neither the prosecution nor defense offered any explanation or scenario of how that actually could have happened, given QuickBooks software's built in anti-fraud features and the company's weekly oversight of the bookkeeper's work by its operations manager and accountant.

The trial transcript further detailed the change in Joe's account of the alleged crimes. While the police report indicated that Joe told police Sally wrote XXX Corp. checks and deposited the funds directly into her personal bank account, his story at trial was completely different. Joe testified that five months after Sally left the company, he reconciled the bank statements and QuickBooks records and "discovered" canceled checks for Sally's utilities bills that were not listed in the QuickBooks ledger.

Several areas of Joe's testimony lead to solid arguments on appeal:

- The timing of Joe's discovery of the alleged theft was simply not plausible. Given basic accounting and business norms, it was extremely unlikely that XXX Corp. would go five months without reconciling its bank statements and accounts payable records.
- There was no testimony regarding the QuickBooks security controls and automatic audit features.
- There was no testimony that Sally had security access to QuickBooks deletion codes or that she deleted the initial entries that created the alleged improper checks.
- There was no testimony addressing whether other employees had access to the QuickBooks and could have deleted the initial entries during the five-month period of Sally's absence.
- There was no testimony that Sally had falsified the accounting books and records.

These observations helped formulate on appeal that there was "insufficient evidence" to support a conviction for theft and forgery.

In addition, it became clear that XXX Corp.'s strong system of internal controls and separation of duties undermined the prosecution's case. Joe testified that Sally, over a period of four years, prepared company checks using QuickBooks software to pay her utilities bills with ComEd and People's Gas without authorization. Yet much of his testimony contradicted that allegation from a business and accounting perspective. For example, Joe testified that:

- He reviewed the QuickBooks ledgers prepared by Sally weekly.
- He reviewed and signed the all checks that were paid for Sally's utilities bills.
- He had ultimate responsibility for the company's checkbook.
- The company's accountant came in twice weekly to review the accounting books and records.

These specific examples of strong internal controls established on appeal that the prosecution failed to prove Sally exercised "unauthorized control" over the company's assets through the QuickBooks accounting system.

Continued on Page 9

Continued from Page 8

Without unauthorized control by Sally, there could be no theft. Joe was the company's operations manager, and he was responsible for all financial operations and check signing. He and the company's accountant reviewed the QuickBooks ledgers weekly, and he signed the alleged improper checks. So how could Joe claim that checks he signed for Sally's utilities were not properly authorized? After all, he signed them and it was his responsibility to make sure all payments were properly made. Moreover, with such internal controls in place, it was not plausible that a fraudulent check would be found five months later. Any false checks would have been found at least within a month, when the monthly bank statements were reconciled.

Mistaken Facts Void Trial Judge's Ruling

In addition to the prosecutor's failure to prove that Sally exercised unauthorized control of the XXX Corp.'s accounting books and records, the prosecutor continuously referred to incorrect facts, which appeared to lead the trial judge completely off course. In particular, while questioning Joe, the company's operations manager, the prosecutor kept referring to "the missing check." But, in fact there was no missing check. Joe testified that five months after Sally left the job, he had found a cancelled check that was not recorded as a QuickBooks entry, but he never said a check "was missing." There is a big difference. A "missing check" implies theft of a piece of paper. But a missing entry in QuickBooks means that someone deleted an entry that had previously created a check. Any number of employees from Joe to the owner could have deleted a QuickBooks check entry during the five months after Sally's departure. This was an essential conceptual error in the case, which strongly impacted the judge's ultimate ruling (it was a bench trial).

In his finding of guilt, the judge specifically referenced "the checks that were written to her own accounts were not found within the cancelled checks that were sent to the company." That was not the testimony of record and was not what actually happened. No checks went missing. I highlighted this crucial mistaken fact in the appellate brief, because under Illinois law a conviction must be reversed if it is based on incorrect facts not in evidence.[3]

In my opinion, this was the best legal argument for appeal. The judge's emphasis on "missing checks" was unfortunately attributable to the attorneys' knowledge deficit of basic business and accounting procedures. Control and integrity of XXX Corp.'s QuickBooks software and falsification of accounting books and records were key issues, that attorneys on both sides failed to address and explain.

Behavioral Aspects of Fraud and Motive

Uncovering falsified accounting books and records is an important part of any corporate fraud or theft case. Attorneys and financial investigators should also pay attention to indications of criminal behavior that are hidden behind numbers and spreadsheets; considering all relevant actions, behaviors, and underlying motivations of company personnel in financial and accounting positions.

The most important aspect of this case that the prosecution failed to consider was the fact that once fraud was suspected, the operations manager did not consult an outside auditor or fraud specialist. Instead, the operations manager claimed to have investigated the alleged crimes on his own. This was clearly a conflict of interest, since he had overall responsibility for XXX Corp.'s financial, accounting and payroll records. Perhaps concerned about revealing accounting and payroll irregularities to objective scrutiny, Joe avoided outside auditors.

In addition, the defendant was a whistle blower. She had filed a labor dispute citing improper overtime payroll practices, a potential motive for the operations manager to head off the complaint by deleting the checks from QuickBooks. Evidence of such manipulation would have existed in the QuickBooks data for a knowledgeable investigator.

Probable Cause and Falsification of Accounting Books and Records

Under state law and rules of professional conduct for attorneys,[4] a prosecutor may not indict unless there is "probable cause" to believe that a crime occurred. In the context of bookkeeper theft, probable cause should encompass some evidence that an accused bookkeeper actually falsified accounting books and records. But the prosecution failed to proffer any such evidence in this case. The real crime of the XXX Corp. case is that Sally was arrested in the first place. The prosecutor accepted too much at face value and failed to procure sufficient evidence of actual criminal activity.

Compare the scenario of the XXX Corp case with several recent large-scale employee theft/embezzlement cases, where prosecutors put together strong cases with solid proof of falsified accounting books and records, leading the accused to plead guilty:

- In November 2012, Rita Crundwell pled guilty to embezzlement of over $50 million from the small city of Dixon, Illinois, with a population of 16,000 and an annual budget under $140 million. Rita was the city's comptroller and the only person in charge of the city's finances. There was no oversight. Her position allowed her to siphon off public funds to secret private bank accounts and finance a lavish lifestyle that featured a championship horse-breeding ranch. Rita's crimes went unnoticed until she took a vacation and her replacement came across the secret bank accounts.
- In October 2012, bookkeeper Diane Pimple pled guilty to interstate transportation of stolen money and tax evasion in a Maryland court. Using QuickBooks, Diane wrote herself over 100 unauthorized checks, stealing $150,000. She hid her crimes by falsifying entries in QuickBooks to show the checks had been paid to other payees and falsified the corresponding account balance ledgers.
- In January 2012, a New Jersey bookkeeper, Sharon Wetter, pled guilty and was sentenced to 21 months in prison for stealing over $500,000 from her employer. Sharon hid her theft by altering the company's electronic accounting records to make it appear that payments she made to herself from the company's bank account were for legitimate businesses expenses.

Fully vetted, there was insufficient evidence to support probable cause in the XXX Corp. case, let alone a guilty verdict. This was a company with adequate internal controls, segregation of duties, and proper oversight of accounting functions. There was little room for fraud or theft in that system without solid proof that accounting books and records had been falsified. Any number of people could have accessed the QuickBooks software and created or deleted the check entries in question, and the prosecution proffered no evidence that Sally was the culprit.

Continued on Page 10

3 *People v. Szudy*, 56 Ill. App. 3d 494, 499, 371 N.E. 2d 1222; 14 Ill. Dec. 169 (1st Dist. 1978), and Illinois Supreme Court Rule 615(a), which provides that a ruling based upon facts not properly in evidence must be reversed under the "plain error" rule.

4 *ABA Model Rules of Professional Conduct*, Rule 3.8, Special Responsibilities of a Prosecutor. Attorneys should also note that 2012 changes to the official comments to ABA Rule 1.1. Competence, require attorneys to have knowledge of relevant technology, which for this case would include QuickBooks accounting software.

Continued from Page 9

Conclusion

In the XXX Corp. case, the prosecution failed to prove the bookkeeper falsified any accounting books or records, and failed to prove she had exercised unauthorized control of the company's financial systems. The trial record shows neither the prosecution nor the defense addressed basic issues of ordinary business and accounting practices. An innocent woman was wrongly convicted.

The XXX Corp. case illustrates the consequences of inadequate training of police departments and law enforcement personnel in basic financial and business concepts and theories. If police officers are going to make arrests for white-collar crime, they should have training in basic business practices—otherwise, how can they possibly know what actions and behaviors are illegal and merit investigation?

The police investigators in the XXX Corp. case should have had enough training in business and accounting essentials to realize that an accusation from an operations manager, made five months after an employee left work, was implausible. At the very least, the police should have interviewed the company's accountant before making an arrest.

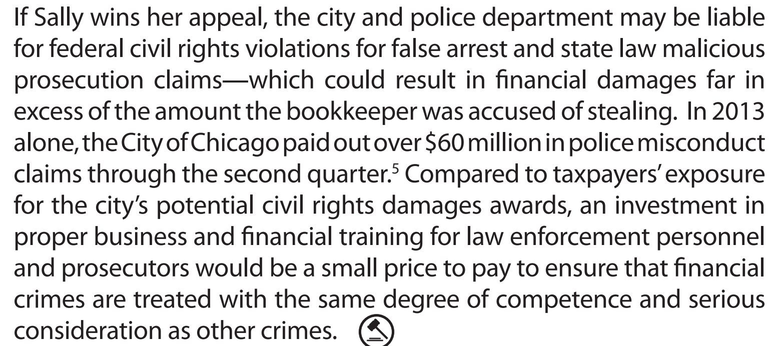
Lack of proper police investigation, along with the prosecutor's lack of understanding ultimately led to glaring errors at trial:

- There was no evidence proving the bookkeeper exercised unauthorized control of the company's financial systems.
- There was no evidence presented relating to the operation and security aspects of the company's QuickBooks accounting software.
- There was no proof the bookkeeper falsified the company's accounting books and records.

These errors may be recognized and rectified on appeal, but it is a lengthy and costly process, which can take years for resolution.

The burden of a fair justice system does not only fall on police and prosecutors. Defense attorneys also play a pivotal role. Attorneys, in civil or criminal practice, should immediately obtain assistance from financial litigation experts in preparing a case outside the scope of their experience. Ideally in this case, the trial attorney should have hired a financial litigation expert to help analyze the case and provide testimony explaining the workings of the QuickBooks software and basic accounting practices. The testimony of such an expert could have helped the trial judge to understand that the central issue in the case was whether unauthorized control of the QuickBooks software resulted in theft. But that issue, unfortunately, was never addressed during trial.

If Sally wins her appeal, the city and police department may be liable for federal civil rights violations for false arrest and state law malicious prosecution claims—which could result in financial damages far in excess of the amount the bookkeeper was accused of stealing. In 2013 alone, the City of Chicago paid out over $60 million in police misconduct claims through the second quarter.[5] Compared to taxpayers' exposure for the city's potential civil rights damages awards, an investment in proper business and financial training for law enforcement personnel and prosecutors would be a small price to pay to ensure that financial crimes are treated with the same degree of competence and serious consideration as other crimes.



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5 Spielman, Fran. "Chicago Taxpayers to Pay $10 Million in Another Jon Burge Settlement," *Chicago Sun-Times*, July 19, 2013.

Practice Tips

Alimony Trusts

By M. Lyn Reagan, CPA/ABV, CVA, MAFF; and M. Elizabeth Key, CPA, CVA, MAFF

An alimony trust is a trust created to provide support to the recipient spouse pursuant to a divorce or separation agreement. The payor spouse transfers property to the trust, and the trust administers the alimony payments to the recipient spouse.

For simplicity, we will refer to the recipient spouse as the "wife" and the obligor spouse as the "husband."

Numerous advantages exist for using an alimony trust in a divorce or separation agreement. In a very acrimonious dissolution, the husband can transfer assets to an alimony trust and appoint a third party trustee. The trustee would then make alimony payments to the wife, eliminating the need for further interaction between the two ex-spouses. In other situations, the husband can appoint himself trustee and retain control over the assets in the trust. For example, where there are few liquid assets in the marital estate, the husband can transfer income-producing equity from his business entity into the alimony trust. Once the alimony obligation is fulfilled, the interest in the business would revert back to the husband. Or, in a situation where the husband is in a highly risky business or faces possible bankruptcy, a transfer of assets to the alimony trust will ensure that the alimony obligation is secure.

Several tricky pitfalls in the alimony regulations can be avoided with an alimony trust. For instance, the alimony recapture rule, IRC Section 71(f), recognizes income in some cases where there is a substantial reduction in alimony payments. Alimony trusts are exempt from recapture. Therefore, an alimony trust enables "frontloading" the alimony payments. In addition, there is no re-characterization of alimony payments, like child support payments, if the alimony terminates on an event such as a child attaining the age of 18 or graduating from high school.

There are some disadvantages to alimony trusts as well. The husband does not get to take an alimony deduction for the assets placed in the alimony trust, but he also does not have to report the income from the alimony trust that is in satisfaction of the alimony payments. The husband does have to report the trust income on any payments that are deemed to be child support, as well as any trust income that is in excess of the alimony payments to wife.

The circumstances under which the trust is created determine whether the wife will be taxed on either the income she is entitled to receive, i.e. trust income, or the actual payments she receives from the trust.

Continued on Page 11

Continued from Page 10

If the trust was created prior to the divorce, pursuant to IRC Section 682—income of trust in case of divorce, etc., "there shall be included in the gross income of a wife who is divorced or legally separated… the amount of the income of any trusts which such wife is entitled to receive." In other words, the wife will pay tax only on the amount of trust income she receives; distributions of principal are exempt.

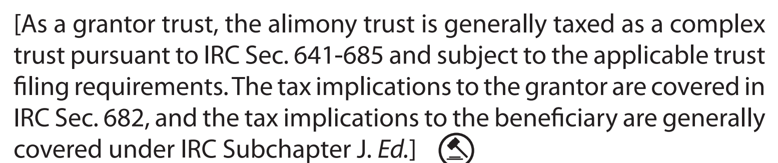
If the trust is created in contemplation of a divorce or separation agreement, IRC Section 71—alimony and separate maintenance payments will apply, and the wife will pay tax on the entire payment received, regardless of the amount of income from the trust. Also, the alimony payable to the wife out of trust income retains its character according to the conduit rules for trust accounting under Subchapter J. Under either scenario the husband will not pay tax on the trust income. The following examples illustrate the application of IRC Sections 682 and 71:

> **Example 1:** Upon the marriage of Husband (H) and Wife (W), H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. The income of the trust, which becomes payable to W after the order of separation, is includible in her income and is deductible by the trust under IRC Section 682. No part of the income is includible in H's income or deductible by him.
>
> **Example 2:** Using example 1 above, the trust is not created at the date of the marriage, but a trust is created during the divorce proceedings. The income of the Wife will be the amount of the payments she receives from the trust, regardless of the amount of trust income.

There are also estate and gift tax implications to consider when setting up an alimony trust. If the grantor retains a reversionary interest in the trust, the trust will be includable in his estate. If the grantor creates a remainder interest in the trust to his children, he has removed the trust from his estate, but has created a gift of the remainder interest when the trust is created.

The cost benefit of setting up an alimony trust must be weighed. Alimony trusts are generally appropriate only where there is sufficient wealth to profit from the economic and tax benefits, as the alimony trust requires its own tax return and administration.

There are many occasions when an alimony trust could, or should, be considered. However, in all cases a competent counsel should be involved in establishing the trust.



[As a grantor trust, the alimony trust is generally taxed as a complex trust pursuant to IRC Sec. 641-685 and subject to the applicable trust filing requirements. The tax implications to the grantor are covered in IRC Sec. 682, and the tax implications to the beneficiary are generally covered under IRC Subchapter J. *Ed.*]

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Business Valuation for the Litigation Practitioner

ESOP Litigation On The Rise: What Do Business Valuations Have To Do With It?

By Adrian R. Loud, CPA, ABV, CFF, CVA, ASA; W. Bard Brockman, Esq.; and Ray Kukreja, CFA, ASA

Background on ESOPs

An employee stock ownership plan (ESOP) is a qualified defined contribution plan subject to the Internal Revenue Code and originated in the 1974 Employee Retirement Income Security Act (ERISA). There are approximately 11,000 active ESOPs in the United States, covering more than 13 million participants,[1] and over 10 percent of the private sector workforce.[2] An ESOP is a type of a profit-sharing plan in which shares of the employer corporation's stock are acquired and held for the benefit of employees. Under the right circumstances, ESOPs provide unique economic benefits to selling shareholders, employees (plan participants), and the corporation through tax deductions and deferrals as well as enhanced labor productivity and loyalty.

ESOPs invest primarily in the stock of the employer corporation. This condition, in addition to the fact that most ESOPs are sponsored by closely held corporations, requires a determination of the fair market value of the stock of the employer corporation at the formation of the ESOP, and at least annually. The standard of value for ESOP valuations is fair market value, which is defined in the 1988 Department of Labor (DOL) proposed regulation,[3] and is similar to the (oftentimes more familiar) estate tax valuation language used in Revenue Ruling 59-60.[4]

Role of the DOL

The DOL proposed regulation further states that the fair market value of the employer corporation's equity will be determined in good faith by the trustee or named fiduciary. This is an important detail as the Internal Revenue Code (IRC) requires that the purchase price paid by an ESOP trust to acquire closely held stock from the selling shareholder may be estimated by an independent valuation professional,[5] but the ESOP trustee is ultimately responsible for that determination. There are no statutes or regulations specifically governing how ESOP trustees should view a valuation; however, case law and general ERISA requirements suggest the value determination be: (1) based on application of care, skill, prudence, and diligence; (2) carried out solely in the interest of ESOP participants; and (3) performed in accordance with the respective plan and trust documents.

The DOL Employee Benefits Security Administration (EBSA) administers and enforces the fiduciary, reporting, and disclosure provisions of Title I of ERISA and, consequently, oversees the consideration paid by an ESOP to acquire employer corporation stock from the selling shareholder. ESOPs (or ESOP participants) may not pay more (or receive less at time of termination) than adequate

1 The National Center for Employee Ownership website, http://www.nceo.org/articles/esop-employee-stock-ownership-plan; information presented as of December 31, 2013.

2 The ESOP Association website, http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics; information presented as of December 31, 2013.

3 See Title I of ERISA and the 1988 Department of Labor Proposed Regulation Relating to the Definition of Adequate Consideration (Prop. Reg. §2510.3-18 (b)(2)(i)).

4 Revenue Ruling 59-60, 1959-1 C.B. 237.

5 Internal Revenue Code §401(a)(28)(C).

consideration (i.e., fair market value) for the employer corporation's stock. If the ESOP trustee pays more than fair market value, the trustee may have diluted plan participant interests while unjustly enriching the selling shareholder. Indeed, EBSA cites incorrect valuation as one of the most common violations of ERISA with regard to ESOPs.[6]

Valuation Deficiencies

Some of the errors observed by EBSA in its review of ESOP valuations include:

- Reliance on difficult-to-support growth projections compared to historical results
- Application of unrealistically low discount rate in an income approach
- Reliance on dated or questionable financial information
- Failure to identify, examine, and test valuation assumptions and inputs
- Inappropriate adjustments to historical or prospective financial statements
- Use of inappropriate or unusual valuation methodologies
- Failure to discount for company-specific risks (e.g., dependence on a single customer or key employee) appropriately
- Inclusion of noncomparable guideline public or merged and acquired companies

Continued on Page 13

6 United States Department of Labor Employee Benefits Security Administration website, http://www.dol.gov/ebsa/erisa_enforcement.html.

Continued from Page 12

- Failure to address future fixed asset and working capital requirements
- Disregarding indications of value based on historical or contemporaneous transactions
- Inappropriate application of control premiums
- Unsupported discounts for lack of marketability
- Mistreatment of ESOP debt financing impact
- Narrative report does not support valuation conclusions

These and other ESOP questionable valuation topics have become increasingly contested, resulting in DOL lawsuits and amicus brief filings as well as class action lawsuits. In fiscal year 2013, EBSA's Office of Enforcement closed nearly 3,700 civil investigations and 320 criminal investigations, resulting in monetary recoveries of $1.69 billion.[7] ESOPs represent a small but growing portion of these matters. Accordingly, EBSA established an ESOP project initiative designed to identify and correct violations of ERISA in connection with ESOPs. The following case summaries highlight several recent ESOP litigation matters.

In *Perez v. PBI Bank, Inc.* (No. 3:13-cv-1400-PPS [N.D. Ind.]), EBSA alleged that the ESOP trustee approved an excessively high $40 million purchase price in conjunction with the 2007 ESOP implementation transaction. Among the problems EBSA identified were: (1) the selling shareholders received a control price, but retained control of the board of directors for years after, (2) an earnout agreement was executed before the ESOP implementation transaction, but was not addressed in the valuation, and (3) the transaction was indirectly financed by the selling shareholders at an interest rate deemed "far in excess of a reasonable rate of interest at the time." The DOL seeks to require the trustee to restore all losses suffered by the ESOP, plus interest, and to prohibit the trustee from ever serving in a fiduciary or service provider capacity for an ERISA-covered plan.

In *Solis v. Webb* (No. C-12-2055, 2012 WL 4466536 [N.D. Cal. Sept. 26, 2012]), the DOL alleged the trustee for the November 2002 ESOP implementation transaction paid approximately $28.3 million to acquire 90 percent of the stock of Entrepreneurial Ventures, Inc. d/b/a Parrot Cellular while relying on a valuation that contained mathematical errors, used inappropriate guideline companies, used overly optimistic profitability projections, and failed to account for an existing $12 million deferred compensation agreement with the company's founder and director.

In *Chesemore v. Alliance Holdings* (No. 3:09-cv-00413, 886 F. Supp. 2d 1007 [W.D. Wis. 2012]), an ESOP was used to spin-off a company (Trachte Buildings Systems, Inc.) in a fairly complex transaction. Unfortunately, the valuation firm that opined on the estimate of value and fairness of the transaction was not independent of management, accepted management's aggressive financial forecast without scrutiny, ignored industry expectations for flat growth, and ignored future working capital requirements to fund growth.

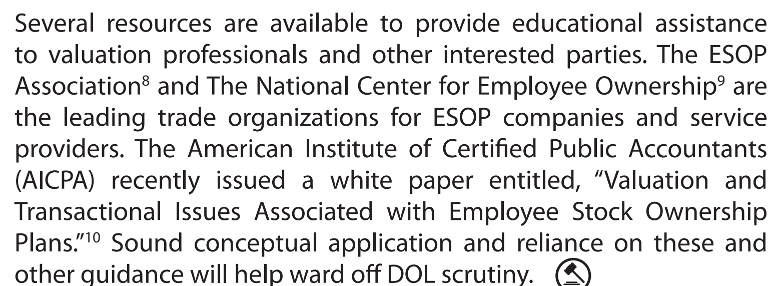
In *Solis v. First Bankers Trust, Inc., Maran, Inc., et al.* (No. 12-cv-8648 [S.D.N.Y.]), the DOL asserted the financial advisor relied on revenue projections 62 percent higher than the historical five-year average, along with gross profits between 71 percent and 98 percent higher. Furthermore, the financial advisor did not consider customer concentration in its analysis and relied on three public companies for a portion of the ESOP implementation transaction analysis then ignored those proxies for the subsequent valuation update, citing lack of comparability.

In *Solis v. First Bankers Trust, Inc., Rembar, Inc., et al.* (No. 12-cv-08649 [S.D.N.Y.]), the DOL asserted the 2006 implementation transaction relied on a faulty valuation analysis in which the financial advisor overstated cash flow by assuming the company could function without a chief executive officer. The financial advisor also relied on projections prepared on a controlling interest basis, yet applied a control premium, effectively double counting the impact of control. The trustee paid a control level purchase price despite the fact the selling shareholder reserved the right to select a majority of board members while the seller debt was outstanding. The valuation report allegedly included other errors or unsupported assumptions.

Conclusion

These and many other litigation matters underscore the importance of accurate and thoughtful valuation analyses. The DOL insists it is not trying to deter ESOP transactions from occurring, but it does want them to occur at the correct price. To that end, the DOL has pledged to propose an amended definition of what comprises a plan fiduciary, expecting to increase the prudence, and likely legal liability, of ESOP valuation professionals. The next proposal is expected to be issued in August 2014 as the "conflict of interest" rule.

In the meantime, valuation professionals engaged to provide financial advisory services to ESOPs must be aware of the nuances of ESOP engagements. Understanding and testing the impact of management projections, repurchase obligation, and transaction terms (e.g., debt financing, synthetic equity, convertible preferred stock, price protection) are critical to ensuring the satisfaction of the parties (selling shareholders, employees, and employer corporation), but also the authoritative organizations such as the IRS and DOL. Working with independent fiduciaries may be prudent as these individuals and entities are well-apprised of current trends in the ESOP community and are often better-suited to challenge assumptions made in the valuation.



Several resources are available to provide educational assistance to valuation professionals and other interested parties. The ESOP Association[8] and The National Center for Employee Ownership[9] are the leading trade organizations for ESOP companies and service providers. The American Institute of Certified Public Accountants (AICPA) recently issued a white paper entitled, "Valuation and Transactional Issues Associated with Employee Stock Ownership Plans."[10] Sound conceptual application and reliance on these and other guidance will help ward off DOL scrutiny.

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7 United States Department of Labor Employee Benefits Security Administration website, http://www.dol.gov/ebsa/newsroom/fsFYagencyresults.html.

8 http://www.esopassociation.org/.

9 http://www.nceo.org/.

10 "Valuation and Transactional Issues Associated with Employee Stock Ownership Plans," AICPA Forensic and Valuation Services Section, October 2013.

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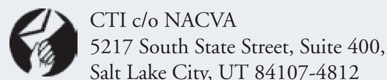

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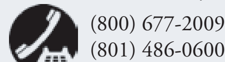

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