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ADVOCATE'S EDGE

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Motobilt, Inc. v. Bystronic, Inc.

Damages expert trips over *Daubert* hurdles

Estimating economic damages is rarely straightforward. If a damages expert's testimony seems simplistic, it could signal a red flag about the expert's qualifications or methods. An automotive parts manufacturer recently learned this lesson the hard way.

What's the dispute?

Motobilt, Inc. v. Bystronic, Inc. involved a breach of warranty claim. The plaintiff sought to recover damages it allegedly suffered when purchased equipment failed to function as warranted. The plaintiff claimed that it bought four items designed to work together to automate the process of metal sheet-cutting. However, two automation components failed to operate as warranted by the defendant. The plaintiff claimed that the defendant was unable or unwilling to remedy the problems for more than a year and a half. As a result, the equipment didn't reliably function as an automated system.

The plaintiff's expert offered two damages models. The first assumed that the equipment was 60% less productive in manual loading operation (when the two parts didn't function as warranted) than it was in fully automated operation. Based on this productivity loss, the expert estimated that the equipment's value at the time of purchase was 60% less than the purchase price.

The second model was based on a blog post on the defendant's website, which stated that adding automation can improve average efficiency by 30%. So, the expert opined that the equipment's value when purchased was 30% less than the price paid.

Was the expert qualified?

The defendant moved to exclude the opinion provided by the plaintiff's expert — and, ultimately, neither of the expert's models survived *Daubert* scrutiny. The U.S. District Court for the Northern District of Illinois, Eastern Division, noted that the expert was a certified fraud examiner whose expertise primarily was in fraud prevention, risk management and compliance. He had no work experience, education or training in valuing equipment.

Backdoor expert testimony closed out

After the damages expert's opinions had been excluded in *Motobilt* (see main article), the only evidence of the plaintiff's damages was an affidavit from the company's president/CEO. He valued the equipment at $568,000, based on his "years of experience in the automotive parts manufacturing industry." Then he estimated that the company's damages were roughly $1.2 million (the purchase price less the value of the equipment).

The plaintiff disclosed the president/CEO as only a lay witness, but the court found that his damages opinions were "in the nature of expert testimony." Lay opinions are limited to testimony that isn't based on scientific, technical or other specialized knowledge. The court said that valuing industrial equipment is a matter of specialized expertise. Because this witness wasn't qualified to offer an expert opinion on the equipment's value, his damages testimony was stricken. With no admissible damages evidence, the court granted the defendant's motion for summary judgment.

However, the plaintiff contended that he didn't need a background as an expert in laser cutting systems to qualify as a damages expert. It argued that damages experts can rely on other experts when their testimony touches on areas outside of their expertise. The court disagreed, pointing out that the proponent of his testimony must show that there's *something* in his background that qualified him to opine about the specific subject of his testimony.

The core of the expert's damages theory was his valuation of the equipment, yet he had no experience valuing *industrial* equipment. Because the plaintiff offered nothing to substantiate his expertise in this area, it failed to prove that its expert was qualified to offer his damages opinions.

Were the expert's models reliable?

Additionally, the court found that, even if the expert were qualified, his damages model lacked any of the usual indicators of reliability. For example, the expert testified that he didn't rely on any treatises, manuals, textbooks or authorities when developing his model. He had never used the methodology in another case and wasn't aware of any court that had ever accepted his models.

The plaintiff argued that the expert applied accounting and economic principles to assess the equipment's value. But the court pointed out that his report didn't identify any such principles or explain how they supported his models. Moreover, his "unprecedented approach" suffered from "obvious analytical flaws." In particular, the court highlighted his failure to consider the equipment's expected service life when determining the extent to which its total value was impaired by its initial failure to perform as warranted. The court said, "Even a layperson surely understands that the price [the plaintiff] paid for the equipment reflects its value over its useful life."

The defendant repaired the automation components approximately 20 months after installation. From that point through the date of the expert's deposition, the equipment functioned as warranted. Thus, the reduced value due to the initial failure to perform should have been amortized over the equipment's service life. Neither of the expert's models accounted for the time that the equipment functioned as warranted. Both assessed the equipment's value as if its productivity were permanently impaired, resulting in a "grossly inflated discount."

Tread carefully

The court in *Motobilt* ultimately concluded that the expert's damages opinions were inadmissible. Don't make the same mistake — carefully vet your experts to ensure they're qualified and use reliable methods. ■

What role do rules of thumb play in business valuation?

Clients often ask valuators about rules of thumb that are used in their industries. A key takeaway from the 2023 Forensic and Valuation Conference hosted by the Virginia State Society of CPAs is that rules of thumb should always be considered when valuing a business — but only as a sanity check.

Sources

Rules of thumb are mathematical formulas designed to gauge business value. They show a relationship between price and certain variables, such as revenue, cash flow, or earnings before interest, taxes, depreciation and amortization (EBITDA). These measures come from many sources, including business brokers, industry consultants, trade associations and publications, and word of mouth. Generally, they apply to small, single-site businesses, though some industries may provide them for larger organizations.

> Often, rules of thumb are based on averages or subjective judgment, rather than objective sources of verifiable data.

A rule of thumb is a variation of the market approach. Under this approach, the value of a business is developed by analyzing valuation multiples from transactions involving similar businesses and making adjustments to reflect the subject company's characteristics. Key to an accurate valuation under this approach is access to information to determine whether other companies and transactions are truly comparable in order to identify appropriate adjustments.

Limitations

Often, rules of thumb are based on averages or subjective judgment, rather than objective sources of verifiable data. Even if a rule of thumb is derived from solid market data, it's impossible — without access to details about the underlying companies and transactions — to determine whether the rule has any relevance to the subject company. For example, a common rule of thumb for valuing full-service restaurants is 30% of annual gross revenue. But prices in actual transactions range from well under 20% to well over 100% of gross revenues.

The reason there's such a wide range is because business value is affected by a variety of factors besides revenue, such as gross profits, lease and

other expenses, cash flow, growth, location, competition, management strength, and risk. A rule of thumb might produce a reasonable value for a business that's near the industry average in these areas. But for businesses that deviate from the norm, rules of thumb are unreliable indicators of value.

Also, rules of thumb generally don't account for transaction terms. For example, do transactions involve cash purchases or seller financing? Are they stock sales or asset sales? Does the formula include real estate and inventory? The answers to these types of questions can have a significant impact on value, but simplified rules of thumb fail to address these issues.

Likewise, rules of thumb can be misleading if their terms aren't defined. For instance, if a business is valued at three times earnings, the term "earnings" could be interpreted to refer to various metrics, such as pretax earnings, net income or EBITDA.

Exercise caution

In situations that demand accurate valuations — such as business sales, litigation or tax planning — rules of thumb are no substitute for comprehensive business valuations. However, they may be useful for developing a rough, preliminary indication of value or for gauging the reasonableness of a formal valuation. ■

Nonprofits: Be mindful of scams this holiday season

Holiday season is right around the corner. Charities and many other not-for-profit organizations typically receive most of their donations at year end. It's critical for these organizations to be on the lookout for fraud during their peak season for donations. Here are examples of fraud schemes that are most common to nonprofit organizations, along with some ideas to help strengthen internal controls to prevent fraud.

Potential vulnerabilities

Many not-for-profits are staffed by people who believe strongly in their missions, which contributes to a culture of trust. Unfortunately, such trust makes nonprofits vulnerable to certain types of fraud. For example, if managers don't supervise staffers who accept cash donations, it provides an opportunity for them to skim (keep a donation for themselves without recording its existence in the books). Skimming is even more likely to happen if a not-for-profit doesn't perform background checks on new employees and volunteers who accept cash donations.

However, skimming isn't the most common type of fraud scheme in the nonprofit sector. According to "Occupational Fraud 2024: A Report to the Nations" published by the Association of Certified Fraud Examiners (ACFE), religious, charitable and social services entities are most likely to fall prey to corruption schemes. This is where staffers might abuse their influence to gain direct or indirect economic benefit — for example, with a bribe or contract with a for-profit business in which they have an interest. The 2024 ACFE report found that roughly 45% of fraud cases in the not-for-profit sector involved corruption.

Other top schemes among nonprofits include:

- Billing schemes (36%),
- Phony expense reimbursement claims (29%), and
- Theft of cash on hand (24%).

For example, nonprofit staffers might invent and submit invoices on behalf of fictitious vendors or

And don't forget to protect electronic records that include financial data on donors, vendors, employees and others. Staff members should be given access only to the information and programs required for their job responsibilities.

collude with actual vendors who are willing to submit false or inflated invoices. Many perpetrators use more than one method to defraud their employers.

Importance of strong controls

Even small nonprofits that consider their employees and volunteers "family" need to establish and follow procedures that limit access to funds. Dishonest staffers who are paid modest salaries or who volunteer may justify their wrongdoing because they would likely earn more if they provided the same services to a for-profit business.

> Religious, charitable and social services entities are most likely to fall prey to corruption schemes.

An important internal control to prevent insider fraud is segregation of duties. To reduce opportunities for any one person to steal, multiple employees should be involved in processing payables. For example, every incoming invoice should be reviewed by the staffer who instigated it to confirm the amount and that the goods or services were received. A different employee should be responsible for writing the check. For large expenditures, not-for-profits should require the approval of more than one person.

Many nonprofits depend on money raised during a big annual gala or other special event at year end. During crowded, chaotic fundraisers, not-for-profits should generally discourage supporters from making cash payments. Instead, they can presell or preregister event participants to limit access to cash on the day of the event. If cash is accepted at the door, organizations should try to assign cash-related duties to paid employees or board members, rather than to unsupervised volunteers.

As nonprofits ramp up for the holiday rush, they might want to consider providing training to workers about common fraud schemes, detection methods and reporting mechanisms. Nonprofits have the lowest implementation rate of fraud awareness training of the industries covered in the 2024 ACFE study. However, those that provided such training uncovered frauds within an average of nine months, compared to an average duration of 24 months for victim-organizations that didn't provide training.

Work with a forensic accountant

A fraud incident can ruin a nonprofit organization's reputation, so it's important to have strong internal controls to prevent fraud. Not-for-profits should consult a forensic accountant to review their controls and brainstorm ways to fortify their defenses and investigate suspicious activity. ■

Beware of low-ball business valuations

When an expert's valuation of a business amounts to less than 3% of the opposing expert's valuation, the disparity may signal a credibility issue. And, if an expert grossly undervalues a business, the court may decide to accept the opposing expert's value. That's what happened in a recent divorce case in Minnesota (*Tennebaum v. Deshpande*).

District court awards settlement proceeds

The husband was hired by an asset management company to open an office in India, so the couple relocated. The husband eventually became a shareholder, and by the end of 2020, he owned 55% of the company. He also had the right to acquire up to 75% by December 2022 for an established share price.

The husband filed for divorce in 2019. The husband's expert valued his interest in the asset management company at less than $140,000, while the wife's expert valued it at roughly $5 million. The district court adopted the value presented by the wife's expert, finding it "much more thorough and logical" than the opposing expert's valuation. It awarded his ex-wife a property settlement of roughly $2.2 million, based partly on the value of the husband's business interest.

Husband challenges settlement award

The husband appealed, arguing that the opposing expert's value failed to account for his personal goodwill. The Minnesota Court of Appeals agreed that, under state law, personal goodwill is excluded from the divisible value of a marital asset. But it upheld the lower court's decision to assign no value to the husband's personal goodwill.

The district court found little evidence that the husband's specific skills and credentials contributed significant value to the asset management company. The company's founder had brought in most of the new investors since 2017, and another employee was being groomed to take over management. In 2021, three employees of the eight-person firm received higher compensation than the husband did. Plus, the husband presented no evidence of the value of his personal goodwill.

The husband also contended that the district court disregarded the purportedly arm's-length transaction when he negotiated his share-purchase price in 2017. However, the appellate court said the lower court considered the price — and found it wasn't an accurate reflection of the company's value. The husband's expert explained that stock sales to employees often involve a "sweetheart deal." And the founder testified that he needed to provide the husband equity to prevent competitors from poaching him.

Judgment stands

The Minnesota Court of Appeals wasn't persuaded by the husband's arguments and ultimately affirmed the lower court's valuation. It deferred to the court's weighing of the evidence and the experts' credibility. ■

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