NOVEMBER / DECEMBER 2016

ADVOCATE'S EDGE

Spotlight on electronic evidence
Social media analytics takes center stage

Clean sweep
Check for fraud and get your house in order

Failure to value goodwill invalidates nonsolicitation agreement

Unlocking the key person discount

Arnie & Company

A PROFESSIONAL CORPORATION OF CERTIFIED PUBLIC ACCOUNTANTS

5100 WESTHEIMER, SUITE 490
HOUSTON, TEXAS 77056
(713) 840-1634
FAX (713) 840-1628

Spotlight on electronic evidence

Social media analytics takes center stage

Social media permeates nearly all segments of our society, and litigation is no exception. As online activities and communities have become an integral part of many people's lives, it's no wonder that attorneys have clamored for a way to get a handle on the massive amounts of data lurking out there on platforms like Twitter, Facebook, Instagram and Snapchat.

That's where social media analytics comes into play. Experts who are well versed in this emerging methodology can use the techniques to provide valuable assistance throughout litigation, from investigation and discovery to jury selection. With social media apparently here to stay, you need to understand how this form of data mining can pay off for you and your clients.

Why does social media matter?

Facebook boasts more than 1 billion daily active users. Twitter claims 310 million monthly active users. Instagram reports more than 500 million monthly active users and more than 300 million daily active users. With that kind of activity, you simply can't afford to ignore social media or the wealth of information on it that people voluntarily make available about themselves.

For whatever reason, many people seem comfortable posting information, opinions and preferences they wouldn't necessarily share in other settings. They also could make posts that serve evidentiary purposes, such as pinning down their locations on certain dates and at

certain times. Photos, for example, can prove someone was, or wasn't, where she said she was at a specific time. Photos also might show someone performing tasks or pursuing activities he claims to be incapable of as the result of an accident. Some posts could reveal undisclosed assets in a divorce.

Even people who have their privacy settings on high aren't in the clear if their "friends" aren't equally vigilant. You might not have access to a plaintiff's Facebook page, for example — but if he or she appears in any way (for example, in photos or by making comments) on the page of a friend whose profile is public, social media analytics can generate insights on that plaintiff. There's really no end to the data you might find.

What is social media analytics?

With people posting multiple times each day, on multiple platforms, it can seem daunting to review all of the data. You might be tempted to stick with more traditional ways to search for the smoking gun. But with social media analytics, the task becomes more manageable and less time consuming.

Social media analytics uses algorithms to dig through expansive mounds of publicly available social media data. It can provide critical intelligence — not just on what people are talking about and the photos, videos and other posts they share but also whom they're connected to on social media — all in a quick and efficient manner.

The ability to identify relationships is particularly important, as these relationships may well generate leads or witnesses you might otherwise never come across. What are the odds of discovering a connection between your accounts receivable administrator and the billing clerk at one of your vendors through traditional methods? But if they're connected on LinkedIn, Instagram or another social network, social media analytics will identify the relationship so you can better focus your investigation and discovery.

Social media analytics and corporate investigations

Social media analytics isn't useful only for litigation purposes. Companies increasingly find the methodology effective when conducting internal investigations of employees suspected of misusing company information or committing fraud. While a tip that an employee is up to no good often triggers an investigation, other information, such as threatening social media postings or online leaks of confidential information, also can prompt an investigation.

Regardless of how an investigation starts, social media analytics can help. In the case of suspicions against particular employees, analytics might pull together social media profiles to determine what they're saying online, whom they're connected with and whether they've undergone any changes in lifestyle (for example, buying fancy cars or homes, or taking luxurious vacations). If you're looking into anonymous threats, leaks or the like, analysts can use the tools to get the name behind the accounts.

Of course, social media analytics isn't limited to the online presence of the parties or others implicated in the litigation — you also can use it to improve your jury selection. Social media may reveal employment histories; education; connections to the parties; political affiliations, hobbies and interests; opinions on relevant issues; and other information that could affect how a juror views your case.

What do you have to lose?

Social media data can make or break a case these days — if you manage to ferret out the critical information. Social media analytics can assist you in identifying relationships and unearthing information you could spend months looking for manually and still miss. ■

Clean sweep

Check for fraud and get your house in order

Many businesses tackle housekeeping chores at year end — whether that involves tax planning, streamlining operations or, more literally, office cleanup. Consider adding one more task to your year-end list to ensure your organization isn't being impaired by fraud: Ask a forensic accountant to conduct a fraud sweep of your company. A fraud sweep can both pinpoint weaknesses in internal controls and uncover ongoing losses that may be going unnoticed.

What are the signs?

There are hundreds of ways to commit fraud, and the signs aren't always obvious, especially to company insiders who are accustomed to how the business operates and may not be aware of best practices for internal controls. A thorough, objective review performed by an outside forensic specialist can unveil suspicious losses that may indicate fraud. It also can identify internal control weaknesses that may leave a business vulnerable to fraud perpetrators.

Among the documents a fraud expert will examine are bookkeeping records, invoices, bank statements, payments, journal entries and financial reports. Management can assist by ensuring easy access to records and personnel — and by paying attention to how long it takes employees to produce documents. If some records are missing, management needs to ask why and what steps employees took to find them. Documents that can't be located are a red flag for fraud.

What doesn't feel right?

Forensic accountants are trained to recognize the signs of doctored, forged or missing documents, or anything that doesn't "feel right." For example, an unusual number of journal entries posted near the end of the fiscal year could be adjustments made to cover theft or misappropriation.

> A thorough, objective review performed by an outside forensic specialist can unveil suspicious losses that may indicate fraud.

Adjustments to receivables and payables are possible signs that employees are misappropriating customer payments or engaging in billing schemes. Another red flag is out-of-balance books. An end-of-year physical count of merchandise or a reconciliation of cash can bring missing assets to light.

Forensic accountants pay particular attention to payroll documents. Missing or otherwise unaccounted-for employees could indicate the presence of "ghost" employees. Management can help to expose such schemes — in which perpetrators pay nonexistent staff members — by personally handing out year-end paychecks or bonuses (or paper stubs if employees have their checks direct deposited). Any leftover checks merit further investigation.

Management should also observe employee behavior. Fraud perpetrators often avoid taking vacation or sick time for fear someone will uncover their activities in their absence. And thieves may seem

irritable or defensive when asked to comply with an organized fraud sweep.

How do you deal with it?

If something appears suspicious, businesses must be willing to confront it — and resist the temptation to explain away exceptions. If an employee is caught, management shouldn't assume that this employee is the only culprit. Unfortunately, fraud schemes often involve more than one person. And people outside the company or a combination of employees and outsiders may commit fraud.

But warning signs don't always lead to a thief. Genuine errors or an ill-designed process may explain accounting irregularities. Better training, process improvements or fortified controls can help correct honest mistakes and prevent future problems.

If a company hasn't already established a system for employees, vendors, customers and the public to report suspicious activities, it should do so. Confidential hotlines, while not required of private companies as they are of public ones, have cut fraud losses by a median of 50%, according to the Association of Certified Fraud Examiners.

Experience matters

There's no way to know for certain whether fraud has managed to creep into your operations. That's why a fraud sweep by a qualified forensic accountant can provide the reassurance you need to end the year well. These experienced outsiders have the necessary objectivity and training to thoroughly investigate accounting records and review internal controls to ensure they're effective at preventing and detecting dishonest behaviors. ■

Failure to value goodwill invalidates nonsolicitation agreement

The value of a private business is instrumental in many legal scenarios, including property settlements in divorce cases, purchase price agreements in mergers and acquisitions, and damages calculations in business litigation. But valuation also may be critical in less obvious matters, like the validity of nonsolicitation agreements, as illustrated by a recent ruling from the California Court of Appeal.

Physician contests nonsolicitation clause

The case, *Monarch Healthcare Inc. v. Orr*, involved a California-based physician who began negotiations to sell her practice to Monarch Healthcare. An appraisal valued her building at $1.7 million, but her medical practice wasn't separately appraised. The buyer (Monarch) indicated to the physician that her practice had no monetary or goodwill value.

They eventually reached an agreement for the physician to sell the building and practice to Monarch and then become Monarch's employee. The arrangement included an asset purchase agreement, a real property purchase agreement and an employment agreement. The real property purchase agreement covered the sale of the building for $1.7 million.

The physician sold the medical practice through the asset purchase agreement for about $35,000. That agreement stated that the assets sold included all of the practice's goodwill but allocated 100% of the purchase price to furniture, fixtures, equipment and supplies. The asset purchase agreement also included a covenant not to compete and a nonsolicitation clause.

> A valuation attached to the agreement included values for several categories and the total of those values equaled the purchase price.

Three years later, the physician terminated her employment with Monarch and reopened her practice. Monarch subsequently sued her. The trial court granted a preliminary injunction prohibiting the physician from soliciting patients but declined to prohibit her from starting a new practice. The physician appealed.

Appellate court finds clause unenforceable

Noncompete and nonsolicitation agreements generally aren't enforceable under California law. But the law provides that such agreements may be enforced when made as part of a transaction for the sale of a business — if the parties clearly indicated that they valued goodwill as a component of the purchase price. The exception is based on the idea that noncompete and nonsolicitation provisions might be necessary to protect the value of the goodwill.

The appeals court pointed out that, though the asset purchase agreement listed practice goodwill as an asset being sold, it also expressly stated that 100% of the purchase price was allocated to furniture, fixtures, equipment and supplies. The parties allocated no part of the price to goodwill. Moreover, a valuation attached to the agreement included values for several categories (not including goodwill), and the total of those values equaled the purchase price. Thus, the court concluded, the nonsolicitation clause wasn't enforceable.

The court dismissed Monarch's contention that the asset purchase agreement must be considered together with the real property purchase and employment agreements. It determined that its conclusion would be the same even if it read the agreements together. The $1.7 million consideration in the real property agreement was entirely for the building, and the consideration in the employment agreement was entirely compensation for services the physician would provide.

Cover your bases

Monarch's failure to obtain a value for the practice goodwill and include it in the purchase price allocation came back to haunt it. When buying a business, enforceable noncompetes and nonsolicitation clauses are often critical to preserving the value of acquired goodwill. During deal negotiations, the parties should hire an objective valuation professional to allocate a portion of the purchase price to goodwill. Failure to do so could invalidate noncompetes and nonsolicitation clauses, depending on state law and the type of business involved. ■

Unlocking the key person discount

Businesses of all sizes — from Fortune 500 giants like Apple to family-owned operations — sometimes rely heavily on one or two key employees. Valuations of such companies may include a key person discount. While such discounts are rare, courts have allowed them in certain cases.

The discount in a nutshell

Key person discounts reflect the reduction in a company's value resulting from the actual or potential loss of a key person. A key person might generate most of the company's revenues; possess intricate technical knowledge, intellectual property, charisma or creative ability; or maintain close relationships with critical customers or vendors.

A discount may be warranted if the loss of the key person is likely to result in significant adverse effects, including lost customers, rising costs and stagnant product development. It's most appropriate when the subject business is continuing (rather than liquidating) and the key person is free to leave the company.

Relevant factors

When estimating a key person discount, valuators generally consider:

- The key person's responsibilities,
- The degree of dependence on the key person,
- The likelihood of losing the key person,
- The depth and quality of other management,
- The availability and likely compensation of a replacement, and
- The risks associated with losing the key person.

The valuator also weighs factors that might offset the loss. Examples include key person life insurance policies and valid noncompete agreements.

The risk of double dipping

Before relying on a valuation that incorporates a key person discount, check that it doesn't account more than once for the risks of losing that individual. Key person risks can be factored into the valuation equation in three ways: 1) through a separate key person discount, 2) by normalizing the company's future income stream, or 3) by factoring it into the discount or capitalization rate (or the pricing multiple).

For example, if the valuator determines the future income stream will decrease as a result of losing the key person, he or she shouldn't also increase the discount or capitalization rate to account for the risk of losing that same key person.

A key component

There aren't many Steve Jobses or Walt Disneys out there. But some lesser-known companies also have owners and employees who play a vital role in their success. Valuators may account for the risks of losing these individuals — whether with a separate key person discount or other adjustments to the relevant methodology. ■

The experience you need. The service you want.

Whether you are dealing with matters of contract disputes, fraud investigations or other economic damages, you need accountants who have extensive experience in preparing and presenting complex commercial cases. In other words, you need Arnie & Company.

For more than a decade, our firm has provided the legal community, business owners and other individuals throughout Texas with prompt, accurate and effective accounting, consulting and litigation support services that include:

- Contract dispute and analysis
- Fraud investigations
- Lost profit analysis
- Securities claims
- Shareholder derivative actions
- Purchase/Sales agreement warranty claims
- Legal and accounting malpractice claims
- Intellectual property analysis
- Other economic damage claims

Arnie & Company has an especially strong depth of experience in the analysis of commercial damages and in conducting forensic investigations. Dennis Arnie is both a Certified Public Accountant and a Certified Fraud Examiner. He has frequently testified as an expert witness in a variety of state and federal courts and various arbitration hearings.

Thanks to the firm's commitment to delivering outstanding service, Arnie & Company has become a trusted advisor to many leading law firms and businesses in the Houston, Dallas, and Austin areas. Our clients include numerous Fortune 500 companies in various industries, as well as significant privately held companies and individuals.

We welcome the opportunity to put our experience and advanced knowledge of commercial damage analysis and forensic accounting to work for you and your clients. Please call us at 713-840-1634 and let us know how we can be of assistance.

Arnie & Company

A PROFESSIONAL CORPORATION OF CERTIFIED PUBLIC ACCOUNTANTS

5100 WESTHEIMER, SUITE 490
HOUSTON, TEXAS 77056