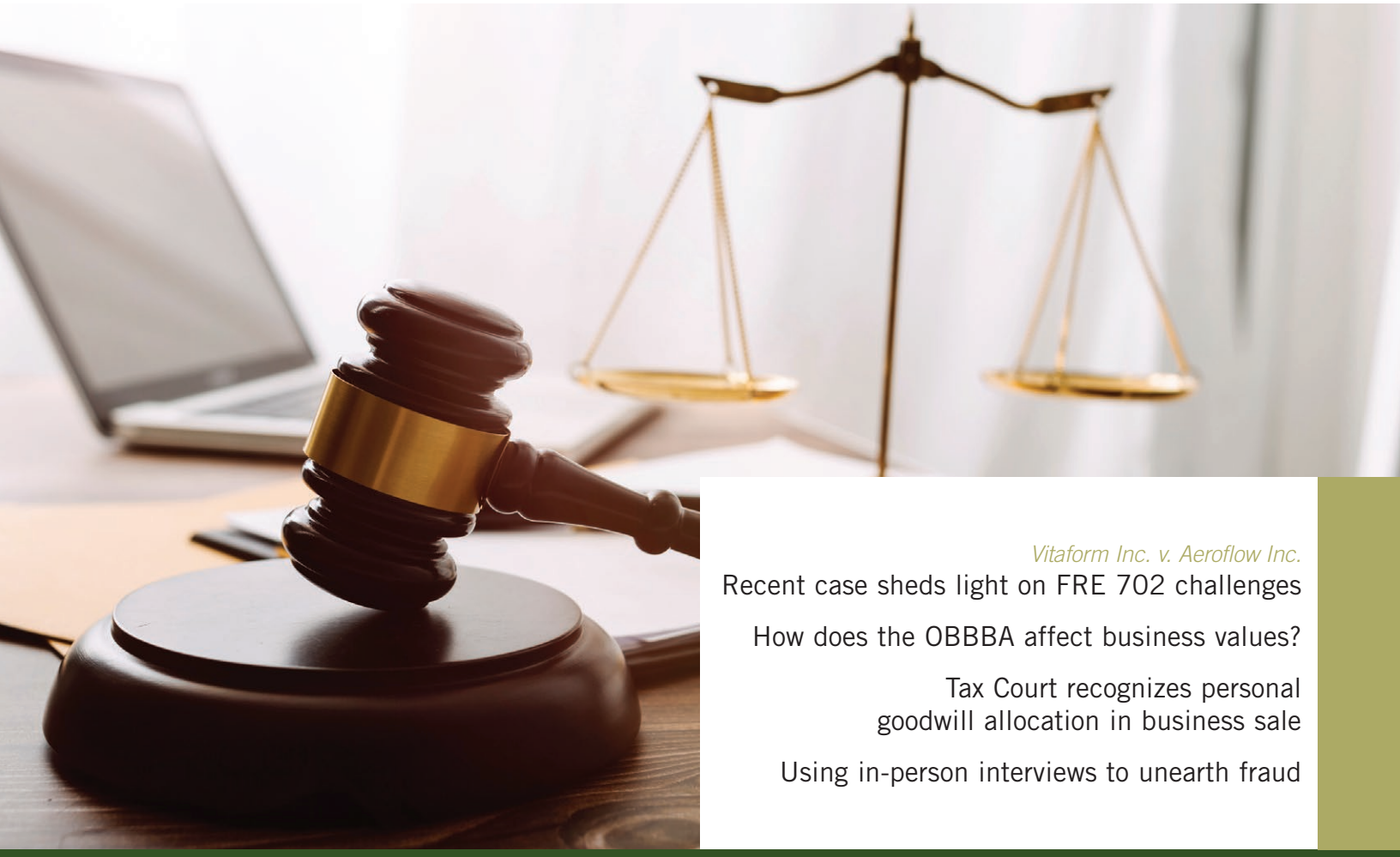
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ADVOCATE'S EDGE



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Vitaform Inc. v. Aeroflow Inc.

Recent case sheds light on FRE 702 challenges

Rule 702 of the Federal Rules of Evidence (FRE 702) provides guidance on the admissibility of expert testimony. Many states have enacted rules of evidence that align with the federal rules. In *Vitaform Inc. v. Aeroflow Inc.*, the North Carolina Business Court excluded the plaintiff's damages expert on relevance grounds under North Carolina Rule of Evidence 702, which incorporates the standard set by FRE 702.

Birth of the dispute

The plaintiff manufactures a line of specialty maternity garments. In 2018, it allegedly entered into an oral agreement for the defendant, a national medical products supplier, to sell the plaintiff's products. The parties also allegedly agreed that the defendant would maintain the confidentiality of the plaintiff's business plan.

The defendant purchased and sold the plaintiff's products for a short period. About a year into the verbal contract, a subsidiary of the defendant began manufacturing its own maternity garments. The plaintiff sued on several grounds, claiming the defendant wrongfully revealed the plaintiff's confidential information to its subsidiary, unfairly allowing the subsidiary to compete with the plaintiff.

Admissible claims

The court dismissed most of the plaintiff's claims, allowing only four to proceed to trial:

1. Fraudulent misrepresentation,
2. Fraudulent concealment,
3. Common law unfair competition and violation of the state's Unfair and Deceptive Practices Act, and
4. Unjust enrichment.

The court specifically dismissed the plaintiff's claims for misappropriation of trade secrets and breach of the covenant of good faith and fair dealing. It concluded that the plaintiff's business plan was already in the public domain when the parties began their discussions.



Misconceived expert analysis

Before trial, the defendant moved to exclude the report prepared by the plaintiff's damages expert and limit the plaintiff's damages evidence.

FRE 702 amendments clarify requirements for expert admissibility

Amendments to Rule 702 of the Federal Rules of Evidence (FRE 702) took effect on December 1, 2023. In *Engilis v. Monsanto Company*, the U.S. Court of Appeals for the Ninth Circuit weighed in on whether the amendments impact pre-enactment challenges to the admissibility of expert testimony.

Here, the plaintiff alleged that exposure to an herbicide manufactured by the defendant caused his blood cancer. Two weeks before the 2023 amendments took effect, the district court excluded the plaintiff's expert's causation opinion. The court ruled that the expert failed to reliably rule out the plaintiff's obesity as a potential cause of his cancer.

In affirming the district court's ruling, the Ninth Circuit addressed the parties' dispute over the significance of the 2023 amendments and their effect on existing precedent. It opined that its decision would be the same under either version of the rule.

The 2023 amendments, among other things, stated that a proponent of expert testimony must establish admissibility *by a preponderance of the evidence*. The Ninth Circuit observed, however, that its precedent confirmed that there's no presumption in favor of admission under pre-amendment case law. While there's precedent for allowing juries to decide on the credibility of questionable expert opinions, the court explained, "'Shaky' expert testimony, like any expert testimony, must still be 'admissible' and this requires a determination by the trial court that it satisfies the threshold requirements established by Rule 702."

In granting the motions, the court noted that the state's evidentiary rule incorporated FRE 702 that "effectively codified" the *Daubert* three-prong test for expert admissibility. The plaintiff in *Vitaform* failed the test's first prong, which requires proposed testimony to be "based on specialized knowledge that will assist the trier of fact to understand the evidence or determine a factual issue." Evidence that doesn't relate to an issue in the case is irrelevant and, therefore, not helpful.

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The court noted that the expert's report analyzed "lost profits and unjust enrichment suffered *as a result of* misappropriation of trade secrets and breach of the duty of good faith and fair dealing." The plaintiff attempted to salvage its expert's testimony, arguing that he also discussed the remaining claims and that "the damages calculation standard applicable to the dismissed claims and the remaining claims is the same."

The court rejected these arguments. It noted the plaintiff's unjust enrichment claim was based on the business plan's value, not the purported profits the defendant allegedly gained by using the plan. However, the expert calculated damages under the assumption that the plaintiff's business plan was a trade secret, so the court excluded the expert's report from evidence.

The expert made no mention of damages flowing from the business plan's value as non-trade secret information and offered no analysis of the remaining claims. He even admitted in deposition that if no trade secret misappropriation occurred, the plaintiff might have suffered no damages.

Delivering reliable testimony

When offering damages evidence, it's not enough that an expert is qualified and uses reliable methods. As *Vitaform* illustrates, it's also critical to ensure that an expert's calculations "match the theories of liability presented." ■

How does the OBBBA affect business values?

The One Big Beautiful Bill Act (OBBBA), enacted in July 2025, contains many tax provisions that build on the changes under the Tax Cuts and Jobs Act of 2017 (TCJA). For most businesses, the OBBBA is less generally disruptive than the TCJA was — but its effects on some entities may be significant. Here's an overview of why taxes matter in a valuation context and how recent federal income tax law changes may impact value conclusions.

The link between taxes and value

When valuing a business, it's important to factor the effects of recent tax law changes into cash flow forecasts. Unfavorable federal tax law changes — for example, increased tax rates or disallowed deductions — generally reduce future cash flows and, therefore, value. Favorable changes have the reverse effects.

Some changes don't necessarily reduce taxes; they just *defer* them. Tax deferrals, such as accelerated depreciation allowances, can increase business value for various reasons. One is the time value of money: A dollar saved today is worth more than one saved in a later year. Another is that businesses can reinvest tax savings in growth opportunities. For instance, they might buy new equipment or hire additional workers. Tax savings can also be used to pay dividends or repay loans; these strategies, in turn, may impact investors' risk perceptions and companies' future capital structures.



OBBBA tax breaks

Most OBBBA provisions that impact businesses and business owners are favorable. Key examples of changes that will likely increase future cash flows or defer tax obligations are:

Permanent expansion of the QBI deduction. Many sole proprietorships and pass-through entities (partnerships, S corporations and most limited liability companies) received a tax cut under the TCJA. In addition to lowering individual tax rates for most brackets, it created a deduction for owners of these entities of up to 20% of qualified business income (QBI). Eligibility for the QBI deduction depends on the nature of the business and the owner's share of 1) W-2 wages, 2) basis in qualified property, and 3) pass-through income. Under the TCJA, the QBI deduction was scheduled to expire

after 2025, but the OBBBA made it permanent, along with the TCJA's individual tax rates. Additionally, starting in 2026, the new law increased the phase-in ranges for the income-based limits on the QBI deduction.

Expanded first-year deductions for fixed asset purchases. For 2025, the Section 179 deduction doubled to $2.5 million, and the phaseout threshold increased to $4 million. These changes are permanent under the OBBBA, and the amounts will be adjusted annually for inflation.

The OBBBA also permanently reinstated 100% first-year bonus depreciation on qualifying new and used property acquired and placed in service after January 19, 2025. Before the OBBBA, 40% first-year bonus depreciation could be claimed for qualified assets that were placed in service in calendar year 2025.

Reinstatement of domestic R&E expensing. Under the TCJA, businesses were required to amortize domestic research and experimental (R&E) costs over five years (15 years if incurred outside the country). The OBBBA permanently allows the immediate deduction of domestic R&E expenses, beginning with the 2025 tax year. However, foreign R&E expenses still must be amortized over 15 years.

Liberalized rules for business interest deductions. Under the TCJA, business interest deductions were generally limited to 30% of adjusted taxable income (ATI). Starting in 2025, the OBBBA increased the limit on the business interest deduction by excluding depreciation, amortization and depletion from the computation of ATI.

Not all changes are favorable

Don't assume that every company's value has increased under the OBBBA. The new law may increase tax obligations for certain entities. For instance, multinational companies and those with non-U.S. shareholders may be adversely affected by changes to the international rules under the OBBBA, which take effect in 2026. The new law also repealed certain clean energy provisions and increased scrutiny of Employee Retention Credit claims.

The OBBBA's effects vary from company to company. Work with an experienced valuation professional to evaluate how the recent tax law changes affect business cash flows. ■

Tax Court recognizes personal goodwill allocation in business sale

The U.S. Tax Court in *Huffman v. Commissioner* acknowledged that a significant portion of business sale proceeds may be allocated to an individual shareholder rather than the business itself. The ability to treat a portion of the purchase price as payment for personal goodwill is significant because that amount goes directly to the shareholder, potentially avoiding entity-level tax. That treatment allows the allocated portion to typically be taxable to the shareholder at more favorable capital gains rates.

All in the family

This complex case involved a family-owned aerospace manufacturing company incorporated in 1958. The founders' son became its CEO in 1987 and, pursuant to various right-to-purchase agreements, eventually acquired 100% of the company's stock. The Tax Court found that the agreements, which allowed the CEO to purchase stock for less than fair market value, generated substantial taxable gifts.

Under the CEO's leadership, the company expanded its products and implemented new strategies to acquire and retain customers. By 2006, the company's revenue had grown to more than $28 million (up from roughly $5 million in 1987).



Purchase price allocation

In 2009, the company sold its assets to another firm for $95.75 million (plus an earnout of up to $60 million). Under the purchase agreement, the assets sold included "all goodwill associated with the Business, including any personal goodwill of [the CEO]." As part of the sale, the CEO signed a four-year noncompete agreement with the buyer.

The purchase agreement required the buyer to have an investment bank and advisory firm value the assets and allocate the purchase price among them. It also required the seller to engage an independent valuation expert to properly allocate a portion of the purchase price to the CEO's personal goodwill.

The investment bank allocated just over $50 million to goodwill. The seller's valuation expert opined that the CEO's personal goodwill was worth $21.8 million, attributing $17.4 million to the CEO's client relationships and $4.4 million to his employee relationships.

Tax Court's ruling

The IRS said no value could be attributed to the CEO's personal goodwill because he wasn't a party to the purchase agreement. As a result, the IRS argued, personal goodwill either wasn't properly transferred to the buyer under the agreement or was already owned by the seller. Thus, the corporate seller should have reported the personal goodwill amount as capital gain from the business sale, and the CEO should have treated it as a constructive dividend, taxable at ordinary income tax rates.

The Tax Court dismissed the IRS's argument, finding that the CEO had created personal goodwill through his relationships with customers and key employees. Moreover, because the CEO had no prior employment agreement with the company, he hadn't transferred it to the company before the sale. The court determined that the parties — through the purchase agreement and related noncompete agreement — successfully allocated a portion of the purchase price to the CEO for his personal goodwill.

The court found the valuator's methodology sound. However, it made some downward adjustments to the value of personal goodwill, finding that the corporate seller should have reported a portion of it as part of the purchase price and the CEO should have reported that amount as dividend income.

Cultivating goodwill

Huffman demonstrates that, under the right circumstances, a shareholder can sell personal goodwill directly to a business buyer. To achieve the desired tax treatment, the parties should ensure that the transaction documents 1) include a noncompete (or similar agreement) with the shareholder, and 2) direct the allocation of proceeds between personal and enterprise goodwill. Even with a written allocation, the IRS may challenge the amount, and the Tax Court may reallocate part back to enterprise goodwill. So it's critical to obtain an independent valuation to support the purchase price allocation. ■

Using in-person interviews to unearth fraud

Virtual interviews have become commonplace in today's business world. But when the objective is to investigate *fraud*, they're often a poor substitute for face-to-face conversations. Forensic accountants are trained to use specialized interview techniques to spot warning signs, test suspicions and gather reliable information when it matters most.

Blind spots behind the screen

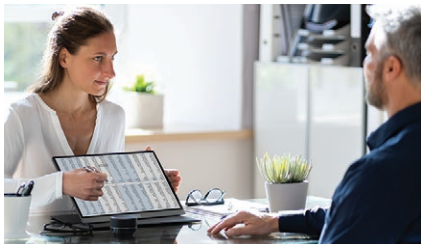
Virtual interviews can be useful as preliminary fact-finding tools. But when behavioral assessment matters, face-to-face interaction can provide clearer, more reliable insight. In-person interviews allow investigators to observe subtle verbal and nonverbal cues that are often lost or distorted in virtual settings. Behaviors that are best assessed without screens, filters and technical distractions include:

- Shifts in speech patterns, such as changes in pace, tone or volume,
- Evasive or overly qualified answers,
- Repeated claims of honesty,
- Fidgeting or restlessness,
- Facial indicators, such as covering the mouth, unusual blinking or lip biting.

Importantly, these signals may warrant further investigation, but they don't necessarily prove fraud. People may appear nervous during interviews for legitimate reasons. Innocent employees may hesitate, deflect or withhold information due to fear of retaliation, loyalty to colleagues, embarrassment or uncertainty about their role.

Inside the interview room

Experienced interviewers start with simple, factual questions to establish rapport and create a behavioral baseline. As questions become more specific, the interviewer uses that baseline to evaluate the individual's behavioral and verbal responses to distinguish ordinary nervousness from responses that warrant follow-up.



When warning signs appear, trained interviewers don't become confrontational. Instead, they probe subtly for additional details, narrowing the focus to identify what triggered the reaction. This approach helps determine whether interviewees are protecting themselves, covering for others or reacting to unrelated issues. The objective is clarity, not accusation.

Fraud rarely reveals itself in a single conversation. To understand what's really happening inside an organization, fraud investigators must speak with people at multiple levels and functions. By comparing responses across roles and departments, they can identify corroborating details, contradictions or unexplained gaps that merit deeper review.

Equally important is asking broad, open-ended questions. When interviewers allow company insiders to describe things in their own words — without leading questions — previously hidden risks often surface organically. This holistic approach provides a clearer picture of how fraud might occur, who may have knowledge of it and where the organization is most vulnerable.

Turn interviews into insight

When investigating fraud, every conversation counts. Through effective face-to-face interviews, an experienced forensic accountant can uncover details others overlook and connect the dots across the organization. Partnering with a trained specialist helps preserve vital evidence, resolve current concerns and strengthen the business's antifraud controls. ■

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