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# Forensic Accountant

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ADVISORY

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How good is expert determination as an alternative dispute resolution process?

Television rights and the expert witness: a case study from Spain

Tracing a company's descent into bankruptcy and the role of the expert witness: a case study from Switzerland

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## Editorial

Welcome to the winter 2010 edition of *Forensic Accountant*, KPMG's magazine exploring some of the key issues currently impacting the litigation and dispute resolution landscape.

**As we move out of the global recession and into a period of recovery, reflection and re-evaluation of business models, the legal landscape around much of the world is likely to shift to mirror what is happening in the corporate sector.**

Many organisations, individuals and groups will feel that they finally have a degree of comfort and time to consider how their operations have been impacted by the seismic events of the last 18 months or so, and what if any legal recourse is open to them where they feel they have suffered by the action or inaction of others.

One area where this may have already begun is within the hedge fund market. Funds have collapsed or run into trouble since the onset of the financial crisis, and now investors

have been moving to claim against both funds and their managers. The intricacies of the funds in question and the difficulties in 'unpicking' them to discover both liability and quantum – not to mention the sums of money involved – means that these can be complex and long-running. Our lead article explores some issues that have already arisen.

Continuing our sector focus, the hi-tech industry is one which has historically been quite litigious. The turbulence in the global economy is only likely to exacerbate this. Two of our sector experts explore what causes technology companies to sue each other, and why technology itself is often at the heart of legal action.

It has long been recognised that many high net-worth investors move their wealth out of their national financial markets into other jurisdictions for tax purposes. A multinational KPMG team of forensic and tax experts explore what US legislators and agencies are doing to try to counter this trend amongst their own citizens. In our next edition, we will explore this particular issue from a UK perspective.

The popularity of alternative dispute resolution has been growing steadily over recent years, and this is in particular focus since money and time constraints may compel both courts and the parties themselves to look outside the courtroom for resolution of their dispute. We take a closer look at expert determinations – one such ADR mechanism – both from a UK and Spanish perspective, to compare

its strengths and weaknesses against 'traditional' litigation.

Finally, we continue our series of articles focusing on the litigation landscape in one of the countries within KPMG's European network. Following on from Spain in the previous edition, we now turn our attention to how the German judicial system works and the types of commercial disputes that typically occur there.

We have supplemented these articles with two case studies – one from Switzerland, the other from Spain – to illustrate how some of the issues we discuss in *Forensic Accountant* manifest themselves in practice, and what we as forensic specialists do to help the parties and their legal teams arrive at a fair and equitable resolution.

I hope you enjoy this diverse edition of *Forensic Accountant* and would be delighted to hear from you should you have any questions or feedback on the articles, as well as suggestions for future editions. FABs



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## Hedge fund disputes: a year in review

Nicholas Good

Claire Stewart



It has been widely reported that the turmoil in the financial markets hit some hedge funds hard, with several running into trouble or collapsing completely. The obvious and considerable scope for a plethora of legal action from investors, both against funds and fund managers, led many to predict a flood of litigation. Nicholas Good and Claire Stewart from KPMG Forensic in the UK explore whether this has actually materialised, as well as considering what can be discerned from some of the cases seen so far.

### Introduction

As the full extent of the financial crisis, and its wide-reaching impact, started to become clear, many expected to see a significant increase in disputes arising in the financial sector: a 'tsunami of litigation', as some commentators have described it. However, it would probably be fair to say that the anticipated volume of litigation, certainly in Europe, failed to materialise in the first 12 to 18 months following the start of the economic downturn in August 2007. In many cases the first priority has been for organisations to attempt to minimise their own losses and ensure their business is secure, before starting to consider entering potentially lengthy litigation or arbitration, with the costs and risks that this entails.

This has applied to an extent to the financial sector, although there has been a trickle of disputes. The majority of those seen at the moment have been led by investors, less concerned with relationships with their counterparties (unlike the large banks). In the case of large investors they are often driven by the need both to comply with their fiduciary duty to their own investors to identify reasons behind any loss in value, and to seek out who is to blame. This is likely to continue apace as the fall-out from the financial crisis continues.

This certainly applies in the hedge fund industry although, as much of the industry operates behind closed doors, the extent of the issues that have arisen is not clear. Whilst doubtless a large part of the industry has weathered the storm without generating disputes, the very number of stakeholders means there is potential for disputes involving many different parties including

investors, fund managers, third party administrators, advisors and auditors.

A number of trends have emerged in the types of disputes we have seen, and been involved with, in the hedge fund market since the financial crisis began. Some key examples of these include:

- Fraudulent activity
- Mismanagement of assets
- Misrepresentation of the value of the fund's assets

### Fraudulent activity

The general economic decline has led to instances of fraudulent activity increasingly coming to light within the hedge fund industry. We have seen investors, motivated by the widespread fall in investment values, attempt to redeem their investments only to discover in some cases that those involved with the fund, such as the investment manager, have been engaged in fraudulent activities and the true value of the fund is negligible. High profile examples include, of course, the alleged massive Ponzi schemes such as those set up by Bernard Madoff and Allen Stanford.

In recent months, further examples of alleged fraud within hedge funds and fund of funds have emerged in the public domain, including several instances of individuals accused of insider trading and securities fraud. In one well-publicised case, an alleged fraudster has been reported in the press to have defrauded several well known banks out of a total of around US\$400 million following their investment in a fund of funds.

“The industry may be moving forward again but will not so easily be able to shake off the legacy of claims and disputes arising from past issues”.

#### **Mismanagement of assets**

As asset values fell and investors made significant losses, there has been a strong trend towards claims around the mismanagement of assets and breaches of mandate, for example claims relating to the alleged misrepresentation of investment strategy.

A recent example that has emerged is the case of Dynamic Decisions Capital Management. In this case the fund is, at the time of writing, being investigated by the Serious Fraud Office. Investors have accused the fund of mismanagement following the change of investment policy in 2008, which it is alleged led to investments which were not only outside of the mandate but also of no value. There has been speculation that the unaudited value of the fund is not indicative of the true value, and the master fund has been unable to pay a number of redemption requests. As investors attempt to recover their losses, allegations of mandate breaches and claims, such as investments into complex products that were not fully understood, are only likely to increase.

Furthermore, additional cases where fund managers have attempted to hide their bad decisions and poor performance by falsifying information provided to investors may also start to emerge. However, following the recent not guilty judgment in the criminal trial against the former Bear Stearns' fund managers accused of deliberately misleading investors regarding the state of their investments, there are indications that investors will need to carefully consider whether there is sufficient proof of mismanagement. The two individuals were accused of having lied to their investors about two mortgage-related funds which subsequently collapsed in 2007,



costing investors around US\$1.6 billion in losses. To date they have been the only individuals working on Wall Street to face criminal charges arising from the sub-prime crisis, and the case demonstrates a number of the difficulties associated with bringing complex white collar crime cases.

The judgment was a statement that poor investment decisions alone are not illegal activities. However, the SEC is expected to continue to proceed with its civil case against the two, who will now have to wait and see if the same judgment is reached under the different standard of proof applicable in a civil trial.

#### **Misrepresentation of fund value**

The valuation of the types of complex products that many hedge funds have invested in has become an increasingly contentious activity. This is particularly true given the tendency for the value



of the fund to determine the fees paid to the investment managers, which has led to claims relating to the overstatement of the value of funds.

A further complexity in the valuation of hedge funds is the trend towards counterparties adding large liquidity premiums in an attempt to protect themselves against adverse market risk on closing out illiquid trades. It can, however, be difficult to distinguish between fair liquidity premiums and those added simply to take advantage of the chaos in the market to extract value from a fund in trouble.

As well as the manager, advisors and service providers are also potentially exposed to this type of litigation brought by investors seeking to recover their losses. This was recently seen in a settled arbitration case brought by a former hedge fund client against its third party administrator.

### Conclusions

The year 2008 was described as an "annus horribilis" for hedge funds by Alexander Ineichen, Managing Director and Senior Investment Officer at UBS Asset Management. However, returns in 2009 have at the time of writing been positive (7.9 percent January to October 2009 for the Eurohedge Composite Index compared to -5.1 percent for 2008). New fund launches have continued. Nevertheless, the events of 2008 have left a mark on the industry with side-pockets and gated funds still not fully dealt with and a number of investors left wondering what happened. The industry may be moving forward again but will not so easily be able to shake off the legacy of claims and disputes arising from past issues. FA35



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How good is expert determination as an alternative dispute resolution process?

Nick Andrews

Fernando Cuñado

Nick Andrews, UK Head of Dispute Advisory Services at KPMG Forensic, has been involved in many expert determinations, both as an adviser and the Expert Determiner. He outlines their characteristics as a viable form of ADR in the present commercial landscape. Determinations are also increasingly popular in Spain, and Fernando Cuñado from KPMG Forensic in Spain presents the Spanish perspective.

To quote Lord Justice Dyson in the foreword to the standard UK legal work on expert determination, "Determination by experts is now established as a well-recognised means of resolving disputes in almost any area of commercial life."<sup>1</sup>

In the accountancy profession, that is certainly the case. As recently as 15 to 20 years ago, expert determinations were mostly confined to post-completion disputes following a corporate acquisition. It became the norm for the dispute resolution mechanism set out in sale and purchase agreements, pertaining to the finalisation of the completion accounts following the transaction, to include the appointment of an independent expert accountant to determine any disputed items arising.

Since then, the use of expert determination has increased to resolve disputes in many other commercial situations. By way of illustrating this point, I personally have acted in the determination of the following wide range of matters:

- The treatment of items in post-acquisition completion accounts
- The amount due under an earn-out agreement by way of deferred consideration in a transaction
- The bonus due to a departing director of a property development company
- The allocation of commuter season ticket revenue between two companies operating trains on a common railway line into London
- The market value of a national telecommunications business following its renationalisation by the Government of the country concerned
- The value of one party's shares upon termination of a joint venture in the capital goods industry
- The price of beer in a supply agreement
- The cost of rectifying a host of property dilapidations

This certainly demonstrates the flexibility of the expert determination in successfully resolving a wide variety of disputes. In all these scenarios, the ultimate forum to resolve a dispute would be litigation through the courts of the relevant jurisdiction. That would very much be a last resort these days, the parties having disregarded the provisions of the contract between them to use an expert determination. It tends to be a very rare occurrence that the curtailed dispute resolution mechanism is not used when a dispute arises.

So, what are the benefits of expert determination? It is worth noting by way of caveat that the right circumstances need to be present to use this form of ADR, and that often litigation may be the most appropriate dispute resolution process – one size does not necessarily fit all.

#### Why do expert determinations work?

- 1 The first positive characteristic of expert determination, in common with other forms of ADR, is the privacy afforded the parties by the confidential nature of the process and the result, in contrast to the publicity that typically accompanies litigation and court hearings.
- 2 Secondly, where a commercial dispute pertains to an issue or a series of issues that are clearly in the domain of a specific professional discipline, such as accountancy, quantity surveying or engineering, a more efficient and informed process can often result from the matter being determined by a specialist in that discipline rather than by a Court.
- 3 Thirdly, the time taken from start to finish of the process for the parties to obtain a decision is generally much quicker than litigation. Indeed, in one case where I was the expert determiner, the parties required a decision within three months of my appointment in order to be able to comply with US SEC accounts filing rules. So I devised a timetable and framework, agreed by the parties, to achieve this. Afterwards, one of the legal representatives

commented that the process had been a revelation in that they had got a decision on a complex, finely balanced set of disputed items in the time it would ordinarily have taken in litigation to get a summary judgment!

- 4 Expert determinations are (in my experience) nearly always exclusively paper-based exercises. They involve the submission by each party of written reports and arguments with supporting documentary evidence and there is seldom need for witness statements or oral hearings. This is a great saver of management time and stress, as well as helping to facilitate a positive, less adversarial environment.
- 5 Allied to the time factor, expert determination is a lot less costly than litigation. Although the parties will still need to appoint lawyers and expert advisers, the expert determiner's own costs will be far less than those of a Court, whilst the time factor should mean that the parties' expenditure on professional advisers will be less.
- 6 There can be flexibility in the precise specification of the determination framework from case to case. Typically, following appointment of the independent expert, there will be a dialogue between him or her and the parties as to the process to be followed, for instance in terms of numbers of rounds of submissions, or whether exchange shall be sequential or simultaneous. Often there can be a process specified in the underlying contract under which the dispute has arisen; however it may be that certain steps in the process need refining once a 'live' dispute has arisen. The expert will have the final say on this, but the parties will be able to make representations to him or her in arriving at an agreed framework for the determination.

<sup>1</sup> "Expert Determination" by John Kendall, Clive Freedman and James Farrell, 4th edition, June 2008.



- 7 Despite being a 'streamlined' form of dispute resolution, expert determiners – like judges, arbitrators and mediators – recognise, in reaching their decision, the paramount importance of the contractual terms of the agreement under which a dispute has arisen, and the importance of the evidence presented.
- 8 If the parties so choose, they can ask for the expert to produce a written reasoned determination, so that they can see how the result came about. Or, they can ask the expert to give a one-line determination, without reasons, just giving his decision – this is even cheaper. It's ultimately the parties' choice.
- 9 As with other forms of dispute resolution, the expert determiner does not have to operate in complete isolation. It can be necessary to seek independent legal advice on the interpretation of the subject contract – and such advice can be shared with the parties. Similarly, if there is an aspect of the dispute that requires the expertise of another professional discipline, then the independent expert can bring in that expertise. An expert could and should consult with colleagues if he considers that his decision on a particular issue could benefit from professional brainstorming, or input from a colleague with specialist knowledge on a particular aspect.
- 10 Finally, and of particular note, in an expert determination the expert's decision is intended to be final and binding on the parties, giving them absolute certainty and the chance to move forward from it. Generally, this is a positive.

However, if a party feels it has been the victim of a palpably bad decision, an expert's determination can be challenged in Court on the grounds of manifest error. This is a very rare eventuality, a fact that itself endorses expert determinations as a wholly attractive, and proven, form of ADR.

In conclusion expert determination, in the right circumstances, is often a viable alternative to litigation, and serves an important purpose in helping to relieve pressure on Courts. Its use will continue to grow, providing expert determiners continue to dispense the highest standard of 'justice' and gain the endorsement of lawyers around the world: the latter have a big part to play advising their clients who are – or might become – involved in expert determinations. FA36



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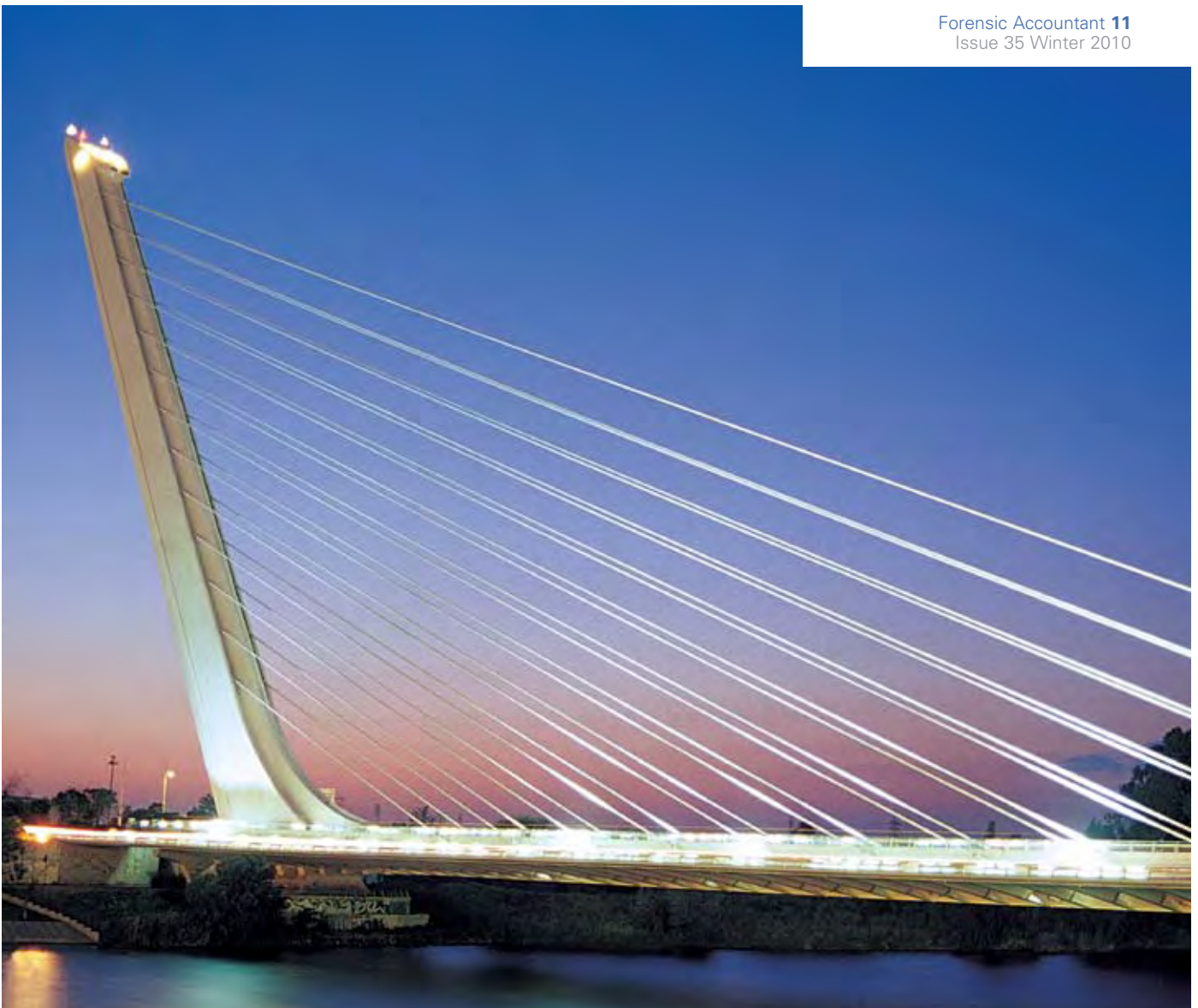
### The view from Spain

Spanish expert determination work is typically undertaken within the context of a dispute following, or in the process, of a merger or acquisition. Nevertheless, as in the UK we have witnessed the emergence of a wide range of matters that require determination. To this end, within the issues presented to us for determination which go beyond the 'classic' price adjustment mechanism (for instance earn outs, working capital, net debt or assets), it is often necessary to carefully evaluate the so-called 'grey areas' that might be inferred from the underlying spirit behind the original agreement, whose clauses and definitions are not always absolutely consistent or simultaneously applicable.

It is our view that the disputes resolved under the scope of an expert determination are becoming more complex, and the parties' position being more polarised, especially in the current climate of financial and economic uncertainty. At the same time, we are seeing a rise in expert determinations due to the increase in the use of ADR as opposed to litigation; a trend perhaps related to the desire to save time whilst maintaining and preserving a business relationship.

There is no doubt that clarity of reasoning and solid supporting technical evidence are two pre-requisites for a good expert determination. It is crucial to understand the positions put forward by each of the parties involved, and to highlight the main issues of dispute; all of this is based on an accurate and solid methodology and criteria, thereby reinforcing the expert opinion and subsequent conclusions which will underpin the final position.

The expert determiner can run the risk of reaching a 'happy medium' between the positions assumed by the parties. This should be avoided. A sound, evidence-based approach that accords with the terms of the contract in question, as well as the applicable accounting or valuation principles, is crucial to ensure precise and numerically accurate conclusions are reached, even when this may mean agreeing fully with the position of one of the parties. This may lead to dissatisfaction on the part of the party that considers it has 'lost', but this risk is considerably outweighed by the need to maintain the main advantages offered by an expert determination: namely, a fast, fair, independent and binding judgment.



## Television rights and the expert witness: a case study from Spain

### *Some background*

Our client, a leading media group, filed a claim against a Spanish football club for breach of a television rights contract, specifically relating to the unilateral withholding of specific sums of money obtained from the club's participation in a European competition.

These amounts were paid in the form of bonuses, and were based on the club's performance in the competition. From the club's perspective, if it was eliminated in the early rounds, the application of the contract would be financially beneficial. The opposite would be true if it reached the latter stages of the competition, in which case it would be obliged to pay out a considerable amount.

During the years where the club performed modestly in the competition, it adhered strictly to the contractual conditions. However, in those years where the club performed well, it allegedly retained the bonuses it had earned - a situation which led to some discrepancies and ended in the unilateral termination of the contract by the football club and the subsequent filing of the claim by our client.

The termination of the contract was based on the opinion of the club's legal advisors, supported by an expert witness report which set out the main figures regarding the cash flows and other financial information relevant to the application of the contract terms.

This report also attempted to reflect the 'full' legal considerations justifying the actions of the club, concluding that they were somehow in line with the terms of the contract as well as relevant legislation.

#### The case details

Our client requested our assistance to assess, from an independent perspective, the accuracy and completeness of the cash flows included in the expert witness report presented by the club and to prepare a responsive report exposing any flaws in the methodological and financial aspects supporting the data. To do so, we (amongst other things) gathered together the relevant sources of information and undertook an in-depth analysis focusing on the television rights money split between the clubs, and the procedures used to distribute these amounts.

Some differences were detected when comparing the cash flows included on the expert witness report submitted by the club with the figures obtained from the sources of public information. Subsequently, this aspect was challenged in the court with the Judge considering our sources more reliable due to their independence and public accessibility.

Notwithstanding the above, the key area of challenge within the opposing expert's report was the nature of the legal considerations included, which were crucial to the resolution of the litigation.


These considerations, which we considered to be both superficial and unsupported, were subsequently opined on by their expert witness, who appeared more concerned with displaying his commitment to his client than with the risk inherent in his position.

Under questioning by the Judge, the expert witness was forced to admit that he was unable to conclude on the legal interpretation included in his report, which cast an extremely negative shadow over his independence and credibility. Our report was preferred by the court, with the Judge ruling in favour of the media company and against the football club on all counts. Given the two parties involved, the ruling received significant media coverage, adding an element of public 'notoriety' to the club's unfavourable result.

**There were two notable aspects to this case which are worth particular mention.**

Firstly, in this period of financial uncertainty many 'intangible' corporate and financial assets (in this case television broadcasting rights) are being revalued.

The value of these intangible assets is mostly based on future expectations and, therefore, often involves a high level of subjectivity. Our view is that in the current climate and outlook, both generally pessimistic, parties tend to change automatically – and sometimes dramatically – the valuation of intangible assets, to a degree which would not otherwise have happened.

Secondly, the position taken by the opposing expert witness with regards to the legal elements in his report made it necessary to consider the relative merits of the opposing arguments, ensuring that the expert ends up with what is a 'reasonable', fair and evidence-based position. Our view is that it is both insufficient and unacceptable to take a formal position without the arguments required to defend that position before the court or opposition counsel. The overriding duty of an expert witness is to the court, so taking an ultimately indefensible stance jeopardises the position of the client, not to mention the expert's personal credibility. 

**“In the current climate and outlook... parties tend to automatically – and sometimes dramatically – change the value of intangible assets.”**



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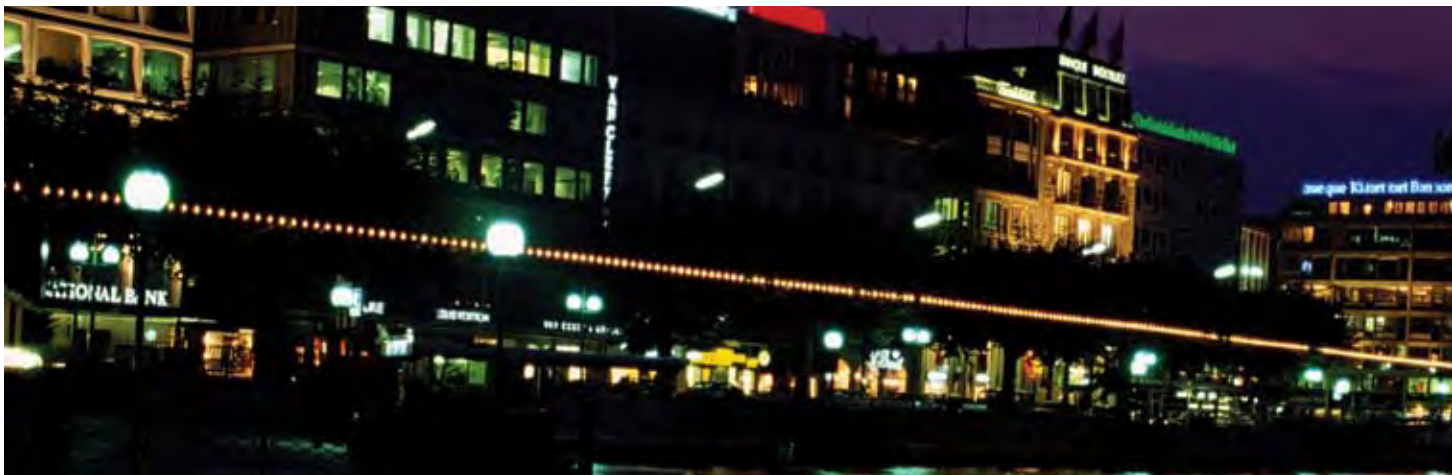
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Tracing a company's descent into  
bankruptcy and the role of the  
expert witness: a case study from  
Switzerland

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### *Some background*

Approximately one year after the global financial crisis took hold in Switzerland, there has been a significant increase in the number of corporate bankruptcy cases – it is expected that they will exceed 5,000 in 2009, an unprecedented number in a calendar year. In Switzerland senior management, directors and external auditors must meet specific requirements when describing the financial health of a company; they must also undertake certain prescribed actions when a company experiences financial difficulties to protect shareholders and creditors<sup>1</sup>.

If a company fails to undertake legally required actions on a timely basis, significant financial damages may result. In many cases, this delay is recognised as a cause for civil liability claims against the company's management, directors and external auditors<sup>2</sup>, as well as for criminal prosecutions against these individuals<sup>3</sup>. If an action is filed against the company's management, directors and/or its auditor, the central question is usually at what point in time the company should have recognised and declared its over-indebtedness to the commercial court.

Furthermore, the last revision of the Swiss Code of Obligation that became effective on 1 January 2008 specified that under certain circumstances companies (stock corporation, limited

liability and co-operative) do not need to have an audit.<sup>4</sup> This may lead to even more declarations of over-indebtedness being improperly delayed, since those companies will not have an auditor legally obliged to take action in such situations.

#### **The case details**

This case study relates to an expert opinion that KPMG Forensic in Switzerland was asked to give to a Swiss court to establish the critical point at which the liabilities of a recently-bankrupted corporation had exceeded its assets for the first time. Specifically, the court asked KPMG's forensic expert to identify, from analysis of relevant corporate data, the hypothetical point in time of the over-indebtedness, and to calculate

the theoretical damage caused to shareholders and creditors<sup>5</sup>.

The accounting files and other documents to be analysed contained fragmented, unstructured records spread across three separate geographic locations. We had been asked to give an initial opinion as to whether it would be possible in these circumstances to determine the point of over-indebtedness. To answer this question, we first collected and scanned all potentially relevant documents, converting them into electronically-readable files using specialised software.

A key factor in compiling the expert opinion was identifying and analysing the available information relating to the Board-approved annual financial

<sup>1</sup> As defined in the articles 725 and 725a of the Swiss Code of Obligations.

<sup>2</sup> Under articles 754 – 755 of the Swiss Code of Obligations

<sup>3</sup> According to article 163 et seq. of the Swiss Penal Code

<sup>4</sup> Art. 727a, para2 code of obligations, so-called 'opting out'. Requirements for opting-out:

- Not a publicly-listed company

- The company does not exceed certain financial thresholds during two successive financial reporting periods (balance sheet sum of less than CHF 10 million / annual turnover of less than CHF 20 million)

- less than an annual average of ten full time employees

- approval of all stockholders

<sup>5</sup> Before this civil proceeding took place, a criminal case had been conducted in which a number of company Directors had been convicted of embezzlement and other offences.



“Based on the documentary evidence and the significant number of adjustments identified, we concluded that the hypothetical point in time at which the over-indebtedness occurred was eight years before the actual filing of the Company’s financial statements.”

statements for a period covering the previous eight years (including sample and draft balances, reconciliation schedules, general ledger accounts, accounting journals and vouchers which had been used to create the statements). Further information was obtained from commercial registers and debt enforcement officers to confirm the accuracy of the entity’s liabilities.

Subsequently, all documents judged potentially relevant from the first screening were reviewed, structured, tagged, grouped using key words, logged and allocated to the fiscal year to which they applied. This pool of information consisted of over 800 different financial and non-financial documents (accounting files, correspondence, meeting minutes, bank statements, expert opinions and police reports from the criminal proceeding). This information was meticulously analysed, interlinked and pieced together to obtain a factually-based picture of events and timeline for each financial year. We found that apparently non-relevant details, or individual figures and statements, revealed wider connections and helped to understand the bigger picture.

Even though detailed accounting files for previous years no longer existed in

a complete format, the documents we gathered were sufficient to establish the essential balance sheet positions for each of the eight year-end periods examined. Based on these balance sheets, the Board-approved annual financial statements could be adjusted to determine the true equity position for each year. Using this analysis, the KPMG expert witness concluded that it was possible to reliably determine the hypothetical point in time at which the company became over-indebted.

This led to us being tasked with determining the hypothetical point in time at which the over-indebtedness occurred, and also to calculate the theoretical damage resulting from the delayed declaration of bankruptcy (compared to the actual point at which the company announced its over-indebtedness). Using the documentation we had compiled, we examined each year closely to correct the equity figures and determine the level of knowledge which the legally responsible individuals in the company had (or should have had).

Establishing this understanding – and therefore the critical decisions they took during the stages of the company’s lifecycle – was of paramount importance to establish liability, due to the fact that there had to be irrefutable evidence that these

persons intentionally and knowingly delayed the declaration of insolvency, a delay which caused subsequent damage to shareholders and creditors. Without this, the case could not have been successful.

Based on the documentary evidence and the significant number of adjustments identified, we concluded that the hypothetical point in time at which the over-indebtedness occurred was eight years before the actual filing of the company’s financial statements. This caused a resulting loss of 25 million Swiss Francs (approximately 16.5 million Euros) for creditors and shareholders, for which the Board of Directors and the statutory auditor were directly liable<sup>6</sup>.

A key factor in the success of this case was our wide-ranging approach, taking into account different types of relevant corporate information, rather than financial figures alone. More than two-thirds of the time spent by the forensic team was devoted to acquiring, screening, grouping and structuring the available information as well as interlinking the relevant evidence. This made it easier to establish the facts, the precise timing of events, the mindset and knowledge of the key individuals, and the decisions they ultimately made. FASB



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<sup>6</sup> At the time of writing, the final result of this case still pending final judgement



## European legal landscape focus on Germany

Rüdiger Birkental

Damian Byrne

In the second of our series of interviews profiling different legal systems across Europe, we look at how commercial disputes are resolved within the German framework. The questions are answered by Rüdiger Birkental, Head of Dispute Advisory Services and Damian Byrne, Senior Manager, both from KPMG Forensic in Germany.



### **Can you provide an overview of the German legal system?**

The German legal system is similar to those of other European Union members, being based on its own well established principles as well as paying heed to wider and more recent legislation such as EU law.

However, there are fundamental differences in the German legal system; differences that impact our work with lawyers and in legally-related matters. In the UK and US legal systems, for example, judicial precedent is applied by judges in their interpretation of statute law. However, case law is not relevant in the German legal system which is based entirely on statute law.

Another significant difference is the burden of proof in relation to civil disputes. While in the UK and US legal systems the parties must disclose all facts and available documents or information, under German law the parties first have to establish grounds for such disclosure. Naturally this can create an obstacle for claimants where relevant disclosure is largely in the hands of defendants.

As Europe's largest economy and the world's biggest exporter, Germany undeniably plays a prominent role in world trade. This makes Germany a natural forum for consultation and cross-border projects but inevitably brings its fair share of legal disputes. Germany has its own well established law firms, with international firms invariably having a strong presence in one or several of the key German cities. Unlike many other countries, in addition to the ICC, German has its own Institute of Arbitration, the DIS<sup>1</sup>, which hears national and international arbitrations under its own rules.

### **How does the commercial or civil litigation system work in Germany? How do judges and arbitrators look to resolve disputes?**

As part of normal legal proceedings, the Court will perform its own assessment of the facts relevant to that particular matter. The burden of proof is crucial in such situations and it is possible that a given fact is not considered if it cannot be convincingly demonstrated by the relevant party.

As a case progresses the Court may be supported by its own Court-appointed expert to advise on technical issues, for example accounting issues.

Arbitration hearings provide a little more flexibility to parties when entering into agreements, typically cross-border agreements. The appointment of experts is determined on a case-by-case basis, and can be influenced by the individual arbitrator. The increasing occurrence of cross-border disputes involving a German party has increased the frequency with which German parties appoint experts in order to match the appointment of experts by foreign opponents.

### **How are disputes or legal claims between German companies often resolved i.e. litigation or an alternative method of dispute resolution?**

The Federal Court in Germany remains the main forum for the hearing of legal claims in Germany. Alternative dispute resolution (ADR), either according to German law or under ICC guidelines, is now a growing area with more and more businesses attracted to the benefits of ADR. In addition, on receipt of a claim, judges will usually explore the possibility of settlement with the parties. We expect to see an increase in ADR cases, especially following the implementation of the 2008 EU Mediation Directive.

<sup>1</sup> Deutsches Institut für Schiedsgerichtsbarkeit, C.V. Cologne, [www.dis-arb.de/](http://www.dis-arb.de/)



**Are there any trends or developments in commercial dispute resolution within Germany which have emerged recently?**

There has been a trend in Germany of an increasing number of cases being referred to an independent expert or mediator in order to avoid the often significant cost of obtaining a decision from a Court. In addition to achieving time and cost savings, such a process often has the benefit of being more flexible where there are a finite number of key technical issues to be decided.

**Are there any particular types of disputes which are more common than others in Germany?**

Whilst there has been a clear fall in the level of M&A activity in Germany as a result of the global economic situation, this situation has also led to an increase in post-deal issues. For example, the difficult economic environment may give rise to valuation issues, or parties may find that the situation at completion is very different to that which was envisaged at the start of the sale process.

**What is the impact of the credit crisis on the economy, legal system and types of disputes in Germany?**

Based on our own experience and that of our clients and legal and professional contacts, the full impact of the global financial crisis and economic downturn has yet to be seen in Germany. Whilst the financial crisis has not been as extreme in Germany as, for instance, in the UK

and the US, Germany's export-led economy is nevertheless intrinsically linked to the global downturn. The evidence we are seeing in Germany is that, as expected, this economic pressure is indeed leading to an increase in disputes, both contractual and post-acquisition, although there is a time-lag involved in how long it takes for such disputes to materialise, often influenced by a resistance of parties to enter into litigation in the current economic environment.

**What do you think will happen over the next year or two in the area of commercial dispute resolution and expert witness work?**

The German legal system is different from that seen in the UK and the US: litigation is significant but less prevalent, and the appointment of experts is limited and generally reserved for the minority of cases. However, especially given the rise in disputes as a result of the global economic situation, the increasing number of cross-border disputes involving a German party, typically in arbitration proceedings, is forcing German businesses and their advisors to consider seriously the appointment of an accounting expert. This is not only to avoid being at a disadvantage where foreign opponents have appointed their own expert, but also as a result of increased exposure to accounting experts and first hand experience of the key role they can play in supporting a business in a dispute. FA35



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FATCA versus 'fat cats' –  
How the US tax authorities plan to  
throw their weight at high-net worth  
Americans investing their wealth in  
overseas financial institutions

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US lawmakers are proposing a new Bill aiming to put a stop to practices by high net-worth citizens to 'hide' assets in institutions outside the US, therefore avoiding federal taxation on these assets. This joint US and Swiss article explores the practical implications, both for individuals and the foreign institutions they use.

On 7 December 2009, the United States House Committee on Ways and Means presented an updated proposal for a new law to prevent tax evasion by US citizens, in particular high net-worth individuals. These so-called 'fat cats' are, according to the Committee, increasingly using foreign financial institutions, foreign trusts and foreign corporations to hide assets from the US tax authorities<sup>1</sup>. "The compliance provisions in this bill will help crackdown on the bad actors who try to hide funds offshore," as Senator and senior Finance Committee member John Kerry commented<sup>2</sup>.

The Foreign Account Tax Compliance Act of 2009 (FATCA), following the direction suggested by the US Stop Tax Haven Abuse Act 2009, provides, among other things<sup>3</sup>, for tax-withholding obligations regarding payments to foreign financial institutions and other foreign entities, unless certain information – mainly about beneficial ownership – is reported to the US Internal Revenue Service (IRS). FATCA stands in line with the recent discussions and efforts by national governments and international organisations to close loopholes in their tax legislation and increase tax revenues. If enacted as currently drafted, FATCA would be effective for payments made after 31 December 2012, with the provision grandfathering payments under any allegation outstanding on the date of enactment.

The proposed reporting regime under FATCA (s101) goes substantially

further than the requirements provided for under the Qualified Intermediary (QI) regime in place since 2001. Moreover, FATCA states expressly that the obligations under this new statute need to be fulfilled by foreign financial institutions treated as QI's, in addition to the obligations arising from their status as a QI. A first noteworthy aspect of the proposed regulation is that the definition of a 'foreign financial institution', for purposes of FATCA, is extremely broad and includes certain hedge funds and other collective investment vehicles.

Secondly, it is significant that FATCA expands the obligations of these institutions in relation to the QI regime. Specifically, while a institution voluntarily signs a QI Agreement with the IRS, FATCA is, in effect, mandatory for all foreign financial institutions as it requires the institutions to enter into an agreement with the IRS to disclose specified information to the IRS; otherwise, they will be subject to withholding taxes of 30 percent on any withholdable payment<sup>4</sup> received by the institution. Thus, in this case they will have to withhold such tax – in their function as withholding agent – on any withholdable payment made to a non-financial foreign entity that does not comply with certain disclosure requirements), and on any "passthru payment" made to a recalcitrant account holder (one that refuses to waive disclosure) or to another foreign financial foreign entity that does not itself enter into an agreement with the IRS.<sup>5</sup> It is significant to note that, for this purpose, a "passthru payment"

includes not only a withholdable payment but, also, any payment that is attributable to a withholdable payment. By including a payment that is "attributable to" a withholdable payment in definition the Bill appears to re-source certain foreign source income paid by a foreign financial institution that enters into an agreement with the IRS to its accounts holders in satisfaction of obligations the foreign financial institution has with respect to those account holders. (Presumably, such re-sourcing is based on some type of conduit assertion, though the Joint Committee write up is silent on this issue).<sup>6</sup>

A third point worth noting is that under the QI regime the QI is able to designate the accounts for which it is willing to act as a QI. Conversely, FATCA requires the institution – if the option of withholding the tax is not chosen – to obtain sufficient information for each account maintained at the institution to determine whether it is a "United States account" as defined within FATCA.

Finally, the information that needs to be provided to the IRS in order to avoid the withholding tax is so comprehensive that FATCA contains a special provision for situations in which foreign law would prevent the reporting of the required information. Non-US financial institutions are required under this provision to either obtain an effective waiver of such a law from each concerned account holder, or to close the account.

<sup>1</sup> House Committee on Ways and Means. (2009, December 7). H.R. 4213, the Tax Exteraders Act 2009 which included an amended version of H.R. 3933, the Foreign Account Tax Compliance Act (FATCA). See original introduction. *Rangel, Baucus, Neal Kerry Improve Plan to Tackle Offshore Tax Abuse Through Increased Transparency, Enhanced Reporting and Stronger Penalties.*

<sup>2</sup> *ibid.*

<sup>3</sup> The FATCA 2009 covers the following areas: Increased disclosure of beneficial owners through reporting on certain foreign accounts and repeal of certain foreign exceptions to registered bond requirements – which is the focus of this article; under-reporting with respect to foreign assets; other disclosure provisions with respect to acquisitions or formation of foreign entities and to passive foreign investment companies; provisions related to presumptions regarding US beneficial ownership and beneficiaries in foreign trusts; and finally the treatment of dividend-equivalent payments to foreign persons (Foreign Account Tax Compliance Act of 2009 (FATCA), 111th Cong., 1st Sess. (2009), 2009).

<sup>4</sup> A withholdable payment is defined in the FATCA 2009 as fixed or determinable annual or periodic gains, profits, and income from sources within the United States, and any gross proceeds from the sale or disposition of any property of a type which can produce interests or dividends from sources within the United States. The inclusion of the "or other disposition" language appears to include stock distributions that may arise from tax-free transactions.

<sup>5</sup> As a witness noted at a hearing of the Committee on Ways and Means' Subcommittee on Select Revenue Measures, the only alternative for non-U.S. financial institutions not to be affected by either the withholding obligations or reporting requirements of the first sections of FATCA would be to "cease making investments that would produce U.S. source income" (Suringa, 2009). He estimates that "it is not inconceivable, however, that some foreign financial institutions [...] would choose the [...] alternative rather than comply with FATCA".

<sup>6</sup> As an example, assume a recalcitrant account holder maintains a deposit account with a foreign financial institution that has entered into an agreement with the IRS to disclose US accounts. In turn, the foreign financial institution invests in US Treasuries as a means to satisfy the obligations it has with its depositors. As drafted, FATCA would require withholding on the foreign source income paid by the foreign financial institution to the recalcitrant account holder with the deposit account to the extent it is attributable to the US source income that the foreign financial institution receives from its investment in the US Treasuries. The tracing of such income will be difficult, if not impossible, for many foreign financial institutions.



Both the identification of 'US accounts' and the beneficial ownership verification, as well as the reporting requirements, are intricately linked to core processes of a financial institution, for instance the 'Know Your Customer' (KYC) and related anti-money laundering (AML) procedures. These procedures were already key considerations for the IRS in the context of the QI agreements, and would appear to occupy an even more prominent position under FATCA.

Deficiencies in these processes can result in non-compliance with US tax law and agreements based on such law – the case of UBS has made sufficiently clear what is at stake for a financial institution in this respect. KYC and AML procedures need to meet all (local/national) legal requirements as well as mandatory international standards; the corresponding controls need to be very carefully designed to achieve compliance, and their operating effectiveness monitored. These same requirements apply to additional processes which need to be

designed to fulfil the requirements of QI and similar agreements – including, in future, agreements based on FATCA.

The efforts needed to fulfil all of these obligations can be quite substantial for a financial institution and often requires specialist knowledge or assistance. A combination of forensic and tax professionals (with in-depth knowledge of US tax law), can assist in a number of ways such as performing a gap analysis of processes, testing the current controls, and suggesting improvements. Forensic technology professionals can help the financial institution to review the IT system landscape, capture and process the information needed for the purpose of reporting to the US authorities, and propose measures for more efficient handling of this data.

However, adequately designed processes and controls alone – with or without independent external assistance – cannot guarantee success. The crucial element is the personnel involved in the processes, namely the employees, managers and leaders of the financial institution in question. The awareness of staff at every level is crucial for the successful management of the compliance risks. Therefore, thorough and regular training mechanisms – customised according to staff level and function – are essential. IFASB



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In the next edition of Forensic Accountant we will explore this issue from a UK perspective

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## The technology sector: still a prolific area for disputes

David Eastwood

Glyn Jones

For many years the technology sector has generated a steady flow of disputes of all sizes including some in which very large sums have been at stake. David Eastwood and Glyn Jones from KPMG Forensic in the UK look at the causes and types of disputes that typically arise in the sector.

The frequency of disputes in the sector is hardly surprising given the pace of change in technology and the extent to which it underpins so much business and personal activity. Change in particular means that business models, plans and activities frequently diverge very quickly from the underlying contracts.

Some of the highest profile disputes have involved the development and implementation of IT systems. In the UK there have been a number of such disputes involving government agencies, as well as large corporates. Unfortunately the complexity, duration, change and value of such projects is such that some form of disagreement is likely. In our experience of such

disputes, there is often an expectation gap between what the supplier considers it has agreed to deliver and what the customer thinks it should be getting. Given the complexity of the systems which are to be delivered, which typically include many subsystems and other parties with interdependent responsibilities, ambiguities can easily escalate into problems.

IT systems disputes can result in very large quantum claims, the largest element of which will often be for loss of profits. As forensic accountants, we are often called in to consider the quantum issues in such cases.

Customers often argue that the new IT system was expected to deliver benefits – additional profit through increased revenues and/or reduced operating costs – and these have been lost or delayed as a result of the supplier’s alleged breach. These claims can cover many years and are often difficult. Evaluating the impact on lost sales of the system delays or failures may need the input of an industry/market specialist as well as technical experts.

IT outsourcing, given its growth over the last decade, is another area where disputes frequently arise. Examples include breaches of service level agreements as well as disputes over software integration, licensing and in relation to subcontractor relationships. An interesting development in the outsourcing area is the potential impact of European law. The Solvency II Framework Directive will take effect in October 2012 and will establish a new framework for the prudential regulation of European insurance companies. The Directive contains specific provisions on outsourcing and it will be interesting to see how this is implemented in the UK and its consequent effects.


Technology disputes are often linked to intellectual property. Nokia recently issued proceedings against Apple alleging that the latter had infringed patents on Nokia’s mobile phone technology, with the media speculating that the claim could amount to US \$400 million.

In addition to technology hardware, software is an area in which disputes

commonly occur, be it in relation to licensing, counterfeiting or design and implementation. Microsoft’s patent dispute with TomTom, which settled in early 2009, is one such example.

The current ‘hot’ IT topic is cloud computing, although this term is used to cover quite a variety of situations. Clouds can be used to support hardware/infrastructure provisioning, software applications and data storage. There are already good examples, such as salesforce.com, but future developments will raise some interesting challenges for both providers and customers in exchange, perhaps, for greater flexibility and lower IT costs. Some of these issues could well lead to disputes.

Obvious problem areas are the reliability of the means by which data is accessed (the data owner no longer has its own IT infrastructure, the maintenance of which it can control) as well as data privacy and security (data will be stored in places which the data owner does not control). The data loss suffered in October 2009 by some customers of one of Microsoft’s recent cloud acquisitions is a good example of the potential problems. There are also difficult issues around portability of data on termination.

Technology owners spend vast amounts in R&D to develop and protect their technologies. Corporates pay large sums of money to obtain the benefits of these technologies and will seek recompense if they fail to deliver. Given this, we don’t expect technology disputes to disappear any time soon. 

### Some examples of our work in the technology sector:

1. We acted on behalf of a satellite operator in a dispute arising from the failure to introduce a new basis for the provision of satellite channels within a particular geographical region (including the use of specific encoding technology). Our work was focused on the claim for loss of profits, calculated under two scenarios.
2. We acted in a dispute between an IT solutions provider and a travel operator. The dispute related to the design and implementation of a customer reservation system. Our work involved assessing the quantum of the claimant’s loss of profits claim, as well as quantifying the defendant’s counterclaim.
3. We acted in a dispute in the high technology zero emission vehicles sector. Our work involved valuing intellectual property using published royalties and potential sales.
4. We gave expert witness evidence in a dispute over licensing terms for software deployed by a Scandinavian company. The issue revolved around technical deployment and licence interpretation.



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