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Second Circuit Supports Nixing of Lost Profits Based on Unsuitable Benchmark

***Washington v. Kellwood Co.,* 2017 U.S. App. LEXIS 21871 (Nov. 2, 2017) (Kellwood IV)**

Kellwood IV concerns a damages case that featured an upstart sportswear company whose founder claimed it could have been a major contender in the market "but for" the defendant's breach. The Second Circuit rejected the plaintiffs' efforts to revive a multimillion-dollar jury award that was based on a shaky yardstick analysis. After so many twists and turns, the latest ruling really may be the end of this litigation.

The plaintiff and his company owned the "Sunday Players" ("SP") brand. Hoping to break into the compression sportswear apparel market, they made an agreement with the defendant that required the latter to market SP's products. The plaintiffs claimed that MTV had expressed interest in partnering with SP to the defendant. An MTV promotion could have generated hundreds of millions in product sales. Nothing came of the MTV deal and in spring 2005, the defendant ended its relationship with the plaintiffs.

The plaintiffs sued, alleging the defendant breached its promise and asked for damages in excess of $50 million. The plaintiffs' expert based his damages calculation on two approaches: a yardstick analysis and a "Market Forecast Analysis." The trial court excluded the latter in response to the defendant's *Daubert* challenge. But the court admitted the yardstick analysis, which used the market leader, Under Armour, as a benchmark and posited that, but for the defendant's wrongdoing, the plaintiffs' revenues would have been 50 percent of Under Armour's at a time when Under Armour was at the top of its game.

A jury awarded the plaintiffs $4.35 million in lost profits or, in the alternative, $532,000 in lost business value. Post-trial, a different trial judge struck down the lost profits award, finding it lacked a sound basis. And even though the judge initially allowed the plaintiffs to prove lost business value damages in a new trial, she changed her mind during pretrial proceedings, concluding that the plaintiffs "had no intention of pursuing a realistic damages award." After reviewing the plaintiffs' damages evidence, the court excluded virtually all of it. "Accelerating the inevitable," it decided to close the case by awarding the plaintiffs one dollar in nominal damages.

Both parties appealed the findings with the Second Circuit Court of Appeals. The reviewing court affirmed the defendant's liability, as well as the trial court's ruling that the plaintiffs had failed to present a plausible damages calculation.

"Under Armour was not a reasonable comparator," the Second Circuit said. At the relevant time, Under Armour was an established business with annual sales of between $49.5 million and $195 million and it controlled about 80 percent of the relevant market. In sharp contrast, the plaintiffs' company sold less than $200,000 in merchandise to a few small retailers and high school and college athletic teams. The expert's claim that revenues were reasonably certain to increase from a few hundred thousand dollars to about $80 million in two years was completely unwarranted and could not create a legal basis for awarding future lost profits according to the Second Circuit said. The trial court's ruling to award the plaintiffs nominal damages was not error, the appeals court said.

Gary R. Trugman CPA/ABV, ASA, MVS, Trugman Valuation's President was Kellwood Co.'s (prevailing party) expert in this matter.

Continued on next page...

In this issue

Court Clarifies Application of Rule 703 to Expert Testimony

***Springer v. Library Store,* 2017 Ill. App. Unpub. LEXIS 2378 (Nov. 17, 2017)**

An unsuccessful shareholder oppression action includes a valuable cautionary note about experts relying on other appraisals. Rule 703 allows an expert to base his or her opinion on information that is outside the expert's area of expertise. Barring an exception to the hearsay rule, this information normally is inadmissible. The proponent of the information has to lay a proper foundation to make the information admissible, which the plaintiff's counsel failed to do in this case. The appellate court's analysis shows what experts and attorneys have to do on direct examination to introduce this type of evidence.

The parents established a business that sold library and school supplies. They gave shares in the business to their three children. The decedent worked for nine years for the company before her employment was terminated and she lost her seat on the board of directors. Shortly before her death in 2008, the decedent sued the other family members in federal court alleging federal and state law violations. After her death, the decedent's husband, who served as the executor of the estate, settled the federal suit but filed a complaint in state court alleging shareholder oppression under the applicable state statute and case law.

In 2010, the company sold its building to an entity the defendant family members owned. The real property entity then leased the building back to the company.

In 2016, a bench trial took place on the plaintiff's oppression claim including a claim of mismanagement of corporate assets. The plaintiff offered expert testimony from a CPA and accredited valuator. The expert compared the salaries of the company's officers before and after the decedent's death (late 2008) and noted that, after the decedent had died, the defendants' wages went up, but distributions to shareholders went down significantly. To assess the reasonableness of the salaries, the expert performed several analyses: historical percentage, historical average and independent investors test. He assumed a 15 percent rate of return and assumed reasonable salaries for officers were 3 percent of sales. He said he based those values on his experience and checked the assumptions against the company's performance before 2008. He found that, from 2008 to 2012, the company was "severely impacted by … an economic downturn" and wondered why salaries were raised at that time. He allowed that the decedent's brothers had done "some good things" to make the company profitable and that, in 2014 and 2015, the company had done "phenomenally well" and actually had underpaid its officers. Also, the parents had received very little salary between 2003 and 2008. According to the plaintiff's expert, during the "bad years," the officers "took too much money."

The defendants retained an expert who was also a CPA and credentialed valuator. As she saw it, the company was forced to change its business model after 2008 "to adjust to the changing economy and industry" in the wake of the recession. She analyzed officers' compensation under the market compensation test as well as the independent investor test. Based on her experience and published information, she assumed an 8 to 12 percent rate of return for the independent investor test. The defense expert concluded the company did not pay its officers enough compensation from 2009 to 2015.

The trial court noted that the "compensation spike in 2009 looks rather questionable" but ultimately was adequately explained by the defendants. The court pointed out that both experts used the independent investor test and "determined most of the variables competently." At the same time, the court found the defense expert's analysis was more credible because the expert cited to publications. And yet, the court found that neither expert's analysis held "too much weight." It concluded that, because of changes in the economy and at the company, the decedent's brothers had to reinvent the company—a change that justified changing the company's distribution of compensation and profits.

In support of the plaintiff's mismanagement of corporate asset claim, the plaintiff's expert sought to testify that the company paid "excessive rent" to the defendants' company. This opinion was based on an appraisal that another expert had prepared. The plaintiff argued the expert was allowed to rely on the opinion and report of another expert.

The trial court precluded the expert from testifying, noting: "Sometimes experts rely on other opinions in making their conclusions, but you have to ask those questions. You have to get to it. You're talking about it, but you're not asking the questions."

The trial court appeared to allude to the failure by the plaintiff's counsel to lay a proper foundation on direct examination of the expert for the appraisal, which by

itself represents inadmissible hearsay. The plaintiff did not offer to put the author of the appraisal on the stand.

The trial court concluded that the plaintiff failed to prove that the defendants engaged in shareholder oppression or mismanagement of corporate funds.

The plaintiff appealed the trial court's findings with the state appellate court, which found the plaintiff failed to show how the defendants' acts amounted to shareholder oppression. In terms of the waste and mismanagement of corporate assets claim, the reviewing court noted the trial court had found both expert analyses had flaws, but the defense expert's testimony was "slightly more reliable." Further, the trial court had found the increase in compensation was "adequately explained." The judgment of the trial court was not "against the manifest weight of the evidence," the appellate court said.

The appellate court explained why the plaintiff's expert was precluded from testifying about the appraisal the plaintiff hoped to use to support his "excessive rent" claim.

Federal Rule of Evidence 703 allows an expert to base an opinion on facts or data that may be inadmissible hearsay "[i]f experts in the particular field would reasonably rely on those kinds of facts or data in forming an opinion on the subject." As the appellate court explained, it is critical that the proponent of the information convince the trial court "that the information is of the type customarily relied upon by experts in the field and that such information is sufficiently trustworthy to make such reliance reasonable." Further, a trial court commits error if it permits an expert "to rely on the report of another where the proponent does not lay a foundation as to whether such hearsay is customarily relied upon in rendering opinions in the expert's field and that such reliance was reasonable."

Here, the plaintiff tried to use the testifying expert to discuss the appraisal another accountant did to prove the plaintiff's claim that the rent was excessive. "That testimony would have been admissible if [the plaintiff's expert] had testified that appraisals are customarily relied on by accountants in rendering opinions and that it was reasonable for him to rely on the appraisal." Because the plaintiff failed to lay the proper foundation for the expert's testimony, the trial court "properly prohibited" the expert from discussing the contents of the appraisal, the appellate court ruled. The exclusion of expert testimony on this point was not error. The appellate court upheld the trial court's judgment in favor of the defendants.

Court Adopts DLOM-Free Valuation of Realty Holding Company

***Kassab v. Kasab,* 2017 N.Y. Misc. LEXIS 2905 (Aug. 3, 2017)**

The question of whether it is appropriate to apply a marketability discount in fair value proceedings involving a real estate holding company has generated divergent answers from New York courts. A decision from the Second Department adopted a valuation that did not apply a DLOM.

Two brothers, Avraham and Nissim, jointly owned two entities that owned three parcels of land in Jamaica, Queens. Nissim ("petitioner") owned a 25 percent interest and Avraham ("respondent") owned 75 percent of each of the entities. Nissim had constant money troubles, while Avraham had money. Avraham, the court noted, engaged in "despotic decision-making practices." For example, although there were offers to buy or lease the land, Avraham was reluctant to pursue any deals and he failed to keep Nissim informed of offers. Ultimately, the breakdown in the brothers' relationship culminated in a trial based on Nissim's request for the dissolution of the corporation and valuation of the entities.

Both sides offered testimony from real estate appraisers on the value of the lots. However, only Nissim, the petitioner, offered testimony from a business valuator on the value of the companies. The expert had extensive experience in statutory fair value cases and has been considered an authority on marketability discounts. The valuator relied on the real estate appraisals his client's appraiser produced. The valuator used a net asset value approach to value the companies. In determining the fair value of Nissim's interests in the two entities, the expert did not apply a marketability discount because the businesses were real estate holding companies whose valuation "already relies upon market exposure." Since Avraham, the respondent, did not offer a competing valuation, the court accepted the petitioner's proposed valuations.

Accordingly, the court found the fair value of Nissim's 25 percent interest in one entity was $3.17 million and the fair value of his minority interest in the other entity was $1.66 million.

Note. Although Avraham and Nissim are brothers, they spell their last names differently. In a footnote, the court explained that, in some prior proceedings and court orders, Avraham's last name sometimes is spelt "Kassab" when it should be "Kasab."

New York Court Validates DLOM in Real Estate Holding Company Valuation

***Matter of Levine v. Seven Pines Assoc. Ltd. Partnership,* 2017 N.Y. App. LEXIS 8795 (Dec. 14, 2017)**

An appellate decision from the First Department in Manhattan approved of the use of the marketability discount in appraising a real estate holding company. This differs from the results in the last case discussed. Clearly, facts and circumstances, as well as different jurisdictions can cause results to be dramatically different.

A revocable trust had a limited partnership interest in a single-purpose entity whose sole asset was a 304-unit apartment building in Yonkers, NY. When the partnership underwent restructuring, the trust had the option of reinvesting in the new entity or taking a buyout of its interest. The trustee asked the Supreme Court of New York (trial court) to fix the value of the trust's 4 percent interest in the partnership in a fair value proceeding.

Both sides offered expert testimony on the value of the building and the business. The petitioner's expert claimed the petitioner's interest was worth $990,000. The partnership's expert found it was worth $325,000. The trial court adopted the partnership expert's proposed value. The court found the latter's real estate and business valuation experts overall were more credible than the petitioner's experts.

The parties' valuation experts disagreed over the appropriateness of applying discounts. The petitioner's expert applied none. The partnership's expert used a 25 percent discount for lack of marketability, as well as a minority discount to account for the interest's lack of control.

The petitioner appealed the lower court's findings with the New York Supreme Court's Appellate Division (First Department). The reviewing court for the most part upheld the trial court's findings, including the lower court's approval of a marketability discount. Citing *Giaimo v. Vitale*, 2012 N.Y. App. Div. LEXIS 8706, the appellate panel noted that this court in the past allowed marketability discounts when valuing real estate holding companies. However, the court rejected the application of a minority discount, noting it was impermissible to discount for lack of control in appraisal actions arising under Section 623.

The appellate panel said there was no need to remand. The record was sufficient to allow the reviewing court to "conduct an independent review of the evidence" and determine the petitioner's interest was worth about $343,200.

Congratulations to our Vice President, Linda Trugman

Trugman Valuation is pleased to announce that Linda Trugman has been appointed as the American Society of Appraiser's representative to The Appraisal Foundation's Board of Trustees effective January 1, 2018.

The American Society of Appraisers is a multi-discipline, non-profit, international organization of professional appraisers representing all appraisal disciplines: Appraisal Review and Management, Business Valuation, Gems and Jewelry, Machinery and Technical Specialties, Personal Property and Real Property. Its mission is to foster the public trust of our members and the appraisal profession through compliance with the highest levels of ethical and professional standards (www.appraisers.org).

The Appraisal Foundation is the nation's foremost authority on the valuation profession. The organization sets the Congressionally-authorized standards and qualifications for real estate appraisers, as well as qualifications for personal property appraisers and provides voluntary guidance on recognized valuation methods and techniques for all valuation professionals. This work advances the profession by ensuring that appraisals are independent, consistent and objective. Headquartered in Washington, DC, The Appraisal Foundation is directed by a Board of Trustees. The Foundation also ensures that the profession adapts to changing circumstances and continues to move forward through the work of its two independent boards: the Appraiser Qualifications Board and the Appraisal Standards Board (www.theappraisalfoundation.org).

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