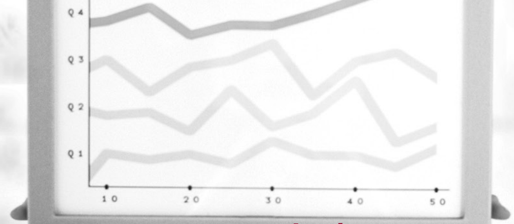

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VALUATION Trends

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Discount Rate Roundup: The 14 Essential Decisions in Economic Damages Cases

Not many published decisions discuss the development of a discount rate in any meaningful detail. The following 14 cases provide essential guidance to experts and attorneys alike:

1. Energy Capital Corp. v. United States, 302 F.2d 1314 (Fed. Cir. 2002)

The plaintiff's expert applied the risk-free rate of return on 10-year Treasury bonds (5.9%), adjusted for company specific-risks to 10.5%. The government's expert believed a 25% discount rate was more appropriate. The trial court adopted the 5.9% risk-free rate without adjustment, but the Federal Circuit Court of Appeals reversed, finding a risk-free rate did not apply when both experts testified the rate should reflect the riskiness of the plaintiff's venture. "We do not hold that in every case a risk-adjusted discount rate is required," the court explained. Rather, the appropriate discount rate is a question of fact, which should reflect the time value of money and adjustments to the cash flow based on risk.

2. Franconia Associates v. United States, 61 Fed. Cl. 718 (2004)

In this case against the federal government for breach of low-income housing loans, the U.S. Federal Court of Claims cited *Energy Capital Corp.* for its holding that the discount rate must reflect the risk and rate of return an investor would demand in the same type of venture. "The higher the risk, the higher the rate of return an investor would require," the court said. Accordingly, it adopted the 11% discount rate applied by the government's expert, who testified that risk was a "major component" of his calculation, compared to the 6% by the plaintiff's expert.

3. AlphaMed Pharmaceuticals, Inc. v. Arriva Pharmaceuticals, Inc., 432 F. Supp. 2d 1319 (S.D. Fla. 2006)

In calculating damages for the defendant's misappropriation of a pharmaceutical, the plaintiff's expert applied a 35% discount rate, citing the risks of development but also stating that the drug was already "proven" in the market. The jury awarded the plaintiff over $78 million in damages and the defendant moved for judgment as a matter of law. The court agreed, finding the plaintiff presented a faulty "chain of assumptions" to link its losses to the alleged harm. Moreover, its expert's "unquestioning" reliance on these assumptions "fatally undermined" his 35% discount rate, and the court reversed the award.

4. In re Magna Cum Latte, Inc., 2008 WL 2047937 (Bankr. 2008)

The plaintiff's expert used a risk-free rate to calculate damages for breach of a lease, compared to the defendant's expert's "risk-adjusted" discount rate of 27.7%. Citing *Energy Capital Corp*., the federal bankruptcy court found the plaintiff's venture was "substantially risky" and settled on a 15% discount rate—or roughly splitting the difference between the two rates.

5. Miller Bros. Coal v. Consol of Kentucky, Inc., 2009 WL 4904032 (Bkrtcy. E.D. Ky.)

In assessing damages for breach of a fixed-price coal mining contract, the plaintiff's expert applied a 10% discount rate based on the plaintiff's actual cost of capital plus a slight risk premium. The expert also believed the 10% discount rate was consistent with the annuity nature of the income stream under the contract, especially given its fixed price and costs. However, a 10% rate was too low, the federal bankruptcy court held, finding 15% "more reasonable in light of the normal attendant risks of mining coal."

6. Purina Mills, L.L.C. v. Less, 295 F. Supp. 2d 1017 (N.D. Iowa 2003)

A pig seller won breach of contract damages of just

Continued on next page...

IN THIS ISSUE

over $225,000. Neither party proposed a discount rate, and the federal district court applied the then-current U.S. Treasury bond ratings, ranging from 1.24% to 3.17% (or just about the lowest in any published decision).

7. Munters Corp. v. Swissco-Young Industries, Inc., 100 S.W.3d 292 (Tex. App. 2003)

At trial, the court awarded the plaintiff nearly $975,000 in damages for the defendant's deceptive trade practices, based on a discounted cash flow analysis by the plaintiff's expert, who used a 10% discount rate. On appeal, the defendant argued (based on its expert's testimony) that the discount factor "should have been somewhere in the twenties." The appellate court disagreed, finding the plaintiff's expert based his opinion on objective facts, figures, and historical data.

8. Kool, Mann, Coffee & Co. v. Coffey, 300 F.3d 340 (3d Cir. 2002)

After finding fraud in the sale of a family-owned business, the bankruptcy court found for the expert's 18.5% discount rate based on "industry standards" in valuing the particular company at issue, and on appeal, the federal district court affirmed.

9. Diesel Machinery, Inc. v. B.R. Lee Industries, Inc., 418 F.3d 820 (8th Cir. 2005)

To determine damages for breach of a franchise agreement, the plaintiff's expert assumed the plaintiff would invest a lump-sum award back into its business and adjusted the discount rate by the risks of the related cash flows. The defendant objected to the analysis because it did not conform to the applicable (South Dakota) jury instruction on present value. The trial court agreed, striking the expert's testimony, and the U.S. Court of Appeals for the Eighth Circuit affirmed, finding the expert used a "sound" methodology but failed to comply with state jury instructions. (Note: This ruling is likely limited to cases applying South Dakota law.)

10. Fairmont Supply Co. v. Hooks Industrial, Inc., 177 S.W.3d 629 (Tex. App. 2005)

On the plaintiff's claim for breach of a requirements contract, its expert applied a 33% discount rate to conclude $1.6 million in lost profits. The defendant's expert used a 36% discount rate, but did not otherwise contest the financial variables that went into the plaintiff's expert's calculations. The jury ultimately awarded $1.2 million in damages, which was upheld on appeal as within the range of evidence at trial.

11. Olson v. Nieman's Ltd., 579 N.W.2d 299 (Iowa 1998)

In a suit for misappropriation of trade secrets, the plaintiff's expert used a risk-adjusted rate of 19.4% to conclude over $670,000 in damages, and the jury awarded $650,000. On appeal, the federal district court found the verdict fell "within the parameters of that evidence," and affirmed.

12. Knox v. Taylor, 992 S.W.2d 40 (Tex. App. 1999)

In a suit for tortious interference with contract, the plaintiff's expert used a 7% discount rate to calculate damages ranging from $9.3 million to $11.6 million. The defendant's expert believed a 30% discount factor better accounted for the risks in this particular business (contract surety) and calculated damages ranging from $190,000 to $895,000. The jury awarded $2.7 million, and, on appeal, the court found the amount clearly fell within the range of the evidence.

13. Burger King Corp. v. Barnes, 1 F. Supp.2d 1367 (S.D. Fla. 1998)

Burger King sued a franchisee for failing to pay its contractual royalties. Its expert used a discount rate of 9% and the court granted its motion for summary judgment, finding sufficient evidence to support the rate and the claimed damages.

14. American List Corp. v. U.S. News and World Report, 75 N.Y.2d 38 (1989)

After the defendant breached a 10-year contract, the plaintiff's expert used a 10% discount rate to calculate damages. The defendant's expert believed a range of 14% to 20% was more appropriate, based on the risk that the plaintiff would be unable to perform in the future. The trial court ultimately applied a "realistic discount factor" of 18%, but the New York appellate court reversed, finding the method inappropriate for an anticipatory breach of contract, and remanded the case for a new calculation of damages and discount rate.

Reasonable Compensation Analysis Must Incorporate Applicable Legal Test

***Multipak Corp. v. Commissioner,* T.C. Memo. 2010-139 (June 22, 2010)**

Over 30 years, a CEO brought a foundering packaging company to financial stability. In 2002 and 2003, his earnings exceeded $2 million, nearly double the amount of prior years. The IRS claimed all but roughly $650,000 per year was unreasonable under IRC Sec. 162, and the taxpayer appealed.

Five-factor test controls. The Tax Court applied the five factors in *Elliott's Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), to determine reasonable compensation in this case, as follows:

1. The employee's role in the company. During his entire tenure, the CEO "made every important decision" for the firm, the court said, and his dedication "directly contributed" to its profitability. Although sales declined in 2003, the firm stayed current on its payables and was essentially debt-free. Overall the court found this factor weighed in the taxpayer's favor.

2. External comparison. The taxpayer's expert compared the CEO's compensation with the average executive pay from various S&P data, adjusting the comparables for their differences in size and types of compensation (including stock options). After these adjustments, the CEO's compensation was still high, among the upper range of the comparables, but still reasonable, the expert said. Further, the 2003 dip in sales was largely due to the economy, and there was no evidence the company paid bonuses to absorb taxable profit.

By contrast, the IRS expert applied the "independent investor" test derived from *Elliott's* (i.e., whether a third-party investor would be satisfied with the rate of return after investing in the company. Using data from comparable, industry, and the taxpayer sources, he concluded that $1.46 million would have reasonably compensated the CEO in 2002 and $670,100 in 2003.

The court wasn't "completely convinced" by either expert, finding their comparables "too dissimilar" to the taxpayer. Moreover, the taxpayer's expert did not perform the independent investor analysis, as "*required by the applicable case law*," the court held (emphasis added). Overall, this factor was neutral.

3. Company character and condition. The taxpayer was prominent in its industry and enjoyed record high revenues, despite its 2003 sales decline. The CEO contributed significantly to this success, weighting this factor in the taxpayer's favor.

4. Conflict of interest. The court examined this factor under the *Elliott's* independent investor test, noting that an investor would likely be satisfied with the 2002 rate of return but not in 2003, thus making this factor a wash.

5. Internal consistency. The compensation was not *per se* unreasonable simply because the CEO was a shareholder-employee, the court held. Moreover, the incentive-based compensation plan was a valuable motivator, weighting this factor in its favor.

Overall, the court found the CEO's compensation of $2.02 million in 2002 was reasonable. It adjusted his salary to $1.28 million in 2003, however, to produce a 10% return on equity, sufficient to satisfy "the overall character of the company" and an independent investor.

Proving Lost Profits Damages: Recent Cases Provide Best Practices for Using Experts

Expert should verify basis for loss.

In *Dong Ah Tire & Rubber Co. v. Glasforms, Inc.*, 2010 WL 1691869 (N.D. Cal.)(April 23, 2010), the plaintiff accused the defendants of supplying contaminated goods. Its expert calculated nearly $6 million in damages, including $1.7 million for the loss a "major" customer and also a Korean contract, and $580,000 for the plaintiff's "rehabilitation tour."

The jury ultimately awarded just over $5.5 million and the defendants appealed, claiming insufficient evidence to support the damages. The federal district court agreed, finding the plaintiff failed to show it had even secured the major customer and that "but for" the defendant's product failures, it would have sold $1 million per year in the Korean market. Apparently, the plaintiff's expert "simply accepted the numbers [the company] provided … and performed loss calculations consistent therewith," the court observed. The plaintiff also failed to show that spending money on its "rehabilitation tour" was a foreseeable consequence of the defendant's breach. Accordingly, the court reduced the damages by the lost profits calculation and reputation costs. The plaintiff could accept the reduced judgment ($3.6 million) or retry its damages case.

Expert should consider current economy.

In *Utility Trailer Sales of Kansas City, Inc. v. MAC Trailer Manufacturing, Inc.*, 2010 WL 1816376 (D. Kan.)(May 3, 2010), the plaintiff sued for breach of a distributor agreement to sell the defendant's trucking trailers. The defendant challenged the plaintiff's damages expert under *Daubert*, claiming lack of industry experience and flawed assumptions. In particular, the expert used sales figures from only two years to calculate over $400,000 in lost profits, and his predictions for 2009 sales turned out to be "wrong." Further, his growth rate (20%) was excessive and incorrectly presumed the 2010 economy would experience a "full recovery."

The expert was a CPA accredited in business valuation with over 22 years of experience, including litigation and lost profits calculations. Although he didn't have specific "trailer market" experience, he had consulted industry sources sufficient to lay a "substantial" foundation for his opinion, the court said. Although he might not have used "the best" method for calculating a growth rate, he used

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basic accounting principles, and the rule for admissibility is “reliability, not superiority.” In addition to sales, he also evaluated the regional and general economy along with business cycles and trends for the trucking industry. Finally, he checked the reasonableness of his growth assumptions by preparing a linear regression analysis of the plaintiff’s monthly unit sales across the entire loss period, 2001 to 2008. Any deficiencies were “ripe for cross-examination,” the court held, and admitted the expert.

Expert should consider contract term.

In *Farmers Insurance Exchange v. Hudson*, 2010 WL 1806660 (Tex. App.)(May 6, 2010), an insurance agent sued for wrongful termination. In addition to actual lost wages of nearly $500,000, his expert projected future lost profits through the agent’s anticipated retirement date ($836,000) and his estimated date of death ($1.1 million), discounted back to present value. After the jury awarded $380,000, the insurance company appealed, arguing the three-month termination clause in the underlying agency agreement limited damages—and the court agreed.

“Generally, the measure of damages for breach of contract is that which restores the injured party to the economic position he would have enjoyed if the contract had been performed,” the court held. The agent did not have a contract term “for the rest of his natural life,” and the insurance company was not obligated to employ him until he retired. Under these facts, the agent’s claim was essentially an “inadequate notice claim,” the court ruled, and limited damages to three months’ lost income.

Expert should avoid ‘cherry-picking’ the data

In *Signature Health Center, LLC v. State of New York*, 2010 WL 2197690 (N.Y. Ct. Cl.)(May 20, 2010), the plaintiff was an approved medical treatment center in New York. After the state failed to publish and pay its 2000 and 2001 increased reimbursement rates, the plaintiff went bankrupt and sued the state for $2.4 million for the loss of its business. After finding the state was not immune to civil suit, the court considered the plaintiff’s proof of damages, presented by a “seasoned” valuation expert, and found several flaws.

First, the expert examined only three out of the nine years of the plaintiff’s operations to conclude it would have generated $2.4 million in profits but for the state’s alleged failures. Second, he did not sufficiently explain how he conducted his investigation or why he rejected other economic factors that could have caused the plaintiff’s decline—such as its failed construction project and default on equipment leases. His limited data selection simply ensured “a higher calculation of lost profits,” the court believed, and dismissed the plaintiff’s proof (and claims) as speculative.

Expert should adequately explain the basis for lost profits calculations.

In *The Water Quality Store, LLC v. Dynasty Spas, Inc.*, 2010 WL 2772702 (Wis. App.) (July 15, 2010), the plaintiff sued for breach of an exclusive distributorship agreement to sell the defendant’s water spas. After establishing its status as a dealer under the state’s Fair Dealership Law, its expert presented over $480,000 in damages, including lost profits ($114,000) and advertising expenses ($348,000) to resume its business with another brand.

The defendant’s expert criticized him for relying on sales from just two years, without including more recent figures, and his inclusion of TV advertising costs when any losses were due to the 2008 recession. In response, the plaintiff’s expert said the historic sales were more reliable than the “forced” sales after termination, and pointed out that despite the downturn, defendant’s sales had increased 8%. Moreover, the defense expert had conceded that, on average, a terminated dealer might have to spend 5% of gross profits on advertising to rehabilitate its reputation. After weighing the evidence, the jury awarded just over $264,000 in damages, and on review, the appellate court affirmed by “backing into” the amount. That is, it examined the two largest components of damages, the projected lost gross profits and advertising costs, and found sufficient expert evidence to support the jury’s award.