TRUGMAN Valuation

VALUATION Trends

Fall 2018

Damages Claim Fails to Provide Yardsticks Capturing Defunct Startup's Value

***Zaffarkhan v. Domesek,* 2018 Cal. App. Unpublished LEXIS 3559 (May 18, 2018)**

A short-lived startup that centered on a medical software application that never made it beyond the beta stage of development gave rise to litigation and claims by the plaintiff that the company was worth $6 million. Both the trial and appeals courts rejected the plaintiff's damages testimony, noting the plaintiff's expert had no experience in valuing a software company and misrepresented basic facts when calculating future lost profits. Besides unpeeling the defects in the damages testimony, the appeals court opinion reveals how an expert might show anticipated profits when dealing with an unestablished business.

In spring 2012, a medical supply company salesman and two doctors embarked on a project to move a software application that aimed to prevent prescription fraud beyond the prototype stage. In June 2012, the threesome formed a company, PDS, to develop and market the product. Each member owned a 30 percent share in the company and each was an officer and director. Together, they were the board of directors. A fourth person, who was not an officer, director or board member, bought a 10 percent interest in PDS.

The three founding members kept their day jobs and dedicated only limited time to their new venture, all the while entertaining big plans for the existing prototype. They seemed aware of a similar system that functioned on a state level and planned to create an application that would function on a nationwide level. The plaintiff, who was one of the two doctors, was brought on board because of his programming experience. He was charged with taking the software to the "enterprise" level where thousands of doctors and patients would access it.

In the end, PDS' software never moved beyond the beta stage of development. The plaintiff later testified that the company "didn't have the resources, the dollars, all the things I outlined in the technical budget that had not been apportioned for yet. We couldn't buil[d] it yet, so it wasn't built. All we did have in place was a concept under beta."

The company's financials were "in disarray." The company never settled on a specific revenue model, but shifted among various possibilities. As a result, the product also was forever changing. The plaintiff later testified: "Every time we took a meeting with someone, they wanted to see something else[,] … wanted a different functionality, so it's hard to define the product requirements when the product itself is changing and the people who want to see data from the product constantly changes." Company projections in late 2012 for 2013 indicated net revenue would be "zero."

The two founders who had developed the prototype eventually claimed the plaintiff did not do enough to help the company succeed and in August 2013, decided to dissolve the company over the plaintiff's objection. The two members also voted to sell the company's assets—the prototype software code—to a new company they set up around the same time with PDS' former 10 percent shareholder. The new company was called ScriptGuard.

Seeking to settle their differences with the plaintiff, the former partners offered to buy out the plaintiff for $110,000. This amount included the $35,000 investment the plaintiff had made in the company, $15,000 in compensation for the allegedly few hours the plaintiff had devoted to PDS and $60,000 in reimbursement for the plaintiff's 30 percent ownership interest assuming a valuation of $200,000.

The plaintiff rejected the offer and sued the medical supply company salesman and the 10 percent shareholder. The plaintiff alleged breach of the shareholder agreement, breach of fiduciary duty and unfair business practices. The trial court dismissed the breach of fiduciary duty allegation against the 10 percent shareholder. The court also rejected the founder defendant's claim that the plaintiff had misrepresented his computer expertise. The trial court found the founder defendant had breached his duty to PDS by participating as an interested director in the sale of the

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company's assets to the defendant's new company.

The plaintiff had the burden of proving damages resulting from the defendants' misconduct with reasonable certainty. The trial court found the plaintiff was unable to do so. The plaintiff's damages expert, the only expert witness testifying, had never been part of a software company startup or valued a software company or any other tech company. He proposed three values for PDS, all based on the assumption that ScriptGuard, the new company, represented the reorganized PDS. The expert said a minimum value for PDS was $1.5 million based on convertible promissory notes issued to ScriptGuard's initial investors, which gave investors the option of converting each $15,000 invested in notes into a 1 percent ownership interest in the company. As the expert saw it, 100 percent of the company would be worth $1.5 million.

According to the expert, the "most likely" value of PDS was $6 million. This amount was based on testimony by the minority shareholder that ScriptGuard's nominal value was $4 per share. Assuming 1.5 million shares of common stock at ScriptGuard's formation, the expert arrived at $6 million. He never explained why this value was the "most likely" value.

The expert produced an $8 million valuation based on a 2013 email that said PDS was looking for a $2 million investment from a single investor or investor group in exchange for a 25 percent interest in the company. No potential investor took up this offer.

The plaintiff's expert assumed, without investigating, that the new company, ScriptGuard, had tested its software in a pilot program in "a large medical group with three offices in Southern Orange County[,] comprised of 12 physicians, two physician assistants … and responsible for more than 35 covered lives." He also believed "there were testimonials as to the product as to how well it worked." In contrast, the founder defendant testified that there had never been such a pilot program.

In seeking to explain PDS' lack of revenue, the plaintiff's expert said history was full of non-revenue-generating companies that sold for millions of dollars based on the expectation that, one day, they would begin to generate revenue and net profits.

The founder defendant said the plaintiff's case was based on a "make-believe valuation." He pointed out that, after PDS had been in existence for a year, the company had no completed product, no customers, no sales and no investors or investments. The defendant wondered how this part-time project had turned into a multimillion-dollar lawsuit.

In his testimony, the 10 percent shareholder characterized PDS as "a very Mickey Mouse operation," which showed in its "poor documentation, poor record keeping, poor legal counsel, and naïve team members." The company's product "could barely support two [beta] baby users, let alone 10,000 users."

The trial court found the plaintiff's damages' evidence unpersuasive, noting that, by the time the remaining board members decided to hold an asset sale, PDS had no physical assets, no product and no investors. Essentially, PDS was a startup with an idea, the court said. Damages were speculative.

In contesting the trial court's finding on insufficient damages evidence, the plaintiff on appeal said, "[T]here is really no evidence that [the company] has zero value in the record." The plaintiff also pointed out that he was the only party offering expert testimony. He claimed that, under the controlling case law, "the uncontradicted expert testimony on a matter solely within the knowledge of the expert is conclusive and cannot be disregarded." The Court of Appeal first noted that the plaintiff failed to understand that it was the plaintiff who had to prove damages with reasonable certainty. It was not the defendants who had the burden to show that PDS had a negligible value, the court clarified.

As for presenting the only expert witness, the appeals court explained that the general rule actually says that the trier of fact may reject expert testimony, like other testimony, as long as the rejection is not arbitrary. The court noted the "uncontroverted expert opinion testimony" represented a "single exception" to the general rule and this exception only applied in professional negligence cases where expert testimony was necessary to establish the standard of care. "Valuing a company does not involve the standard of care," the Court of Appeal said. Therefore, the general rule applied, which gave the trier of fact discretion to assess witness credibility and to weigh the evidence.

The Court of Appeal found it was reasonable for the trial court to "put little stock" in the testimony of the plaintiff and the plaintiff's expert and consider the proposed valuations "speculation and wishful thinking on the part of the plaintiff and the defendants." The trial court reasonably could find the expert lacked credibility where the latter failed to understand basic facts, had never valued a startup company and had made an unfounded assumption that the company had successfully tested its software in a medical practice with 35,000 patients, the appeals court said. It emphasized that the company never showed any capacity to perform its true value proposition—that is, an ability to interact with third-party prescription databases to guard against fraud and abuse.

The Court of Appeal explained that damages in a new business usually are based on lost anticipated profits dependent on future events. To move beyond speculation and conjecture, the plaintiff must present evidence that makes reasonably certain the occurrence and extent of such events, the court went on to say.

Further, the court noted that the plaintiff "made little use of the yardsticks commonly employed to value new businesses." To show damages with reasonable certainty for unestablished businesses, the plaintiff may use expert testimony, economic and financial data, market surveys and analyses, business records of similar enterprises and the like, the court noted. It went on to say that here the plaintiff may have avoided using those indicia of value "precisely because PDS never settled on a revenue model; therefore, it was difficult, if not impossible, to provide relevant economic and financial data, market surveys and analyses, business records showing the degree of success of similar enterprises."

Finally, the Court of Appeal agreed with the trial court that the amounts various parties proposed at various points were nothing more than "people making bets that the business would succeed" and these amounts said "nothing about the intrinsic value of the business." The Court of Appeal declined to "second-guess" the lower court's ruling and upheld the zero damages finding.

Virginia Court Nixes Challenge to Appraisal Done According to Valuation Agreement

***Olli Salumeria Americana, LLC v. Vosmik,* 2018 Va. Cir. LEXIS 72 (Jan. 5, 2018)**

In the category of buyout disputes notwithstanding a valuation agreement, a Virginia case stands out for showing the evidentiary hurdle a challenger must overcome to defeat a third-party appraisal done in accordance with a controlling agreement. The court found that the plaintiff did not satisfy the applicable "palpable error" standard.

The two founders of a gourmet food producer and restaurant made an agreement that required the company to buy the defendant minority shareholder's stake in the company. The contract called for an independent appraiser to calculate the enterprise value of the company. Ultimately, the company rejected the value determination and instead sued, urging the court to invalidate the appraisal because it allegedly contained numerous "palpable" errors. The appraiser misinterpreted the agreement, was biased in favor of the defendant and made errors of commission and omission, the plaintiff contended. At trial, both parties offered testimony from highly qualified valuators as to the alleged palpable errors, but neither expert prepared an independent valuation. The appraiser also testified.

The court explained that where a valuation contract exists, it is not the court's role to substitute its judgment for that of the appraiser or to decide which testifying expert was correct. Instead the court must determine whether the appraiser understood and executed the provisions of the valuation contract. And, under the palpable error standard, a court may only set aside a valuation for "errors apparent on its face, misconduct on the part of the [valuators], some palpable mistake or fraud in one of the parties."

The court found no evidence that bias infected the valuation and concluded the appraiser's interpretation of the agreement was justified as a "fair and reasonable exercise of business judgment." Moreover, on the stand, the appraiser addressed the alleged errors of commission and omission and was able to show in each instance that he used his professional judgment "fairly and reasonably." And, since the company's expert did not do his own appraisal, the company was unable to show that any of those claimed errors were material to the value calculation, the court said. It declined to vacate the appraisal.

Nursing Home Valuation Must Separate Real Estate from Business Activity

***Arbors East RE, L.L.C. v. Franklin County Bd. of Revision,* 2018 Ohio LEXIS 885 (April 26, 2018)**

The Ohio Supreme Court weighed in on a tax assessment case centering on the valuation of a nursing home. The case shows that, in determining property taxes, nursing homes and similar facilities present value challenges because the sales price may include value for real estate, as well as non-realty components. The high court found that the Board of Tax Appeals committed a number of legal errors when it adopted the entire sales price as the property value in the face of an expert going-concern valuation that allocated the sales price to the property's various components.

In April 2011, Arbors East, the appellant, bought the property for a total sales price of nearly $7.5 million. A contemporaneous conveyance fee statement assigned the entire price to the real estate. Initially, the county auditor appraised the property at $4 million for tax purposes, but the Columbus City Schools Board of Education ("BOE") filed a complaint that argued the value was $7.5 million. In a separate complaint, Arbors East claimed the value was $3.5 million.

In 2014, the Franklin County Board of Revision ("BOR") held a hearing at which Arbors East offered an appraisal from a business valuation expert. The parties agreed it was proper to use the sales price, but the sticking point was whether to and, if so, how to allocate the sales price among the property's component parts. The expert testified that the 2011 sale had been an arm's-length transaction of a going concern. The transfer included the real property; furniture, fixtures, and equipment ("FFE"); and business goodwill. These components were "mingled together" to make up a going concern, the expert said.

He used a comparable sales approach, cost schedules and market-extraction techniques to determine how to allocate the sales price to the various assets of the nursing home business. Of the $7.5 million total price, he allocated $300,000 to FF&E, $1.8 million to a certificate of need (a legal document certain states require for the construction, development, or establishment of certain healthcare facilities) and $750,000 to business value (about 10 percent of the sales price). The appraiser assigned the residual amount of the sales price (i.e., 62 percent) to the value of real estate. He found that the 62 percent rate was in line with the 52.8 percent rate his comparable transactions analysis showed.

Arbors East also offered testimony from a tax manager of nursing homes in Ohio, who affirmed that the sale of a nursing home typically involved the sale of the "operator's lease" including all the licenses necessary to operate the nursing home. He called it a "realty plus" transaction. Both witnesses for Arbors East testified that there was no contemporaneous allocation of the sales price to the multiple assets.

The BOE seemed to object to the expert's methodology and claimed the expert's statement that the 2011 sale was of a going concern was hearsay. Ultimately the BOR decided to deduct about $287,000 from the total sales price, noting that, based on the property owner's tax return filings, this amount was the "net book value as reported to the IRS" of certain personal property. The BOR decided it could not break out other elements of the sale because there was no contemporaneous allocation of the sales price and the expert's allocation was done "well after the sale."

Arbors East appealed the finding with the Board of Tax Appeals ("BTA"), which concluded that the total sales price was the best evidence of value. BTA said Arbors East had not met its legal burden to demonstrate that its expert's allocation of the sales price was proper and justified a reduction from the sales price. It noted "all documentation submitted to the county auditor reflects value for realty only" and there was no contemporaneous allocation of the sales price. Therefore, BTA found itself "unable to verify which items other than the real property described in the sales documents in fact transferred or the portion of the overall purchase price attributable to those items." Moreover, BTA said that the state Supreme Court had held goodwill was not an asset that could be separated from the realty.

Arbors East appealed the BTA decision with the state Supreme Court, which discerned "multiple legal errors" in how BTA handled the case and in its conclusion. Specifically, the state high court noted that, even though BTA declined to allocate the 2011 sales price to assets other than real estate, it never found that the sales price reflected the transfer of real estate only. The high court said this was not surprising since an earlier determination by BOR had found the sales price was "the price paid for the going concern." Further, BOR earlier had reduced the sales price by allocating a certain amount to the value of FF&E.

The high court noted the two guiding principles of how to value real estate that is transferred in a single transaction together with other property ("bulk sales"). One principle holds that an actual, recent sale of the property in an arm's-length transaction represents the best evidence of "true value in money." A second principle says that the law favors a "proper allocation of [a] lump sum purchase price" over "an appraisal ignoring the contemporaneous sale."

According to the state Supreme Court, the issue here was whether the allocation that Arbors East had proposed was legally acceptable. The high court noted that Arbors East had obtained a partial reduction in property value at the BOR based on documentation showing the value of FF&E. However, BOR had failed to transmit this evidence to BTA. For its part, Arbors East had failed to ensure at the BTA hearing that the record was complete. The high court said that, when BTA finds that there is evidence missing, it should use its investigative authority to obtain any missing documents or other evidence that is necessary to determine the value of real estate. BTA did not do so in thist case.

Case law makes it clear that the sale of a congregate care facility (including a nursing home) includes the sale of real estate and business activities, the high court said. The facilities charge residents for providing care and services, which represents general business activity. Further, the facilities charge rent, which represents real estate activity. "In a valuation of only the real estate, the two activities must be kept separate," the state Supreme Court noted.

It went on to say that, against this body of case law, it was legal error for BTA to hold that any allocation of goodwill was improper. According to the Supreme Court, BTA's reliance on prior cases that dealt with the sale of a hotel or a self-storage facility was misplaced because those entities generated profit from permitting others to use real estate. In contrast, in the instant case, the nursing home sale involved business value and real estate value and therefore presented materially different circumstances.

The Supreme Court also found BTA placed undue weight on the absence of a contemporaneous allocation of the sales price to various bulk assets. Case law does place importance on "corroborating indicia" or the "best available evidence" of what the parties contemplated at the time of the sale, the court allowed. However, other case law provides that "negotiation of the allocation itself is neither a necessary nor a sufficient condition" to conclude an allocation reflects the value of the various components, the high court pointed out. It noted that the property owner here offered appraisal testimony to show the conveyance fee statement did not reflect the property value. And this appraisal was "particularly incisive, given that its examination of the market involves not merely a valuation of the real-estate component but also a justification for viewing the total sale price as consisting of realty and non-realty components," the high court said.

The Ohio Supreme Court called BTA's decision "marred by legal errors" and remanded for further proceedings. BTA had to: (1) exercise its authority to obtain the complete record in order to decide the case; (2) determine whether there was evidence that the sales price included value for assets other than real estate; and (3) if there was a determination that this sale was a "'bulk sale' in the relevant sense," BTA had to perform a proper allocation of the sales price.

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