VALUATION Trends

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# Public Company, Market Cap Approach Attacked Under Daubert

**Cooper Tire & Rubber Co. v. Farese, 2008 WL 5188235 (N. D. Miss.)(Dec. 9, 2008)**

Cooper Tire & Rubber Company's stock plummeted $500 million within one hour after the defendants wrongfully disseminated a disparaging affidavit. By the end of the day, Cooper's stock had fallen nearly 11%, with a trading volume of over 7.65 million shares. The company sued the defendants in federal court, but prior to trial, the defendants challenged their damages expert under the Daubert and Kumho Tire standards, claiming that he lacked qualifications to value a public company and his methodology was unreliable. They also raised an interesting side issue—whether the corporation or its shareholders were the appropriate party to recover for alleged damages to stock value.

As to the first challenge, the U.S. District Court (N.D. Miss.) agreed that the expert had never valued a public company's market capitalization and had never consulted for a tire company. Nevertheless, as an accredited CPA and former partner with Big 4 accounting firms, he was qualified to testify. An expert witness is not strictly confined to his area of practice, the court said. "[A] lack of specialization does not affect the admissibility of the opinion, but only its weight."

The company lost nearly $184 million in share value. In his report, the plaintiff's expert examined the one-day drop in stock value after publication of the disparaging statement, along with the trading volume. He concluded that the company lost over $184.8 million in market capitalization. He further analyzed the price of the company's stock over an eighteen-year period to determine if the precipitous decline on the damages date was abnormal and could be attributed to the defendants' action. He concluded that a trading volume of over two million shares of plaintiff's stock was atypical, and that price changes exceeding plus or minus 7.5% were likewise atypical. Based on his analysis of subsequent events, he ultimately concluded that the plaintiff's stock never recovered from the harm caused by improper dissemination of the defendants' affidavit.

To rebut these conclusions, defendants first argued that any trading losses on the alleged damages date belonged to the shareholders, not to the plaintiff; thus, only the shareholders had standing to recover the alleged decline in stock value. The court quickly dismissed this claim, however. "Definitive" state law (Mississippi) held that an action for diminution in stock value belongs to the corporation, not the shareholder. Accordingly, the plaintiff tire company was the proper party to recover any damages to its stock value.

The defendants next argued that the IRS, the SEC, and Generally Accepted Accounting Principles did not recognize the plaintiff's alleged losses. The court quoted Daubert, which held that "[g]eneral acceptance is not a necessary precondition to the admissibility of … evidence under the Federal Rules." Defendants could better address any questions concerning acceptance by other authorities on cross-examination.

Finally, defendants opposed the "simple math calculation" that plaintiff's expert used to determine loss of market capitalization, claiming that it was neither an appropriate nor an accurate measure. However, these were simply "battle of the expert issues," the court said. "Numerous courts have addressed and admitted testimony of experts who used the market capitalization approach to corporate damages, albeit in cases with dissimilar fact and not as the only method utilized."

Lastly, the expert's testimony would assist the trier of fact in determining if the plaintiffs suffered damages because of the published affidavit, the court held, and admitted the expert's evidence.

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## Statutory Fair Value Versus Fair Market Value: A Brief Historical Perspective

The two most prevalent standards of value in federal and state litigation matters are fair market value, as used and defined in bankruptcy code and tax cases, and statutory fair value, most often applied in shareholder dissent and oppression cases. (Note that this discussion does not include "fair value" as defined by the Financial Accounting Standards Board in its financial reporting and accounting statements.)

In purely linguistic terms, if you remove the "market" modifier, fair value takes on the broad meaning of a "value" that is "fair." An asset's fair value could be its market value, intrinsic value, strategic or investment value; its liquidation or going concern value. As a result, the standard gives a court wide discretion in reaching an ultimate conclusion of fair value. Perhaps that explains why there is still no universal definition of fair value in the context of dissent and oppression cases

By contrast, the definition of fair market value is well-established in legal, tax, and accounting settings, and is generally more limited to an asset's exchange value in the context of a real or hypothetical sale. Interestingly, however, the definition of fair value in Black's Law Dictionary says, "see fair market value," and provides a bankruptcy case by way of example, in which the court uses the term fair value. This circular referencing has muddied the distinction between the two concepts in a broader legal context. Over the years, however, specific precedent, statutes, and commentary have helped distinguish them in more particular cases.

An historical overview. References to standards of value began emerging in early 19th century case law, but without any specific definition. As the century progressed, the growth of railroads helped develop large, multi-shareholder companies in which unanimous consent for corporate action gradually gave way to majority rule. Accordingly, state legislatures and the courts began to look for equitable ways to value corporate ownership interests for tax purposes and in cases of shareholder disputes. Contract cases (for stock, real property, and other assets) contained the first references to fair value, but the concept still remained largely undefined.

At the beginning of the 20th century, litigation involving business valuations began to emerge. The American Bar Association drafted its Model Business Corporation Act, which helped state legislatures to codify dissenters' rights statutes. The 1933 Illinois Business Corporation Act became the model for shareholder oppression statutes, and in the early 1940s, California instituted the first statutory buy-out remedy in the shareholder oppression context. In 1950, the Delaware Chancery Court issued its landmark decision in Tri-Continental Corp. v. Battye (1950 Del. LEXIS 23), finding that fair value entitled the stockholder in a statutory dissent case "...to be paid for that which has been taken from him, viz., his proportionate interest in a going concern."

Similarly, the definition of fair market value began to emerge during the 1920s, through various case decisions that begin to discuss the concepts of willing buyer, willing seller, lack of compulsion and full knowledge ("known or knowable") of the relevant facts.

Businesses began to change during the latter half of the 20th century. Once their most valuable assets, "bricks and mortar" (real property and equipment) were replaced by intangibles such as patents, trademarks, trade names, and goodwill. Disputes over the disposition of intangible assets required more complex business valuations in the judicial context. At the same time, the concepts of equitable distribution in divorce matters and the codification of fair market value in Treasury Regulations and IRS Rulings began to establish a body of case law that defined and refined the FMV standard of value. As of the present date, the U.S. Tax Courts continue to confront fair market value issues including shareholder-level discounts, trapped-in capital gains, and the effect of subsequent events. Family courts still struggle with the treatment of professional and practice goodwill, the application of discounts, and the effect of buy-sell agreements.

Similarly, the past 30 years have also seen significant developments in the context of shareholder disputes. As more states adopted versions of the model business corporation statute, including its buy-out provision and the prohibition against application of discounts in amended versions, the fair value remedy has became more prevalent and available to oppressed/dissenting shareholders. Previously, for example, courts were reluctant to dissolve a company unless its conduct was particularly egregious. With the institution of the statutory buy-out remedy, courts became willing to compensate minority shareholders with the fair value of their stock. Finally, the decision by the Delaware Supreme Court in Weinberger v. UOP, Inc., 457 A.2d 701, 713 (1983), held that customary and current valuation techniques may be used in determining fair value in shareholder dissent cases.

## 20 Ways to Avoid an IRS Appraisal Audit

Some of the suggestions outlined below are simple common sense, while others tackle more complicated valuation matters. Nonetheless, tax attorneys, CPAs, and financial professionals will want to review the following list of the most common tax-related appraisal errors to avoid an IRS audit:

1. **Math errors.** This is an obvious recommendation that bears repeating, because even a simple math error may raise a red flag to an auditor, and/or result in a significant misstatement of value.
2. **Recent and relevant data.** In the current economy, make sure the appraiser has used industry and market data that are not so aged as to be unreliable or irrelevant.
3. **Qualified appraiser.** Does the appraiser have proven expertise in the field? Make sure the appraiser has the appropriate credentials to perform a particular appraisal, and has not crossed over into practicing law by asserting legal conclusions.
4. **Appropriate discounts.** Make sure any discounts "fit" the facts of the case and are appropriate to the interests at issue.
5. **Clarity of the conclusion.** The appraiser should clearly explain what method or weights were applied and how they were reconciled to the ultimate valuation conclusion.
6. **Reality check.** Check the bottom-line conclusion against this question: Would a reasonable person be willing to pay that amount for the company?
7. **Avoid intrinsic values.** Remember, tax-related appraisals must account for the hypothetical nature of fair market value.
8. **Avoid appraiser bias.** Business appraisers must be able to demonstrate the reasonableness, independence, and objectivity of their valuation conclusion.
9. **Avoid bias in the data.** Appraisers should be able to cite independent support for their selection of data; anything that skews the valuation in an obvious direction will raise a red flag.
10. **Stick to the facts.** An appraiser's opinion must be supported by the specific facts and circumstances of any case.
11. **Comparable companies.** Any use of guideline comparable companies in a market approach to valuation should account for the specifics (cash flow, earnings, etc.) of the transaction data vis-à-vis the subject company.
12. **Pay attention to the assets.** Stand back from the appraisal and make sure it values the particular rights and ownership interests at issue. In an intellectual property valuation, for example, did the appraiser value a prototype, the rights associated with it, or something else?
13. **Focus on the future.** Instead of focusing on historic cash flows, for example, the appraisal should consider what will happen to the cash flows going forward.
14. **Pay attention to capital structures.** Make sure the appraisal assesses this factor in relation to the facts of the case, use of guideline companies, the subject company, etc.
15. **Discount and cap rates.** Consider: Is the appraiser's growth rate appropriate for the subject company's first two years, or for years three and four?
16. **Adjust income statements.** Reasonable compensation for officers and directors is the most common focus of IRS inquiry, typically for smaller firms. Make sure the appropriate adjustments have been made to determine reasonable compensation for the particular entity.
17. **Watch tax-affecting.** Consider the facts and circumstances of each case in terms of the appropriateness of tax affecting, and whether it matches the growth and capital requirements of the subject company.
18. **Address intangibles.** For valuations of intellectual property and other complex assets, you may want to consider obtaining a separate appraisal.
19. **Premise of value.** Make sure the premise of value—going concern versus liquidation value, for example—fits the facts of the case and the assets and enterprise at issue.
20. **Document, document, document.** Make sure the appraiser can fully support the assumptions in the valuation and documents the valuation of inventory, accounts receivables, etc. at fair market values.

# *Lost Profit Testimony Falls Short of the Necessary Financial Expert Evidence*

**Neiman v. Bunnel Hill Development, Co., 2008 WL 4694998 (Ohio App.)(Oct. 27, 2008)**

This decision illustrates what happens when a plaintiff fails to retain a qualified expert to testify to lost profits damages, and the defendant offers a credible expert to rebut those same claims.

The plaintiff operated a pizzeria in mall space that he leased from the defendant/landlord. The parties' lease included the right of first refusal for adjoining space. However, when the tenant wanted to expand into this space, he discovered that the landlord had rented it to another restaurant. The tenant sued for breach of contract and damages, including the profits he lost from the time of the breach until he could reopen the pizzeria at a new location, plus associated costs.

At trial, the plaintiff failed to present any expert testimony on lost profits damages, including any market surveys or industry analyses. Neither did he ask the jury to consider the profits that his pizzeria made at its former location and then use these to project the profits that he could have anticipated from expanding that space. In fact, he admitted that he was not qualified to make these calculations.

Instead, he submitted two years of tax returns: one showing profits at the old location and another illustrating profit at the new location, three years later. The jury was asked to find that the latter (some $203,000) was evidence of the profits he would have made, had the landlord permitted him to expand into the former space. He also requested about $60,000 in the moving and build-out costs incurred at the new location.

The defendant presented an expert witness. At trial, the defendant retained a forensic-certified CPA to demonstrate that the plaintiff's lost profits calculations were inconsistent with generally accepted accounting principles. It was inappropriate to compare tax returns from the old and new businesses, he maintained, because there were substantial differences between the two, including their locations, rents, equipment, and parking availability. In addition, a competing pizza restaurant was moving within one mile of the old location, which plaintiff failed to account for in his calculations. The plaintiff also failed to present evidence of the costs he would have incurred in expanding the old location; instead, he only submitted his build-out costs at the new location.

Nevertheless, the jury awarded him unspecified damages for $162,500. The defendant appealed, claiming that the pizza owner's methodology failed to prove lost profits to a reasonable certainty.

The court of appeals agreed that the plaintiff's lost profits calculations fell short of the requisite standard. To establish these amounts with reasonable certainty, the plaintiff needed to show what his profits would have been in the expanded space, "and then subtract from that figure the costs he would have incurred in expanding his pizzeria there, as he planned to do before [the defendant] breached the right of first refusal clause in the parties' lease," the court said. Without this evidence, "it was impossible for the jury to determine with reasonable certainty what [the plaintiff's] net lost profits would have been," but for the breach.

Further, it was not clear from the jury's award what portion accounted for the plaintiff's moving and build-out costs, and what portion accounted for lost profits. Accordingly, the court reversed the award and remanded the case for a new trial and proper accounting of lost profits.

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