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VALUATION Trends
Trugman Valuation Associates, Inc.

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Two Notable Valuation Decisions From the Delaware Courts

Two recent Delaware cases gave the courts the opportunity to implement "bright line" rules in the often complex world of corporate valuation.

Chancery Court defines 'funds legally available.' In *SV Investment Partners v. Thoughtworks, Inc.*, 2010 WL 4547204 (Del. Ch.)(Sept. 8, 2010), a group of preferred stockholders wanted to redeem their $27 million investment in an IT firm. By its terms, their stock agreement permitted redemption "for cash out of any funds legally available" and required the company to value its available assets "at the highest amount permissible under applicable law."

The stockholders claimed that the phrase "funds legally available," commonly found in stock redemption agreements, simply meant funds "that carry no legal prohibition on their use." In other words, any corporate surplus is "legally available" for redemption of stock, the plaintiffs argued, and surplus is the amount by which net assets exceed its stated capital. To support their claims, the plaintiffs' valuation expert found the company as a going concern ranged in value from $68 million to $137 million, finding sufficient funds available for the redemption of the preferred stock.

However, the phrase "'funds legally available" is not synonymous with "surplus," the court held. "Distributions are never, and can never be, paid out of 'surplus'; they are paid out of 'assets,'" it explained. "No one ever received a package of surplus for Christmas." Instead, the phrase contemplates funds (cash) that are readily accessible and do not violate statutory or common law restrictions against a redemption that would render the company insolvent. The valuation provisions of the preferred stockholders' agreement did not override these basic concepts, the court found. They did not create an obligation to redeem shares when no funds exist, nor did they trump other legal impediments to the use of funds, such as cash flow insolvency. The expert's valuation—although theoretically defensible—failed to consider the "real economic value" of assets the company could use for redemption while also continuing as a going concern, the court held, and denied the plaintiffs' suit.

Should market price be presumptive proof of fair value? In *Golden Telecom, Inc. v. Global GT LP*, 2010 WL 5387589 (Del. Supr.)(Dec. 29, 2010), the company appealed the Court of Chancery's decision that its $105 merger price fell short of its statutory fair value by more than $20 per share. In an efficient market, they argued, Delaware courts should defer exclusively to the merger price in statutory fair value appraisals or, at the very least, regard it as rebuttable "presumption" of fair value.

The Delaware Supreme Court dismissed this argument as too simplistic. The state business statutes require the courts to account for "all relevant factors" in making an independent determination of fair value. Moreover, Delaware case law specifically defines "fair value" as the value to a shareholder in the firm as a going concern rather than its value in a merger or other transaction. Accordingly, "there is no basis for a court, in a statutory appraisal proceeding, to conclusively, or even presumptively, defer to a merger price as indicative of 'fair value,'" the court held.

Similarly, the court rejected the dissenting shareholder's claims that the company should have been bound by the financial information it used during the merger process. Such a "bright line" rule would constrain the flexibility of the appraisal process as well as the "significant discretion" given to the Court of Chancery to decide fair value. It would also "pay short shrift to the difference between valuation at the tender offer stage—seeking 'fair price' under the circumstances ... and valuation at the appraisal stage, seeking 'fair value' as a going concern," the court ruled, and dismissed the appeal.

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Divorce Courts Reject 'Calculation Values' Offered by BV Experts

During these tough economic times, parties and their attorneys may often request a business appraiser to perform a preliminary "calculation valuation" for settlement purposes. Although the majority of cases do settle, these two recent cases highlight problems of presenting anything less than a complete valuation in court.

***In re Marriage of Hagar,* 2010 WL 4807559 (Iowa App.)(Nov. 24, 2010).** The husband and wife owned three dry cleaning stores, which they bought from his parents for $300,000 with a promissory note. Over the marriage, they paid down the note to nearly $121,000, but when the relationship deteriorated, the husband defaulted and his mother threatened forfeiture, so the wife borrowed money to pay the arrears. At trial, the court faulted the husband for wanting to "ruin the parties' financial picture," and valued the business at $95,000, or the midpoint in a range of $71,000 to $120,000 provided by the family's longtime CPA.

On appeal, the husband pointed out that the CPA actually testified that the business was worth between $71,000 and a negative $120,000. However, the wife pointed out that the CPA had offered his figures as a mere calculation of value, using "rules of thumb" and industry standards that didn't require the same professional judgment as a complete valuation.

The appellate court agreed that the CPA expressed his $120,000 value as a negative number. "However, we do not use [his] calculations because he admittedly did not 'use judgment.'" The CPA also failed to recognize the family relationships that affected value. Based on the couple's purchase of the business for $300,000 and their creation of equity by paying the note down by $140,000, the appellate court valued the business at this higher amount and confirmed its award to the husband.

***In re Marriage of Cantarella,* 2011 WL 86284 (Ca. App. 4 Dist.)(Jan. 11, 2011)(unpublished).** In this case, the parties agreed to split the value of the marital business, which they said was worth $60,000, and the trial court adopted their agreement in its final orders.

Four months later, the wife returned to court with an attorney and a business appraiser, whose "preliminary valuation" indicated the business was worth $172,000. However, the appraiser admitted that he lacked the documentation with which he would typically perform a complete business valuation, including aged accounts receivable, payroll tax returns, equipment appraisals, etc. But the wife had traditionally handled all the business accounting, the husband argued, and withheld the documents to hide the business's debts and depressed accounts.

Based on this evidence, the trial court refused to reconsider its prior orders. At the same time, it *did* revise the value of the marital residence, based on a formal appraisal that the husband had withheld during discovery. The wife appealed the denial of her request to reconsider the value of the business, reasserting her appraiser's preliminary valuation. The appellate court rejected her claims, finding that—unlike the formal appraisal of the house—the calculation of value did not establish clear evidence of a mistake, and it confirmed the prior orders.

IRS Reveals Seven Mistakes of Highly Unsuccessful Appraisals

In recent conferences sponsored by business appraisal professional organizations and industry associations, the IRS has made an effort to discuss, on an informal basis, the most common reasons for auditing a business appraisal associated with a gift or estate tax return. Most of the following "red flags" will not surprise estate and gift tax attorneys (or their financial advisors) so much as confirm the areas that require continued professional oversight and appraisal expertise:

1. **Discounts.** The reasonableness of valuation discounts used in estate and gift tax appraisals is still a primary focus for the IRS, which will often flag discount conclusions that are not supported by the data or that apply study averages without sufficient explanation.
2. **Standard of value.** Likewise, the IRS is still seeing valuation reports that apply the fair value standard instead of fair market value, or consider the perspective of only one person (either the hypothetical willing buyer or the seller) rather than both.
3. **Tax-affecting.** Valuation of S corporations is another problematic area, in which the courts, valuation experts, and IRS examiners have not always been consistent. Rather than focus on the case law, attorneys and appraisers would be well-advised to carefully consider the particular facts and circumstances of any case. Related issues are tax considerations in C to S corporation conversions and the valuation of embedded capital gains tax liability.

4. **Factual errors.** Appraisal inaccuracies will also get the attention of the IRS. More than mere mathematical errors, these include presenting false information or assuming facts related to the appraisal that do not exist.
5. **Valuation errors.** Unfortunately, the IRS is still finding appraisals of business interests that purposefully include or exclude valuation approaches; ignore strong market evidence; or disregard professional standards. Many of these mistakes are made by individuals without the appropriate training or experience, and can be avoided by using qualified appraisers.
6. **Analytical errors.** The IRS is also finding appraisals that lack a strong, consistent factual development; an income stream that's inadequately or inappropriately matched to any adjustments (discounts); an incomplete tax rate analysis. Appraisals that supply a good "analytical fit" to the facts of a case clearly show how the valuation conclusions were reached; what adjustments were made; what data were used; and what law was relied on.
7. **Documentation errors.** Also watch out for: exhibits and computations that fail to follow the analytical narrative or are incomplete; and failure to document according to all relevant professional standards.

Lost Profits Roundup: Better Industry Research & Expertise Proves Essential

Five new cases demonstrate that the more comprehensive and careful the analysis, the more an expert's calculations will lend certainty to a finding of lost profits damages.

A complete menu of restaurant research. In *LB 4 Fish, LLC v. Developers Diversified Realty Corp.*, 2010 WL 2723545 (Cal. App. 2 Dist.)(July 12, 2010) (unpublished), a jury awarded the plaintiff nearly $12 million in damages for a breached restaurant lease, and the defendant appealed. After confirming liability, the appellate court considered damages. The plaintiff's expert had relied on numerous sources to support his lost profits calculations, including the pleadings; discovery; the parties' lease; the restaurant's forecasts and investment memoranda; its monthly financial reports and daily sales reports for four years; several comprehensive commercial databases regarding restaurant statistics and industry intelligence; and forecasts from the National Restaurant Association. From the research, he culled data on restaurant financial ratios, working capital, return on investment, and sales as a percentage of assets and liabilities. The expert also consulted with the plaintiff's management team, which had successfully run similar restaurants in nearby locales for over 30 years.

"At each step of the process, [the expert] took a conservative approach," the court said. Moreover, the expert "explained his selection process, as well as where he obtained his data and how the information affected his analysis," the court added, and confirmed the jury's award.

First-time expert challenged. In two successive opinions, *Metro Tech Corp. v. TUV Rheinland of N.A.*, 2010 WL 4117123 (D. Puerto Rico.)(Oct. 18, 2010); and *Metro Tech Corp. v. TUV Rheinland of N.A.*, 2010 WL 4117115 (D. Puerto Rico.)(Oct. 18, 2010), the plaintiff alleged the defendant breached its contract to provide ISO certification and claimed over $35 million in lost profits. In two successive motions, the defendant requested summary judgment and to disqualify the expert under *Daubert*.

In the first of its successive opinions, the federal court permitted a substantial portion of the claims to proceed to trial. In the second, the court found the plaintiff's expert, a Ph.D. and international economist, sufficiently qualified. As to his methodology, the defendant claimed it was unreliable because the expert had never calculated lost profits before or applied Ibbotson multipliers, and didn't know if the methodology had been peer-reviewed. The plaintiff responded by saying the methods were commonly accepted and peer-reviewed (although the court opinion does not set forth any citations). Further, the expert reviewed extensive regional data pertaining to each damages claim as well as any lost contacts or quotes. The court ultimately permitted his testimony, finding any alleged weaknesses were better suited to cross-examination at trial.

Internet and informal sources are questionable. In *R&R International v. Manzen, LLC*, 2010 WL 3605234 (S.D. Fla.)(Sept. 12, 2010), the defendant breached its distribution agreement after only five months, and the plaintiff claimed $8 million in damages. The defendant filed a Daubert motion against the plaintiff's expert, an investment banker.

The court found the expert's "substantial" i-banking experience in the beverage industry qualified him. His lost profits calculations, however, suffered from numerous flaws, including: 1) his market share studies were from Wikipedia and other unidentified sources; 2) he failed to explain how he developed the plaintiff's

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sales figures or distribution costs; 3) under the market approach, the expert compared the plaintiff, a beverage *distributor*, to several national beverage companies; 4) he failed to conduct any formal market or consumer surveys, relying on telephone interviews and visits to stores—which he conceded could not be replicated.

More importantly, the expert admitted that—as an investment banker, he could not have used his report to make a recommendation. When an expert "is unable to attest to the reliability of his own lost profits analysis, this court is hard-pressed to reach a different conclusion," the court said, and struck his testimony.

Similarly, in *Total Clean, LLC v. Cox Smith Matthews, Inc.*, 2010 WL 4108820 (Tex. App.)(Oct. 20, 2010), the court considered the plaintiff's expert evidence regarding losses arising from the breach of a contract to build a new automated truck wash. The plaintiff's expert had no experience in the truck wash industry. To support his revenue projections, he relied on information found on the Internet and a fax from the plaintiff's industry consultant. Moreover, he admitted that some of his assumptions regarding capacity were simply "untrue," and the court confirmed summary judgment of the plaintiff's claims.

Lost business value must relate to parties-in-suit. In *Precision Fitness Equipment of Pompano Beach, Inc. v. Nautilus, Inc.*, 2010 WL 5349652 (D. Colo.)(Dec. 20, 2010), the plaintiff alleged the defendant destroyed its business, and presented an expert who valued the plaintiff in combination with its affiliate at $5.8 million. The defendant claimed the expert's opinion was stale, because it provided a value three years pre-breach. It also challenged the expert for failing to give a separate value for the plaintiff, when clearly its affiliate was not related to the litigation. In response, the plaintiff said additional witnesses would provide the link between the expert's value and the value at the date of breach. The value of the combined companies was relevant, it said, because the defendant knew the companies were related and relied on this relationship to keep from having to enter a separate contract with the affiliate.

The court did not find the timing of the expert's valuation fatal. To the extent that he purported to value the plaintiff at some point in time before the breach, his opinion was "arguably" relevant, the court said. However, it is "axiomatic" that only the entity which claims damages can recover such damages. The affiliate's alleged damages were not relevant to any claims asserted in the case, the court ruled, and struck the expert's conclusions.

***Daubert* requires sufficient evidence of new business sales.** Finally, in *Ho Myung Moolsan, Co. Ltd. v. Manitou Mineral Water, Inc.*, 2010 WL 4892646 (S.D.N.Y.)(Dec. 2, 2010), the plaintiff claimed over $133 million due to the defendant's breach of a distribution agreement. The trial court granted the defendant's *Daubert* motion, finding his conclusions were unreliable and strayed into improper matters of legal and factual opinion, and the plaintiff appealed.

The federal district court confirmed, finding that the expert's contract constructions were either not relevant, because they required no specialized knowledge, or strayed impermissibly into the court's or the jury's role. Likewise, his claims regarding the contract's exclusivity "demonstrated no intellectual rigor" or independent authority. To reach his $133 million damages calculations, for example, the expert assumed that the plaintiff's requirements would increase from one million to three million over the five-year contract term. But, "there was no evidence whatsoever" for these assumptions, the court held. More importantly, the expert relied on no documentary evidence establishing that the plaintiff, a relatively new business, had made "even a single sale," the court held, and confirmed the exclusion of his report.

Trugman Valuation
ASSOCIATES, INC.

Call (800) 330 - VALU to request a free CD-ROM brochure
or visit our Website at:
www.trugmanvaluation.com

Florida: 1776 N Pine Island Rd, Suite 314
Plantation, FL 33322
Phone: (954) 424-4343

New Jersey: 2001 Rte 46, Suite 310
Parsippany, NJ 07054
Phone: (973) 983-9790

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