TRUGMAN Valuation

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Court Disapproves of Use of Damages Model to Establish Liability

Select Comfort Corp. v. Tempur Sealy Int'l, Inc.

An economic damages case featuring two major mattress manufacturers and claims of false advertising provides an insightful discussion of two theories of damages: disgorgement and lost profits. The court rejected one of the plaintiff expert's two disgorgement models as not sufficiently tailored to the alleged wrongdoing and found that the expert's lost profits analysis was legally and methodologically unsound.

Select Comfort and Tempur Sealy (dba Tempur Pedic) were rivals. Both marketed products that aimed to improve on traditional innerspring mattresses. After Select Comfort had come out with its "Sleep Number" brand, Tempur Pedic entered the market with the "Tempur Choice" line of beds.

Mattress Firm was a bedding retailer that sold Tempur Pedic products and at one time had sold Select Comfort products.

Select Comfort sued Tempur Pedic and Mattress Firm, alleging both defendants made false statements about Select Comfort, specifically the Sleep Number products, which hurt Select Comfort's sales, reputation, and goodwill. The statements appeared in a flyer that Tempur Pedic had developed and distributed via Mattress Firm that outlined why the Tempur Choice collection beat the Sleep Number brand. Moreover, Tempur Pedic provided Mattress Firm with training materials for employees, which contained false representations about Sleep Number beds.

Select Comfort's expert calculated damages specific to each defendant. The defendants offered separate rebuttal testimony and both filed separate Daubert motions to exclude the plaintiff expert's testimony.

In terms of Tempur Pedic, Select Comfort's expert performed a two-model disgorgement analysis. The "low-end" calculation focused on disgorgement of Tempur Pedic's profits attributable only to the sale of Tempur Choice mattresses and related products. The Tempur Choice line competed directly with Select Comfort's Sleep Number brand. In contrast, the "high-end" calculation included Tempur Pedic's profits from sales of all Tempur Pedic products.

The court explained that, in a disgorgement analysis, the plaintiff merely has to prove the defendant's sales of allegedly falsely-advertised products. The burden then shifts to the defendant to prove that sales were not the result of the alleged misconduct. The court found that only the expert's low-end calculation, which, it said, took pains to exclude sales that were not related to the false advertising, was admissible.

In terms of Mattress Firm, Select Comfort's expert also performed a "before and after" lost profits calculation (besides the disgorgement analysis). In essence, he compared average monthly mattress sales of certain Select Comfort stores located near a Mattress Firm store (the A Stores) with sales of certain Select Comfort stores not located near a Mattress Firm store, but within a certain distance of another retailer that sold Tempur Pedic bedding (the B Stores).

The comparison focused on the change in performance in the A Stores relative to the B Stores after the court had granted Select Comfort's motion for a temporary restraining order prohibiting Mattress Firm from making negative statements about Select Comfort.

The before and after analysis showed the A Stores

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performed better against the B Stores after the injunction was issued, the expert found.

Mattress Firm objected that under the law, the plaintiff had to prove that the false statements Mattress Firm employees allegedly made about Sleep Number beds were part of an organized campaign to penetrate the relevant market. The plaintiff failed to do this; its expert assumed there was liability based solely on the proximity of the A Stores and the B Stores, not on evidence that the false statements were actually made.

Also, the lost profits analysis did not adequately consider important market factors that could have caused the plaintiff's losses.

The court agreed with Mattress Firm on both points. It found the plaintiff tried to meet its burden of proving liability at trial by using the expert's damages model. Specifically, it tried to use the expert's "before and after" data to show there was nationwide, systemic disparagement of its products. The plaintiff's use of the expert data was "inappropriate." Also, the lost profits model did not consider the effect of the plaintiff's own increased advertising in the "after" period with regard to certain A Stores, nor did the calculation sufficiently account for the presence of competitors other than Tempur Pedic.

The expert's high-end disgorgement and the lost profits analyses were inadmissible, the court said. Testimony as to the low-end disgorgement calculation was admissible.

Court of Appeals Sides With Taxpayers on Right to Vet IRS Expert Valuation

Cavallaro v. Commissioner (Cavallaro II)

In 2014, taxpayers who had relied on estate planning professionals to affect the transfer of their family business to their sons confronted a tax liability on a $29.6 million gift. A decision from the appeals court, however, offers them a glimmer of hope. The latest ruling says that the taxpayers have a right to rebut the Internal Revenue Service's expert valuation and, if successful, obtain a fresh assessment from the Tax Court.

The parents owned Knight Tool Co. (Knight), a business that developed an automated liquid-dispensing machine—CAM/ALOT. In 1987, the parents' three sons formed a separate company, Camelot, to refine and market the technology.

In 1994, the taxpayers hired experienced accountants and lawyers for estate planning advice. The professionals had to decide which entity owned the value of the CAM/ALOT technology and come up with a strategy of how to pass the value on to the sons in a way that minimized estate tax liability. The lawyers created a narrative in which the value transfer started with the incorporation of Camelot even though there was no record to back the story up. A lead lawyer told everyone not to be "discouraged by having to squeeze a few embarrassing facts into the suitcase by force."

The professionals shaped a merger based on the premise that no gift tax was due because, in 1995, on the merger date, Camelot already owned the CAM/ALOT technology. After the IRS became alert to a possible gift tax liability related to the merger, it sued and discovered documents that proved harmful to the taxpayers' case, including the lawyer's statement. In its deficiency notice, the IRS claimed the merger resulted in a roughly $23 million gift from each parent to the sons. The taxpayers petitioned the Tax Court for a redetermination.

At trial, the IRS reduced the gift to $29.6 million based on expert testimony the IRS had obtained for trial. The expert assumed Knight owned the technology and found the merged entity was worth $64.5 million. Knight, he decided, owned 65 percent of that value—$41.9 million—and Camelot owned 35 percent of it—$22.6 million. The IRS initially had assigned zero value to Camelot.

The taxpayers offered two expert appraisals, both of which were predicated on the understanding that Camelot owned the technology at the time of merger. Both experts used a market approach and neither appraiser prepared an alternative valuation assuming Knight owned the technology and manufactured the machines.

In front of the Tax Court, the taxpayers claimed that the IRS's expert valuation was fatally flawed because the expert proceeded from the wrong assumption and his income-based analysis had serious methodological flaws.

The court concluded that Knight owned the value of the technology on the merger date and that the taxpayers had "the burden of proof to show the proper amount of their tax liability." Since the valuations they offered were both based on an incorrect assumption, they were unable to meet their burden of proof. Therefore, "it is all but immaterial that the Commissioner's expert reached this $29.6 million gift number by an arguably flawed analysis," the Tax Court said. It adopted the IRS's figures.

The taxpayers appealed the decision with the U.S.

Court of Appeals for the 1st Circuit. The reviewing court found there was legal and factual support for most of the Tax Court's findings.

However, the 1st Circuit sided with the taxpayers on their claim that the Tax Court erred in refusing to consider their critique of the IRS expert's valuation report. According to the 1st Circuit, the taxpayers merely had to show the IRS's determination was "arbitrary and excessive," which they tried to do by casting doubt on the IRS's expert valuation.

The taxpayers had a right to the Tax Court's assessment of their valuation challenges, the 1st Circuit said. It remanded. Should the Tax Court decide the IRS's liability determination indeed was arbitrary, the court is obligated to determine the proper amount. The Court of Appeals also authorized the Tax Court to consider a new expert valuation.

Reasonable Compensation Analysis Ignores Objective Evidence, Tax Court Says

Transupport, Inc. v. Commissioner

Expert independence was front and center as an issue in the Exelon tax case. Now comes a reasonable compensation case in which the Tax Court zeroed in on the same point. The court rebuked an experienced compensation analyst for what it perceived to be his advocacy for the taxpayer and it dismissed his testimony as unhelpful.

The case involved a family business that was a supplier and surplus dealer of aircraft engines and engine parts used in military vehicles. The founder of the company served as president and CEO. His four sons were the company's only full-time employees and officers, doing whatever needed to get done to keep the business successful. None had special experience or skills. In 2005, the father transferred stock valued at the maximum allowed without incurring gift tax to the sons, allowing them to pay the remainder of the purchase price in installments.

In 2007, the father tried to sell the company. Marketing materials, which later found their way into the hands of the IRS, included a "Recast Financial Summary." The accompanying explanation said: "Five Shareholder salaries recast to market rate of $50,000 annually each."

The father, alone, determined compensation to the sons. He seemed guided by the aim to reduce taxable income for the company, achieve equal treatment of the sons and facilitate share ownership.

During an audit by the Internal Revenue Service, a senior appraiser and valuation specialist prepared a reasonable compensation analysis. The analysis was not flawless. For example, he relied on a database for executive compensation, instead of one providing a broader salary base.

The IRS deficiency notices alleged that the company had claimed excessive deductions for salaries or other compensation and had understated the value of its inventory in all of the relevant tax years in order to reduce tax liability. The taxpayer challenged the assessments in the Tax Court.

In terms of reasonable compensation, both parties offered expert trial testimony. The taxpayer's expert was an expert in "normalizing owner compensation," which, he said, is "adjusting the numbers to what they think a buyer might experience." In this instance, he did not adjust based on any of the objective factors courts usually consider in assessing reasonable compensation, including shareholder-employees' compensation compared with nonshareholder-employees and prevailing rates of compensation for comparable positions in comparable businesses.

And, even though he has recommended that analysts use various data sources, he relied on only one source in this case. He placed the sons in the 90th percentile of employees in claimed comparable positions even though the sons seemed unfamiliar with key aspects of the job for which they were responsible. The expert did not adjust for the fact that the father set the compensation based on his own criteria.

The IRS relied on a different compensation expert at trial than the specialist who had prepared the analysis underlying the deficiency notices. This expert generated a reasonable compensation figure that was lower than the one the IRS specialist achieved, raising the taxpayer's liability.

The court discredited the taxpayer's compensation expert, noting "[e]xpert opinions that disregard relevant facts affecting valuation or exaggerate value to incredible levels are rejected." Usually, the problem with experts was not their qualifications, but "their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, which is contrary to their professional obligations," the court said.

Here, instead of performing an independent analysis, the expert sought to "validate and confirm" the amounts the taxpayer reported in its tax returns. The resulting compensation determination was unreliable, the court decided.

Ultimately, the court adopted the reasonable compensation figures underlying the Service's notices of deficiency.

Chancery Bases Fair Value Calculation on Income-Based Model

Dunmire v. Farmers & Merchants Bancorp of W. PA

In a statutory appraisal action, the Delaware Court of Chancery rejected the deal price as evidence of fair value citing a suboptimal sales process. Only an income-based approach that the experts for both parties used represented a reliable methodology, the court found. The court provided a useful discussion of synergy and a critique of the experts' input choices.

The dispute arose out of the 2014 merger of two small community banks that the Snyder family controlled. The banks, Farmers & Merchants Bancorp of Western Pennsylvania (F&M) and NexTier, underwent a stock-for-stock transaction based on an exchange rate that implied a valuation of $83 per share for F&M and a valuation of $180 per share valuation for NexTier. At trial, the minority shareholders (petitioners) and the bank (respondent) offered expert testimony from experienced valuators. The bank also claimed the merger price was "a strong indication of the value of F&M."

The court disagreed. Typically, it is appropriate to rely on the deal price if there was a "robust" sales process, the court observed. This was not the case here. F&M pursued the merger at the request of the controller, who "stood on both sides of the transaction." There was no auction—no one reached out to potential third-party buyers. And, even though F&M's board installed a special committee, "the record does not inspire confidence" that an arm's-length transaction took place. The court gave no weight to the merger price. The expert valuations had flaws as well, the court found. It ultimately performed its own income-based analysis by drawing on the experts' opinions.

The petitioners' expert based his value conclusion—$137.97 per share (i.e., 66 percent above the deal price) on a comparable transactions' analysis. He performed a discounted future benefits analysis as a cross-check; this calculation produced a value of $139.45 per share, taking into account certain adjustments.

The comparable analysis was unacceptable, the court found, because it failed to account for any synergistic value captured in the eight comparable transactions. "Fair value," in the context of statutory appraisal, means "the value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction." Instead, the petitioners' expert assumed "bankers who buy other banks don't pay for synergies." The court observed that public statements related to the comparable transactions expressly mentioned potential synergies.

The respondent's expert based his value conclusion of $76.45 per share on three methods that he weighted equally. The court rejected his M&A analysis because "too much doubt exists over the appropriateness of the comparables." It also found his guideline public-company valuation was problematic because the selected companies had low trading volumes.

The court decided that since both parties agreed fair value could be calculated based on a discounted net income analysis, this was the appropriate methodology. In assessing the four key inputs, projected net income, discount rate, growth rate and adjustments (excess capital), the court said it relied on the Duff & Phelps *2014 Valuation Handbook - Guide to Cost of Capital* and Duff & Phelps *2014 Valuation Handbook - Industry Cost of Capital* (Duff & Phelps Handbook) "to maintain consistency in the analysis."

The experts agreed on the risk-free rate (2.87 percent) and the size premium (3.87 percent), which, the court noted, came "directly" from the Duff & Phelps Handbook "and are ostensibly reasonable." Accordingly, the court adopted those inputs. The experts sharply disagreed over the remaining inputs. The court, looking for an expert opinion that was consistent with the principles of the Duff & Phelps Handbook, Chancery case law and the record of the case, and found the respondent expert's analysis more persuasive.

The court adopted all of the respondent expert's inputs, except for beta and arrived at a fair value of $91.90 per share for F&M.

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