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VALUATION Trends
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Roundup: Lost Profits Damages and Lessons Learned from Daubert

Three recent decisions illustrate the ways in which a pre-trial *Daubert* motion can make or break a plaintiff's case for lost profits damages, based solely on the reliability and relevance of its expert evidence.

***Victory Records, Inc. v. Virgin Records America, Inc.*, 2011 WL 382743 (N.D. Ill.)(Feb. 3, 2011)** In this first case, the plaintiff sought millions of dollars for the defendant's alleged interference with its multi-album recording contract with a rock 'n' roll band. Its expert, a music industry accountant, calculated damages based on a "before and after" approach, comparing what the plaintiff's sales would have been absent the alleged interference, as well as the "yardstick" analysis, which looks to profits produced by industry comparables. Both methods must rest on "adequate" assumptions and "cannot be the product of mere speculation," the federal district court observed.

However, the expert's "before and after" approach relied almost exclusively on the plaintiff's internal sales projections, without independently verifying whether they were accurate. When a party's internal projections rest on its "say-so" rather than statistical analysis, they are unreliable under *Daubert*, the court held. Similarly, the expert relied on the plaintiff to recommend a single rock band to use as a yardstick comparable. This "paltry foundation" failed to meet the reliability requirements of Rule 702 of the Federal Rules of Evidence, the court held, and excluded the expert's evidence.

***Insignia Systems, Inc. v. News America Marketing In-Store, Inc.*, 2011 WL 167259 (D. Minn.)(Jan. 14, 2011)** The plaintiff's expert in this case also used two approaches to estimate damages (ranging from $121 million to $214 million) for the defendant's antitrust violations. Under the first, he selected "a cohort" of comparable, publicly traded firms to serve as a proxy for the plaintiff's "but for" market performance and market capitalization. Under his second approach, the expert calculated separate categories of the plaintiff's lost profits based on management's "best estimates" of future performance.

The defendant challenged the evidence under *Daubert*, claiming that the expert's market approach used companies from different industries and failed to account for alternative causes of loss; and his projections came from "biased" and unverified sources. In response, the expert noted that in a market with so few players, it would make little sense to compare the plaintiff's performance against competitors that were unaffected by the defendant's antitrust violations. Nevertheless, he submitted a supplemental report, which recalculated damages by using a set of comparable companies in the plaintiff's same industry, resulting in a range of damages similar to his original calculations.

"The law is clear that comparable companies must be as similar as possible," the court held. However, in this case, his rebuttal evidence met the required standard. Further, even though the expert attributed the plaintiff's entire market loss to the defendant's misconduct (instead of its earnings drop), these determinations were better subject to cross-examination at trial than dismissal under *Daubert*, the court held. Likewise, the expert may have relied on "optimistic" management forecasts, but any alleged bias could be tested at trial, and the court admitted the expert's lost profits conclusions.

***The Citrilite Co. v. Cott Beverages, Inc.*, 2011 WL 284915 (E.D. Cal.)(Jan. 25, 2011)** In this last case, the federal district court confirmed that the expert's use of a statistical regression analysis to calculate

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losses for breach of a distributorship agreement was both relevant and reliable under *Daubert*. At the same time, the court rejected any calculations by the expert that were based on a term longer than the contract's 60-day termination provision. As a result, the expert's calculations were relevant only to the extent they projected lost goodwill value based on the plaintiff taking over the defendant's sales after the expiration of the contract. These calculations must be based on "sound" projections and include the plaintiff's tangible costs, the court ruled, and ordered the parties to submit additional briefing on the merits of the expert's "lost goodwill value" analysis.

Divorce Roundup: Best (and Worst) Practices for Valuing Small Businesses

A summary of recent cases highlight both the best and worst practices for valuing small businesses in divorce, including the benefits of using an experienced BV expert; the possible limits to using a joint expert; and the continuing complexity of valuing goodwill and tax/marketability discounts.

Joint experts in divorce: When to seek a second opinion? In *Cox v. Cox*, 2011 WL 208312 (Miss. App.) (Jan. 25, 2011), a joint expert valued the husband's structural steel company at $4.3 million before the marriage and $4.9 million at the end, but discounted the latter by 50% due to declining industry and company conditions. At trial, the wife argued the expert should have discounted the premarital value of the business as well, but the trial court accepted the expert's reasoning and the wife appealed. On review, the appellate court affirmed that the value was supported by "substantial evidence' from the joint expert, including his conclusion that the closely held steel company "lacked an active market' and was "by definition . . . illiquid.' Moreover, the wife had "ample opportunity' before trial to present her own evidence on the premarital value of the company, but failed to do so, and the court affirmed the finding of no appreciation.

Courts prefer credentials, compliance, and experience. In *Nuveen v. Nuveen*, 2011 WL 988826 (N.D.)(March 22, 2011), the husband presented a certified appraiser to value his orthodontic practice; the wife presented a lawyer-broker, who typically appraised dental practices. Both experts considered the husband's purchase of intangible assets three years before the divorce—but only the broker doubled that value, due to the practice's consistently high earnings. The trial court found the husband's expert more credible, not only because he was certified and prepared his report according to BV professional standards, but his intangible value was more accurate given the flat market conditions. The court declined to apply the expert's 12% marketability discount, however, and the appellate court confirmed, finding the valuation was within the range of evidence presented by both parties.

By contrast, in *In re Marriage of Bruns*, 2011 WL 237969 (Iowa App.)(Jan. 20, 2011)(unpub.), the husband presented a broker-expert who valued his dental practice at $77,000. But this was only slightly higher than the $75,000 that the husband had paid for the practice 30 years before, and it excluded goodwill. The wife's expert, a certified appraiser, said the practice was worth $241,000, including goodwill. The trial court valued the practice at $115,000, finding the broker understated the value but the BV appraiser had limited experience valuing dental practices. The appellate court affirmed, noting that the value complied with state precedent regarding the exclusion of professional practice goodwill.

Also of note: In I*n re Marriage of Meek-Duncomb*, 2011 WL 768831 (Iowa. App.)(March 7, 2011), the wife presented a CPA to value the husband's trucking business at $145,000. But the CPA admitted he did not perform "certified valuations,' and the trial court found his opinion was "less credible than a business audit.' It valued the husband's semi-truck at less than $10,000, and the appellate court affirmed.

Has Mississippi muddied the goodwill waters? Mississippi and Kansas are the only two states that still decline to assign any value to the goodwill of a marital business. In *Rhodes v. Rhodes*, 2011 WL 80222 (Miss. App.)(Jan. 11, 2011), the Mississippi Court of Appeals recited the long-standing precedent: "goodwill is simply not property; thus it cannot be deemed a marital asset,' in affirming the trial court's rejection of an expert who failed to exclude goodwill or assign it a separate value in his appraisal of the husband's home furnishings business. A strong dissent argued that a proper reading of state law precludes goodwill only from professional practices.

However, less than a month later, the Mississippi Supreme Court decided *Lewis v. Lewis*, 2011 WL 322410 (Miss.)(Feb. 3, 2011), which said the law of the state is "clear and comprehensive,' and "stare decisis demands' the valuation of the parties' real estate firm, excluding any goodwill. The issue may not be so settled; two Supreme Court justices dissented, arguing that general accounting principles support valuing a

business' intangible assets, including goodwill.

Tax and other discounts depend on facts. In *Shuck v. Shuck*, 2010 WL 206845 (Neb. App.)(Jan. 25, 2011), the Nebraska Court of Appeals held that discounting the value of a marital business for built-in capital gains tax liability is relevant only in two situations: when the sale of the business is reasonably certain to occur in the near future; or when liquidation is necessary to satisfy the owner-spouse's financial obligations in divorce. At the same time, tax adjustments to the entity's cash flow streams under the income approach are proper, because these relate to the business's obligation to pay annual, ordinary income taxes rather than to any built-in depreciation or capital gains tax realized on sale. Lastly, the court affirmed that under state law the application of minority and marketability discounts to the value of a marital business falls to the trial court's discretion, depending on the particular facts of the case.

Uncooperative owner-spouse may hurt his own appeal. In *Salumbides v. Salumbides*, 2011 WL 835102 (Neb. App.)(March 8, 2011)(unpub.), the husband failed to disclose sufficient financial information to value his neurosurgery practice. The trial court conceded the difficulty, and ultimately valued the practice at a "significantly low' $155,000 based on the wife's appraiser's assessment of accounts receivable and tangible assets. The husband appealed the value for lack of support, but the appellate court affirmed, noting that he could hardly complain of a situation he helped create.

Taxpayer Wins in 9th Circuit Family LLC Case

***Linton v. United States*, 2011 WL 182314 (C. A.9 (Wash))(Jan. 21, 2011)**

On Jan. 22, 2003, the Lintons met with their tax attorney to sign and date several documents to form and fund a limited liability company (LLC) with real property as well as cash and securities. At the same meeting, they signed but did not date the agreements that purported to give their children's trusts equal interests in the LLC.

Attorney error. A couple of months later, the Lintons' tax attorney filled in "January 22, 2003" as the missing date on the trust and gift agreements—but later testified that he meant to insert January 31, 2003. The Lintons' accountant and appraiser corroborated the lawyer's testimony, and in addition, his preparation of the taxpayers' return shows an initial credit of LLC assets to their individual capital accounts and then subsequent transfers to the children's trust accounts. The LLC's ledger (prepared by the attorney) and an LLC valuation (prepared by the appraiser) showed a similar train of subsequent transfers. Based on this appraisal, the taxpayers also claimed a 47% combined discount for lack of marketability and control on their federal gift tax returns.

The IRS rejected the discount, claiming that the taxpayers made indirect gifts of property to their children's trusts; or, in the alternative, the step transaction doctrine collapsed the transfers into a single gift. The taxpayers disputed the deficiencies in federal district court (Washington). On the government's summary judgment motion, the court relied on the express language of the trust and gift documents to find that the taxpayers' contributions occurred with or just after their gifts of LLC interests to the children's trusts, and thus constituted indirect gifts of the cash and property. In the alternative, even if the LLC contributions occurred prior to the gifts of LLC interests, the step transaction doctrine applied. The taxpayers never decided to delay the gifts, the district court noted, and no evidence suggested that the trust property was never exposed to any "real economic risk' during the nine days that allegedly lapsed between the initial LLC funding and subsequent gifts to the children's trusts.

The taxpayer appealed to the U.S. Court of Appeals for the Ninth Circuit, which found that the signing and dating of the relevant documents created a "considerable objective ambiguity' as to when the taxpayers intended their gifts to become effective. Because the record failed to resolve this ambiguity, the Ninth Circuit remanded the case for the district court to find when the taxpayers "objectively manifested the intent to donate the LLC interests' under applicable state law (Washington) by putting the gift documents "beyond retrieval.'

LLC is a 'business activity that makes sense.' The court also found that the step transaction doctrine did not apply, because in this case, ample evidence supported the taxpayers' intent to convey the LLC interests to their children without also conveying ownership or management interests. Importantly, the court also found that the taxpayers' steps were not so interdependent that one would be fruitless without the completion of the others. "The placing of assets into a limited liability entity such as an LLC is an ordinary and objectively reasonable business activity that makes sense with or without any subsequent gift,' the court held. The taxpayers' creation and funding of

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the LLC enabled them to specify the LLC terms and to contribute a desired type and amount of assets. These ”reasonable and ordinary‘ business activities did not meet the requirements of the interdependence test, the court held, and reversed summary judgment by the district court.

Discounts are Appropriate When Oppressed Minority Wants to Sell Shares

***Ritchie v. Rupe*, 2011 WL 1107214 (Tex. App.)(March 28, 2011)**

A successful investment corporation in Texas was owned by four siblings. When one died, passing his 18% interest to his wife, she tried to sell the shares back to the company, but the parties were unable to agree on a price. In 2004, she hired a broker to help her sell her interest, but the company denied information and access to any potential buyer. Ultimately, the broker was unable to find a buyer, and the widow sued the corporation for shareholder oppression and asked for a forced buyout.

After a trial, a jury found the company liable and then determined a buyout price, based on evidence from the minority shareholder's experts, who concluded that the fair value of her 18% interest was worth between $7.37 and $8.92 million, without discounts. The jury awarded the minority shareholder $7.3 million, and the majority owner appealed, claiming the jury used an incorrect valuation date and erroneously excluded discounts.

Two types of fair value. As a preliminary matter, the Texas Court of Appeals confirmed that a buyout remedy is available in shareholder oppression cases in Texas. The court also found no error in the valuation date, because the appellants failed to show any material change in share value between the date of oppression (the company's refusal to meet with potential buyers) and the date of its last audited financial.

Turning to whether to include discounts in the buyout price, the court explained that there are ”two types‘ of ”fair value‘: enterprise value and fair market value. Although enterprise value of stock is determined by the value of the company as a whole, the court said, ”fair market value‘ turns on the hypothetical willing seller/willing buyer standard. In this case, the jury awarded enterprise fair value, which is appropriate when a minority shareholder, ”with no desire to leave the corporation, has been forced to relinquish his ownership position by the oppressive conduct of the majority,‘ the court said. Enterprise fair value is also appropriate in the context of a ”squeeze out‘ merger, when there may be a willing buyer but the minority shareholder is an unwilling seller.

In this case, however, the trial court should have provided the specific relief that the majority owners' oppressive conduct sought to prevent: i.e., a sale at fair market value. She was entitled to ”no more than that,‘ the appellate court said. Two factors affect a sale at fair market value: the stock's lack of marketability and its minority status. By expressly instructing the jury to exclude these factors in determining ”fair value,‘ the trial court erred by ordering the company to buy back the minority shareholder's interest at more than fair market value, thus providing her ”excessive relief,‘ the court held.

There was some evidence for discounting the minority shareholder's interest, the court added. For instance, her experts testified that an appropriate marketability discount could range from 13% to 45%, with an average of about 30%; an appropriate minority discount would fall between 5% and 30%. The appellate court declined to decide the factual issue, however, and remanded the case to the trial court to determine the fair market value of the stock.

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