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VALUATION Trends

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When One Business 'Steals' Another, Its Net Profits Can Provide Basis for Damages

Electronic Funds Solution, LLC, v. Murphy, 2009 WL 1717383 (Cal. App. 4 Dist.)(June 19, 2009) (unpublished)

It's the high school garage band story all over again in this case—the band mysteriously dissolves, only to re-form an almost identical group with a different bass player. Here, three partners designed a company to help commercial establishments electronically recover funds from customers' bank accounts after their checks bounced. Within a few months, the company had over 50 clients and licensing agreements with suppliers.

Within nine months, however, two of the partners decided to oust the third. They changed the locks on the office, removed his electronic access, appropriated his mail, and stopped forwarding calls. They also converted company funds and entered into new customer contracts without his knowledge or consent; and they renamed the company, telling customers that nothing else had changed. The former partner sued (a big difference from high school).

It doesn't pay to mislead the court. During discovery, the plaintiffs asked for specific emails and electronic data, but the defendants claimed that a virus had completely destroyed their computer files. On examining the computers, the plaintiffs' IT expert determined that the defendants had copied the hard drives to an external source and then erased them. After the defendants refused to turn over the copied data, the plaintiffs asked the court for terminating sanctions, including a default judgment and damages. Finding the defendants' discovery violations willful and egregious, the trial court granted $8 million in actual damages and assessed an additional $16 million in punitive damages.

The appellate court overturned the award, however, because it was erroneously based on the market value of the company rather than its net lost profits. On remand, the trial court assessed over $67 million in total damages ($10 million in lost profits) and the defendants appealed (again); the court was not entirely sympathetic.

The appropriate method for estimating losses for a start-up business. Net lost profits are "gains made from sales after deducting the value of the labor, materials rents, and all expenses, together with the interest of the capital employed," the court said. Recognizing that start-ups are a special circumstance in which a court is allowed more latitude in estimating damages, the court went on to say that this is particularly so when the "difficulty in estimation arises from the defendant's bad faith."

In calculating compensatory damages at trial, the plaintiffs' expert used financial data from the successor company to determine total damages of approximately $40.6 million. But because the plaintiffs' amended complaint requested only $10 million in damages, the trial court entered this amount as a default judgment and then added substantial punitive damages and penalties to reach a total assessment of over $67 million.

On this second appeal, the defendants challenged the use of their data to compute the plaintiffs' lost profits. However, when the defendants "stole" the original company—its business methods, office, computer system, and customers—their successor company provided an appropriate "surrogate" for estimating the lost profits of the plaintiffs' original enterprise, the court held.

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"We conclude the methodology used to calculate compensatory damages appropriately determined net profits," the court said, and it confirmed the $10 million award of compensatory damages. The punitive damages were struck as excessive.

Jury Awards $10M Lost Value for Internet Start-up—Court Reverses

M&A Technology v. iValue Group Inc., 2009 WL 2456289(Tex. App—El Paso)(Aug. 12, 2009)

A Texas jury sided with the underdog and its damages expert to find that a small Internet start-up without any capital, customers, or products would have been worth $3 million, "but for" the defendant's bad acts. Then it added $6 million in punitive damages, plus interest and penalties, for a total judgment of $10 million—this for a company that had $238.00 in its bank account the day the defendants allegedly shut it down.

Company would be the amazon.com of adventure travel. iValue began in 1999, as its founder's dream of creating an online gift market similar to Buy.com. When this didn't pan out, the company acquired Explore.com's stock, hoping to become a "one-stop shop" for outdoor gear and adventure travel. The economic downturn of 2000 exhausted its working capital, however, and its parent company, iValue Group (IVG), considered sale or liquidation.

M&A Technology, a computer-networking company, hired the iValue founder to raise equity investment. In return, M&A would house the IVG servers and web assets and use the Explore.com name to attract web-hosting clients. Capital markets were still tight, however, and in June 2001 the iValue founder wrote a letter to inform former Explore.com shareholders that despite having failed to procure financing, he still hoped to launch in time for the 2001 holiday season. By August 2001, the site still had no products available for sale.

That same month, M&A traced several forged checks to the iValue founder, who was summarily terminated before he could recover the IVG servers. IVG sued M&A for breach of contract and conversion of property, and the defendants counterclaimed for theft. Each party retained forensic computer experts, who determined that the IVG servers had been shut down and their hard drives wiped clean the same day the founder was fired. Whether this was a deliberate act or a power failure remained in dispute.

Expert projects average annual growth rate to top 75%. At trial, the plaintiff (IVG) presented an accredited forensic, accounting, and valuation expert to prove its damages claim. But for the defendant's destruction of the servers, IVG would have become a highly profitable e-commerce business. The expert used the income, market, and cost approaches to come up with values of between $2.2 million and $7.1 million.

It's all speculation. After the jury returned its $10 million verdict, the defendant appealed, claiming that the plaintiff's expert relied on assumptions that were "pure speculation," especially given IVG's status as a new, unproven business. The plaintiff countered that lost value is a restitution-based remedy based on market value; thus its proof did not have to meet the same evidentiary standard as a lost profits claim. The court agreed with the first assertion, but "just as in a market-value analysis, lost profits of a business would be a factor to consider in determining its value." Moreover, a historically unprofitable or untried business must produce "some other objective data, such as future contracts, from which lost profits can be calculated with reasonable certainty."

The court found none and reversed the judgment.

Experts in Court: Round-Up

In many cases, the need for a valuation expert is obvious and inescapable, which raises a second question: how to choose and use an expert to the best advantage for your legal argument. Recent case law offers some tips in answer to these questions.

It doesn't pay to skimp. In Villaje del Rio, Ltd. v. Colina, L.P., 2009 WL 1606431 (W.D. Tex.) (June 8, 2009), the developer/plaintiff tried to cut costs by designating himself an expert to testify in regards to the value of his own real estate project, and supplemented his own with two experts' testimony, based on appraisals they prepared in connection with the project's financing, two years prior to the insolvency at issue. The court struck the appraisal experts for their failure to consider the relevant facts and data of the actual insolvency, and the plaintiff as well, saying, "lay testimony results from a process of reasoning familiar in everyday life, while expert testimony results from a process of reasoning which can be mastered only by specialists in the field."

A cost efficient compromise. Although a plaintiff often has no choice but to present an expert, the defendant may have other options. In Sossikian v. Ennis, 2009 WL 2106106 (Cal. App. 1 Dist.) (July 16,

2009) (unpublished), the defendant found an ideal solution, by using an expert for rebuttal purposes only to discredit the damages evidence offered by the plaintiff's expert. This choice left the jury with no basis for a damages award and they awarded $42,182 on the plaintiff's $800,000 claim.

Who is qualified? When you make the decision to incur the cost of an expert, you want to make sure it's the right one. In MDG Internat'l v. Australian Gold, Inc., 2009 WL 1916728 (S.D. Ind.) (June 29, 2009), an otherwise "supremely qualified" expert failed to satisfy the requirements of the Federal Rules of Evidence and Daubert. The expert, a professor of accounting and chair of an accredited MBA program deeply experienced in valuing public companies, was engaged to value a private company. The court concluded that he lacked the requisite "knowledge, skill, experience, training, or education" to testify regarding the value of the closely held business at issue, and went on to find that the expert's opinions and methodologies were riddled with deficiencies. "Expert" is not broadly defined. It is critical to engage someone experienced in the particular issue of the case.

Of course, there are always outlier situations. Chick-Fil-A v. CFT Development, LLC, 2009 WL 1754058 (M.D. Fla.) (June 18, 2009) is one such case. At issue was whether Panda Express (the defendant), which was proposed to be built next to a Chick-Fil-A, would derive 25% or more of its gross sales from the sale of chicken (and thus be enjoined from opening under a restrictive covenant on the property). The plaintiff's and defendant's experts proposed alternative methods of calculating the 25%, and both parties filed Daubert motions, claiming the other's expert was unreliable or irrelevant. In the absence of any precedents (legal or accounting) on how to calculate the percentage of sales from chicken (for example, does it include non-chicken ingredients in a chicken dish?), the court permitted both experts to testify, saying that "the certainty and correctness will be tested through cross-examination and presentation of contrary evidence."

Not all experts face the Daubert test. Certain states continue to use a hybrid of that new federal rule and their own standard, based on the so-called Frye rule (from Frye v. United States, 54 App. D.C. 46 (1923)), even though Daubert overruled that case. The Frye test requires that an expert's opinion derives from a principle that is "sufficiently established to have gained general acceptance in the particular field in which it belongs." This was the test used by the court in 8000 Maryland LLC v. Huntleigh Financial Services, Inc., 2009 WL 2144895 (Mo. App. E.D.) (July 21, 2009). There the court of appeals affirmed that the plaintiff's expert, a CPA/ABV, ASA, CVA with a master's degree in finance and twenty-five years experience valuing public and private companies, had based her conclusions on facts and data reasonably relied on by similar experts.

Watch your expert's language. You've hired an expert. They've passed the hurdle of court acceptance. They give their opinion. It goes without saying (or does it?) that that opinion needs to be powerful, well presented, and not based on speculation. In Lucent Technologies, Inc. v. Gateway, Inc., 2009 WL 2902044 (C.A. Fed.) (Sept. 11, 2009), the plaintiff's expert's patent damages calculation, which resulted in a jury award of $358 million, was thrown out (and the jury award reversed), based largely on the expert's testimony that to calculate a lump-sum amount (of damages), the parties might start by looking at the running royalty "and then speculating as to the extent of the future use" (emphasis by court). Perhaps it was semantics, (the expert might just as easily have said "estimate"), but the court held that what it dubbed the "lump sum speculation theory" improperly suggested guesswork, not rigorous analysis. The court went on to bolster its decision, finding that the expert's comparables had no probative value, as the technology at issue was unique and difficult to compare meaningfully.

The bottom line: it pays to hire an expert, but be sure it's the right expert doing the best job possible.

Top Five Must-Haves for Tax Valuation Reports

Hiring an expert for a tax valuation? Is the expert you've hired following best practices? At the recent NACVA/IBA 2009 Consultants' Conference in Boston, the Honorable David Laro (U.S. Tax Court) joined fellow panelists Howard Lewis, currently the IBA's executive director and former National Program Manager for the IRS Engineering and Valuation programs; and Mike Eggers, principal of American Business Appraisers (San Diego), to come up with the following checklist for "best practices" in tax-related valuation reports:

1. **Transparency.**

   Valuation reports must be logical, rational, and clear, with transparent analysis by the lead appraiser of the company, the data, the factors

supporting the conclusion, and the underlying rationale. If you don't understand a valuation report, chances are the judge won't either, and that makes it hard for the judge to reach a decision that will withstand review on appeal.

2. **Credibility.**

In other words, the report is believable, reliable, experienced, well prepared, sincere, and performed using peer-reviewed methods. The strengths and weaknesses of the good expert's valuation report should be self-evident, with clearly stated rationale for why areas or methods might have been ignored or omitted, for lack of data or lack of applicability. Though the lawyer's role is advocacy for a position, the role of the expert is the same as that of the judge—to arrive at the truth. Anything else will diminish the credibility of your expert.

3. **Intellectual honesty.**

In case it wasn't clear from the above, your expert's opinion must be free of bias and advocacy, independently arrived at, and transparent. What about sitting at the attorney table? Are you passing notes with your expert during the opposing witnesses' testimony? Your expert may be offering guidance regarding what questions to ask the witness on cross-examination, but the practice can blur the line between independence and advocacy. "When I see that happening in the courtroom I put an end to it," Judge Laro said. The same caution applies when an attorney comments on drafts or otherwise assists in developing an expert's opinion. Allow your expert to be credible, ethical, and independent.

4. **Complete.**

Rule 26 of the Federal Rules of Civil Procedure limits expert evidence to the content that is actually written or displayed in the report. Everything your expert says on the stand needs to be in their report.

5. **Credentialed.**

This point speaks for itself.