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Valuation Perspectives

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Another 'Must-Read' Decision From Del. Chancery on the DCF, Discount Rate

***In re: Appraisal of The Orchard Enterprises, Inc.*, 2012 Del. Ch. LEXIS 165 (July 18, 2012)**

A private equity group sought to cash out its controlling interest in The Orchard Enterprises, an online music provider. When no prospective buyer agreed to pay a $25 million liquidation fee that the sale would trigger, the PE group engineered a going private merger at just over $2 per share. A group of dissenting stockholders petitioned the Delaware Court of Chancery for a statutory appraisal, claiming their shares were worth $5.40 per share.

To start, the court (in an opinion by V.C. Strine) found the $25 million liquidation preference was too speculative to include in any going concern valuation. It also rejected the market approach utilized by the company's expert, finding his selection of comparables and multiples was geared solely to "justify an outcome." As in recent cases, the court showed a distinct preference for the discounted cash flow (DCF) approach, but made several important decisions related to the derivation of the discount rate:

- The court rejected the build-up method (BUM), finding that it was "larded with subjectivity" and failed to find support among "mainstream of corporate finance scholars";
- As a result, rather than average the experts' results under the BUM, the court used only the capital asset pricing method (CAPM);
- Since both experts agreed the underlying management projections were sound, any application of a company-specific risk premium was inconsistent with the CAPM approach and would, in fact, "infect" it with the subjectivity of the build-up model, the court said; and
- Given the "default" acceptance of the supply-side equity risk premium (ERP) in recent decisions such as Golden Telecom and Gearreald v. Just Care, the court rejected the historic ERP.

Finally, only the company's expert claimed—citing a 2008 article by James Hitchner—that using the supply-side ERP required an upward adjustment to Ibbotson's size premium. The shareholders' expert cited Cost of Capital, by Shannon Pratt and Roger Grabowski, to persuade the court that no such adjustment was necessary in this case, leading to its ultimate valuation of $4.67 per share.

Expert's Evidence Is Key to Reversing a Zero Damages Verdict

***Heritage Operating, LP v. Rhine Bros. LLC*, 2012 Tex. App. LEXIS 4939 (June 21, 2012)**

During the sale of their well-established propane business—including 10 locations in Texas and across the South—all but one of the owners decided to stay with the company under new management. The one retiring owner signed a noncompetition agreement (as did the others), which prohibited him from engaging in a propane business for 10 years beyond the date of sale (2003) and within a 75-mile radius of the company's Texas location. The buyer agreed to pay the owner $500,000 for the noncompete, paid out over five years; their contract also stipulated that $7 million of the $15.5 million purchase price was for the goodwill and other intangible assets of the firm, including its customers and pricing lists.

After receiving the final payout for the noncompete, the owner—through his wife and sons—began operating a competing propane business within 75 miles of his former company's location. The company sued the owner and his new company for breach of contract. At trial, it presented a CPA expert to provide evidence of its lost profits damages. The defendants challenged the expert under the Texas state law equivalent of the Daubert standard, claiming his lost profits calculations were unreliable because they were based on "illustrations" of potential lost sales based on customers that the expert believed were lost due to the owner's alleged breach.

The court overruled the defendants' objections, and, by the time of trial, the expert was able to present calculations based on a review of all financial and sales

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information from 2004 to mid-2010, projected through the term of the noncompetition agreement (2013). During that time, the defendants' new company had solicited 18 contracts from its former customers for a net profit of $72,000. Projecting these sales through 2013, the expert estimated that lost profits equaled just over $235,000.

The defendants presented no rebuttal damages expert, but did offer five of the customers who had decided to leave the defendants' former company for their new one, based on lower prices. After hearing all the evidence, the jury found the defendants liable for breach of the noncompetition agreement, but awarded zero damages for lost profits or loss of goodwill/reputation. In a post-trial judgment, the trial court also found the noncompetition agreement was not enforceable beyond five years following the 2003 sale of the company. The plaintiff appealed on several grounds.

The court took another look at the parties' 10-year, 75-mile noncompetition agreement, noting that the former owner carried the burden to show it was unreasonable. His evidence at trial that the value of customer relationships eroded within five years did not obviate the defendants' claim that, in addition to paying him $500,000 for his noncompete, they paid $7 million for all intangibles, above and beyond customer lists. "Goodwill is a protectable, valuable interest," the court said, "and parties may determine its value and contract for its sale." The court found that the noncompete was a reasonable way for the plaintiff "to protect its $7 million investment for ten years."

Finally, the court examined all the evidence regarding the plaintiff's lost customer contracts. Offering a lower price might be an explanation for why the customers left the plaintiff, but it was "no defense" to liability for the breach. The expert's testimony together with the evidence at trial provided sufficient, objective evidence that the plaintiff suffered damages sufficient to reverse the jury's zero award, the court held. The record, however, was insufficient for the court to determine the precise amount of lost profits, and it remanded the case for a new trial.

Georgia-Pacific Gives Experts 'Multitudinous' Leeway in Rate Analysis

***Ergotron, Inc. v. Rubbermaid Commercial Products, LLC*, 2012 U.S. Dist. LEXIS 121795 (Aug. 28, 2012)**

The plaintiff manufactures and distributes a patented vertical lift system for electronic medical workstations. It sued the defendant for infringement. Both parties retained experts to calculate damages, who both applied the Georgia-Pacific factors to determine a reasonable royalty rate based on a hypothetical negotiation.

Specifically, the plaintiff's expert assumed that the plaintiff would likely "require" a rate above 20%. At the same time, considering the defendant's historical profit margins of around 40%, he believed the defendant would not accept a margin of less than 30% on the accused products. Based on these assumptions, as well as the Georgia-Pacific factors—in particular "expected sales and risks"—the expert determined a royalty rate of 10% of net sales.

The defendant's expert, by contrast, initially assumed that a reasonable royalty rate ranged from 0.4% to 2.4% of net sales. After talking with the defendant's key personnel, she reset her rate range to between 1.0% and 1.6%.

Before trial, both parties filed *Daubert* motions to exclude the other's expert testimony. In particular, the defendant contended that the plaintiff's expert improperly used the EMVR and did not sufficiently explain how he arrived at a 10% royalty rate. Similarly, he produced no analysis to support his lump-sum figure, the defendant said, and these deficiencies rendered his opinion unreliable.

The court agreed that aspects of the testimony were problematic. Under the EMVR, an expert may calculate damages based on the entire market value of the accused device only when the patented feature creates the "basis for customer demand" or "substantially creates the value of the component parts," the court stated, citing *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011).

In this case, the infringing products included many nonpatented features, the court noted. But the patented vertical height adjustment was "the *sine qua non* of the accused products." The accused products also functioned as a single unit. Given these considerations, a jury could find that the EMVR applied, the court observed.

In terms of the expert's arrival at the 10% rate, the court was satisfied with his explanation that he derived the rate by assuming the defendant would not reduce its historic profit margins by more than 10% and denied the defendant's *Daubert* motion.

According to the plaintiff's motion, the defendant's expert improperly relied on the defendant's target profit margins and design-around costs to limit the projected royalty rate. Consequently, the court permitted both experts to testify, but reserved the right to revisit discrete issues at trial.

Valuation 'coming to the fore' in current ESOP litigation

Valuation evidence and experts were the "big issue" in a recent jury trial—and the big reason why the plaintiffs, former participants in an employee stock bonus plan, won $1.5 million from their employer and plan administrator, reports Steve Whittington (Willamette Management Associates) in the most recent post to WMA's new blog, "Business Valuation Expert."

In *Finnerty v. Stiefel Laboratories, Inc.*, Case No. 09-21871-CV (S.D. Fla.), a group of disgruntled shareholders claimed the plan (which, for 25 years, was an ESOP) valued their put rights at only $13,000 to $16,000 per share when—during the same period—the plan's appraiser knew that PE funds offered upwards of $60,000 per share. Indeed, the company closed one of those deals and ultimately sold for $68,000 per share. At trial, the plaintiffs' experts conducted multiple appraisals under various scenarios, including controlling and noncontrolling, as well as discounted, values. All showed a range of value well above the plaintiffs' put price. "In sum," Whittington says:

> ESOP litigation is an area where we are seeing a lot more activity these days than at any time in the past. This case calls to the fore the critical issues for a dissenting or disgruntled shareholder: Did I get all the money I was due? The natural focal point of that question is whether the valuation was properly performed or not. In this case, it appears that the proper due diligence and valuation considerations were not taken into account.

Case update: After the $1.5 million verdict, the defendant immediately moved for a judgment as a matter of law and also—to preserve its rights—filed a notice of appeal to the 11th Circuit.

Patent litigation reaches record highs, new PwC study shows

Patent holders filed 4,015 infringement actions in 2011—the highest number ever recorded, according to PricewaterhouseCooper's recently released *2012 Patent Litigation Study*. These filings represent a 22% increase over filings during the prior year (2010) and an overall compound annual growth rate of 6.4% since 1991, when the PwC annual study began. Median awards in patent cases have also continued to climb. Last year saw two of the four largest awards, totaling approximately $1 billion each.

"Last year marked the most dramatic change to the U.S. patent system in nearly six decades," notes the PwC introduction. For example, passage of the Leahy-Smith America Invents Act (AIA) in September 2011 effectively converted the patent system from a "first to invent" basis to a "first inventor to file." Unlike prior drafts of the legislation, however, the AIA as enacted "did not address the calculation of damages, leaving any reform in this area squarely up to the courts," says PwC. In fact, the Federal Circuit's recent elimination of the 25% "rule of thumb" along with other important rulings "have demonstrated that the courts, not Congress, [will] continue to shape the future of patent law and play the primary role in how patent damages are determined."

IRS focus is more on operations of FLPs, says Porter

Recent Tax Court decisions have dealt "a significant blow to the lack of economic substance, lack of business purpose, and gift-on-formation positions taken by the IRS in the family limited partnership (FLP) area," says attorney John Porter (Baker Botts). "Subject to the continuing development of case law and IRC I 2036, if a partnership is valid under applicable state law and the entity is respected by the partners, the Tax Court will recognize that entity for transfer tax purposes," he says.

In light of these decisions—and in dealing with the IRS at the audit level and in litigation—Porter has seen "the IRS increase its focus on the actual operations of the partnership." For instance, the IRS now routinely asks to examine the partnership's books and records, its bank statements, and its operational documents to ask such questions as:

- Did the FLP make distributions according to the terms of the partnership agreement?
- Was the partnership operated as a separate legal entity or merely a second bank account for the decedent?
- In the formation, funding, and operation of the FLP, did the partners (and planners) dot the proverbial i's and cross the t's?

"The IRS attacks on partnership-based valuation discounts can be thwarted with careful planning, documentation, and operation of the entity," Porter observes. "This includes ensuring that the partners respect the entity and [obtain] qualified, supportable, and well-reasoned appraisals E when valuing the transferred interests."

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Tax Court excludes draft reports from discovery

Following the trend in federal district and circuit courts, the U.S. Tax Court recently amended its Rules of Practice & Procedure to exclude the draft of expert reports from discovery, "regardless of the form in which the draft is recorded."

In addition—and also to align with the federal rules—the Tax Court's Rule 70 now protects communications between experts and attorneys from discovery, "regardless" of their form, with three important exceptions relating to communications that contain: (1) the expert's compensation; (2) facts or data that the attorney identifies for the expert; and (3) assumptions that the attorney provides to the expert.

The new Tax Court rules also protect the reports and opinions of any consulting (nontestifying) expert. The changes to the rules became effective in July 2012.

Not surprisingly, the Tax Court has yet to issue any decision interpreting the amended rules, in particular, the two exceptions concerning communications in which the attorney identifies facts or provides assumptions that the expert later uses to form a final opinion. This also follows a trend in federal courts, which have published few cases concerning the revised Rule 26, leaving many unsettled or "gray" areas.

About Our Firm.................

Our firm has years of experience assisting attorneys and business owners in determining value for litigation support, gift and estate tax planning, marital dissolution, buy and sell agreements, and business sale purposes. Whether you are determining the fair market value of a closely held business interest for sale, gift, or estate planning, knowing what your company is worth is one of the most important financial aspects of being in business.

In addition, you may use a business valuation as a management and planning tool. Besides acting as a scorecard that will help management determine whether the company is gaining or losing value, the valuation provides a better understanding of the real profitability of the business. Whatever reason you have for needing a business valuation, John R. Janicek, CPA P.C. is prepared to assist you in being your valuation solution.

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