John R. Janicek, CPA, P.C

Valuation Perspectives

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Summer 2007 115 Shivel Drive | Hendersonville, TN 37075 | Phone: (615) 822-8315 | www.cva.johnjanicekcpa.com

Two Economic Damages Cases Dismissed for Lack of Reliable Valuation Evidence

***Gordon Partners v. Blumenthal,* 2007 U.S. Dist. LEXIS 9110 (February 9, 2007); *AccuWeb v. Foley & Lardner,* 2007 Wisc. App. LEXIS 61 (January 31, 2007)**

Two recent cases demonstrate what happens when plaintiffs fail to provide diligent, well-prepared valuation testimony to support their loss causation analysis—and what happens when the defense does.

Securities claims require reliable market study

The *Gordon* plaintiffs were hedge fund partners who had invested most of the fund's assets in NTL, Inc., with whom the partners had personal as well as business ties. At the start of 2000, an NTL share was worth over $100, and the hedge fund's entire investment was worth $30 million.

Within eight months, the NTL price declined to $44, and by May of 2001,to $31. Even so, the Gordon founder admitted he would not have sold NTL until its price dropped to $27.50 in mid-May. But at that time, the company announced a 32% increase in quarterly EBITDA and stated it was "on track" to reach its financial goals. The plaintiffs alleged that NTL made similar misleading statements through a major acquisition and attempted restructuring, despite knowing that both were plagued with serious problems. NTL stock dropped to an "all-time low" of $1.50 in September 2001, and bankruptcy followed in April 2002, wiping out all of the hedge fund holdings.

Alleging fraud and misrepresentation against NTL and its individual members (the defendants), the *Gordon* plaintiffs sought damages amounting to over $16 million for the period January 2000 through April 2002, calculated by relying on the price they paid for NTL stock as of August 2000.

The plaintiffs did not submit an expert report—but the defendants did. Their expert testified that plaintiffs' damage calculations lacked "any reliable basis" because they failed to adjust for market, industry, and company-specific factors that affected NTL's price during the loss period but that were unrelated to any alleged fraud, including a "marked decline" in the telecommunications industry.

Moreover, defendants' expert conducted a comprehensive, chronological assessment of public information available about NTL during the loss period, using regression analysis to study the material effect of each major report and finding few significant price reactions related to these publicized risks.

The plaintiffs called such analysis "an academic exercise" and "nonsense." In response, defendants asserted that the courts require "reliable principles and methods" to exclude unrelated price declines from any estimate of damages. The plaintiffs had merely booked all such declines into their measure of damages, and the Court agreed, dismissing all of their claims.

Fair market value of patent requires proof

In the second case, attorneys for plaintiff AccuWeb apparently allowed a technology patent to expire in 1995 by failing to pay a maintenance fee; AccuWeb sued, alleging legal malpractice and damages based on: (i) the loss of a potential sale of the company due to the loss of the patent; (ii) the loss of the fair market value of the patent; and (iii) the diminution of the future resale value of the business.

The attorneys filed for summary judgment on all claims based on a lack of causation as well as failure to prove damages with a "reasonable degree" of certainty. The appeals court agreed there was insufficient proof tying the lapse of the patent with the loss of the potential sale, which apparently failed due to general economic conditions.

As to the loss of the patent itself, AccuWeb claimed "uncontroverted" proof of its fair market value, but failed to explain what that value was or how a trier of fact could determine the amount. "More fundamentally," the Court said, "AccuWeb has not by way of testimony or affidavit demonstrated it has suffered any damages simply because the…patent lapsed."

AccuWeb did submit an expert report attempting to show its diminished value. The expert calculated damages as the difference between the value of the

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company's assets with the patent ($5 million to $10 million under the market approach, $6 million to $18 million under the income approach) and its value without the patent ($1.7 million to $3 million) on the date of the valuation report in November 2002. But the Court found that the expert should have valued the patent as of the lapse date in 1995. (The dissent disagreed, arguing that the date of the *report* had no bearing on damages, which could be measured on an ongoing basis up until the date of trial.)

Further, the expert assumed that without the patent, future competitors would be able to introduce similar technologies impacting AccuWeb's value, but the Court found this speculative. No competitors had in fact exploited the unpatented technology, and AccuWeb was unable to point to any who might with "reasonable" certainty.

Finally, a 1997 valuation of the company (two years after the patent lapse) had estimated its worth between $8.5 million and $11.5 million, with a "strategic value" of up to $22 million. These values fit within the expert's "undamaged" valuation as of 2002, and AccuWeb did not adequately reconcile the asserted damaged values to the 1997 appraisal. Though the dissent argued that the expert report raised a material dispute, the majority summarily dismissed all claims.

When 'Fair Value' is Not The Standard of Value in State Shareholder Disputes

***Kim v. The Grover C. Coors Trust,* 2007 Colo. App. LEXIS 394 (March 8, 2007)**

This Colorado Court of Appeals case is a good reminder that the standard of value should be among the first points of discussion between analysts and attorneys in any litigation involving shareholder disputes.

Shareholder alleges unfair transaction

In 1999 to 2000, a packaging company owed $525 million for a prior acquisition. It intended to fund the short-term debt by selling a paperboard mill—but when that deal fell through, the company needed a quick infusion of cash. It decided to sell 1 million shares of convertible preferred stock for $100 million to a trust for which at least two of the company's directors served as trustees.

The company formed a special committee of independent directors to evaluate the transaction. The committee obtained a fairness opinion from an investment bank, indicating that the stock sale was financially fair; after several meetings, it approved the sale. A minority shareholder sued the directors, among others, for breach of fiduciary duty in approving and executing the allegedly unfair transaction.

Fairness has a broad, fact-based definition

The shareholder claimed that by "sitting on both sides of the transaction," the company's directors had manipulated it sufficiently to dilute the value and voting rights of the minority shareholders. According to local law and statute (Colorado's version of the Model Business Corporation Act (MBCA)), the directors needed to prove the fairness of the transaction. And because the Colorado statute so closely resembles the original MBCA (as in many states), the Court looked to the Act's official comments for further definition of "fair," finding that these comments gave the term a "special, flexible meaning and wide embrace."

As many state courts have also concluded, the Colorado court found that the fairness of the transaction turned on its facts and circumstances; in particular, whether there had been earmarks of an arms'-length transaction, including the company receiving "full value." The plaintiff/shareholder urged the adoption of Delaware's "entire fairness" test, which focuses on process and price, but the Court found no "functional difference" between that test and the approach under local law, which requires reviewing the transaction "as a whole."

Best price at best value includes discounts

Applying this standard, the Court found that the shareholder had failed to provide evidence that a better price was available. By contrast, the company presented testimony that there was no public market for the convertible preferred stock and no third-party buyer; even if there were, the purchaser wouldn't have offered better terms. Likewise, the shareholder lost the arguments that the transaction lacked sufficient disclosure, independence, good faith, or price concessions.

As to the fairness of the transaction's value, the shareholder claimed that the company's expert incorrectly applied a discount, citing a Colorado case that excluded minority discounts in "dissenters' rights actions" in all but extraordinary circumstances, because the MBCA's "fair value" provisions precluded the application of marketability or minority discounts.

"However, this case is not a dissenters' rights action," the Court said. "It involves the question of whether a transaction was fair, not the 'fair value' of dissenters' shares." It was therefore proper to discount the stock value by 15% to 20% for lack of marketability, which made the $100 million sale price fair.

Lawyers and Appraisers Alike Should Beware the Overly Litigious Client

***Davison v. Margolin Winer & Evans, LLP,* 2007 N.Y. Misc. LEXIS 816 (March 8, 2007)**

Some litigants simply won't give up the fight—and they can be the most difficult clients, because their resistance often extends to paying professional fees or, in the worst case, suing their professionals for malpractice.

When goodwill turns to bad

Two physicians sought judicial dissolution for their large medical practice. Their shareholder agreement provided for arbitration, and the first issue that one doctor (the plaintiff) contested was whether the goodwill of a cardiac scanning department was a divisible asset. The arbitrator held that it was, so the doctors each obtained an appraiser (per the shareholder agreement), one valuing the goodwill at $1 million—the other (plaintiff's) at $3,600.

Given this wide variance, the shareholder agreement obligated the doctors to choose a neutral and binding third appraiser. They couldn't agree on one, so the arbitrator chose Margolin Winer & Evans, LLP (defendant). The doctors signed an agreement that the defendant's appraisal would be "final and binding." In its report, defendant valued the scanning practice goodwill at $1 million. The arbitrator adopted the value and issued his award. Plaintiff moved to vacate or modify the award, based in part on an allegedly flawed appraisal. The court denied the motion, and confirmed the arbitrator's award.

After losing these battles, the plaintiff sued the defendant for malpractice, resurrecting the claims from his previous litigation: that the appraisers had failed to consider certain relevant factors and had based the report on management interviews instead of "sworn testimony;" and that the calculation of goodwill contained errors in methodology and math.

Defendant moved to dismiss, claiming collateral estoppel; that is, the plaintiff had already tried to win these arguments, first in arbitration, then on appeal. In effect, his complaint was largely a "rehash" of all his prior complaints, for which he was given ample time and opportunity to litigate, with no success.

The Court agreed. "This action is nothing more than a collateral attack on the arbitration award and the orders granted by the [trial court]." It dismissed the plaintiff's complaint—hopefully for the last time.

Delaware Chancery Permits Shareholder to Sue Board For Backdating Stock Options

***Ryan v. Gifford,* 2007 U.S. Del. Ch. LEXIS 22 (January 29, 2007)**

More than 200 companies are currently under investigation for backdating stock options, involving over $75 billion. The figures involved may go even higher, as the Delaware Chancery Court recently permitted shareholders to proceed with this derivative suit against a corporate board and compensation committee in the backdating context.

Stock option grants 'fortuitously timed'

From 1998 to 2002, the directors of Maxim Integrated Products, Inc. granted the company's founder "millions" of stock options under a shareholder-approved plan filed with the SEC. The exercise of the options would be "no less than fair market value" of the company's common stock, measured by the closing price for Maxim stock on the grant date.

But then last year, studies by Merrill Lynch and reports in the *Wall Street Journal* revealed the questionable compensation practice called backdating: A company issues executive stock options on one date while providing documentation that it actually issued them earlier, on a date coinciding with market lows (and thus reaping the executives a windfall on exercise). The Merrill Lynch analysis—which included Maxim—said company officers had benefited from so many "fortuitously timed" grants that backdating seemed the only logical conclusion.

The report spawned several federal derivative suits in California against Maxim, which have since been consolidated into a single action. This case against Maxim before the Delaware Chancery is similar, alleging at least nine claims of backdating, violation of the stock option plan, misrepresentation, and breach of fiduciary obligations relating to adverse tax and accounting consequences.

Delaware law may govern many U.S. actions

Defendants moved to stay and/or dismiss the suit on several grounds, including federal pre-emption and failure to show that the founder had exercised the options and thus become "unjustly enriched." But as to the stay, the Delaware Chancery noted the "great import" of the claims, including the propriety of the compensation practice and the implied non-compliance with shareholder-approved plans as well

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as disclosure requirements. Investors are challenging the practice throughout the United States, the Court said, and in many cases Delaware law will control and affect the outcome.

As to the requirements of proof, the Court cited the Merrill Lynch findings that Maxim's average annualized return of 243% on executive-granted options was almost ten times higher than the 29% annualized market returns during the same period. The Board had also granted the options sporadically rather than regularly, adding to the appearance of impropriety. And the plaintiff had shown "demand futility" and bad faith sufficient to rebut the business judgment rule.

Finally, even if the founder never exercises his options during the litigation, he will have retained something of value, and expert testimony regarding the "true value" of the option grants could help the Court fashion an appropriate remedy. The Court did dismiss any claims relating to options granted while the plaintiff was not a Maxim shareholder but permitted the rest to proceed. Given the damages at stake, it's not hard to imagine that a shareholder with proper standing to sue on the lost claims will join the litigation.

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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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John R. Janicek, CPA, P.C.
115 Shivel Drive
Hendersonville, TN 37075