



Business Valuation Update™

January 2011 Vol. 17 No. 1

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Fresh Start Reporting: A Growing Opportunity for Appraisers

By C. Brett Cooper, CPA/ABV, ASA, BVAL, Cr.FA

Chapter 11 (reorganization type bankruptcy filings) increased 61% in two years—from 8,799 in the 12-month period ending Sept. 30, 2008, to 14,191 in the same period in 2010, according to the Administrative Office of the U.S. Courts. “Fresh start” accounting is available for many of the companies filing for reorganization under Chapter 11, providing them with the possibility of staying in business as a new entity. Business appraisers can benefit from this growing market, but they need a firm grasp of fresh start accounting.

Accounting Standards Codification (“ASC”) 852 addresses the financial reporting under U.S. GAAP for fresh start reporting. The value of the emerging entity must be determined (fair value is the standard of value). In addition to the considerations enumerated in this article, the ultimate entity value must be assigned to the assets and liabilities of the emerging entity as set forth in ASC 805, *Business Combinations*. In essence, the fair value of assets (both tangible and intangible, including goodwill, if any), liabilities, and minority interests must be determined. What follows is a discussion of the entity level value determination.

Background: When a business files for Chapter 11 relief, the goal of the proceeding is to maximize recovery by creditors and shareholders by preserving it as a viable entity with a going concern value. For that purpose, the entity prepares a plan of reorganization which must be confirmed by the court. The plan provides for treatment of all the assets and liabilities of the debtor. For the plan

[continued on page 6...](#)

Discounts, Tax Affecting, & Fast Appeals: Insights from Recent IRS Roundtable

“It shouldn’t be any surprise to you that the number one issue we deal with is the reasonableness of discounts, most often in estate and gift tax cases,” Susan Kurzweil, CPA, ASA, and IRS national business valuation issues coordinator, told attendees at the recent 3rd Annual Advanced Summit on Business Valuation: Resolving Tax & Legal Issues, presented by BVR and Georgetown School of Law in Washington, D.C. The IRS still sees discount conclusions that are not supported by the data or that apply study averages without sufficient explanation.

[continued on next page...](#)

INSIDE THIS ISSUE

Fresh Start Reporting: A Growing Opportunity for Appraisers . . .	1
Discounts, Tax Affecting, & Fast Appeals: Insights from Recent IRS Roundtable	1
How Fast Do DLOMs Change?	7
Patent Claims Are Determinative of Patent Value	9
Draft Expert Reports No Longer Discoverable in Federal Court . . .	11
Proposed DOL Regulation Includes Appraisers as ERISA Fiduciaries	12
Issues and Controversies in Damage Claims	13
Ambulatory Surgery Centers, Diagnostic Imaging Centers, and Skilled Nursing Facilities: Sources of Free Industry Data	15
Legal & Court Case Updates	
– R&R International v. Manzen, LLC	18
– Brighton Collectibles, Inc. v. Coldwater Creek, Inc.	20
– Manpower, Inc. v. Insurance Co. of Pennsylvania	21
– LB 4 Fish, LLC v. Developers Diversified Realty Corp.	22
– Total Clean, LLC v. Cox Smith Matthews, Inc.	23
– Brooks v. Brooks Furniture Mfgs.	24
– Interplan Architects, Inc. v. C.L. Thomas, Inc.	27
– In re Chemtura Corp.	28
– Metro Tech Corp. v. TUV Rheinland of N.A.	31
– In re Fairvue Club Properties.	32
– Miller v. Miller	33
CALENDAR	35
COST OF CAPITAL	36

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“We frequently see valuation reports that consider the perspective of only one person or use the fair value standard,” Kurzweil added, without having to remind the sophisticated summit audience that of the 800-plus provisions of the Internal Revenue Code (IRC) dealing with valuation, all apply the fair market value standard, considering the perspective of the hypothetical willing buyer and seller.

Valuation of S corporations is another “contentious area,” Kurzweil admitted, in which the courts, valuation experts, and even IRS examiners have not always been consistent. Analysts need to carefully consider the facts and circumstances of each case, she said. “Staff are still seeing appraisals where the actual cash flows of the S corp are being adjusted by a 40% tax rate.” A less common but perhaps no less contentious issue arises in C to S corporation conversions and the valuation of embedded capital gains tax liability. Other hot-button issues: valuing fractional interests, reasonable compensation, and international transfer pricing.

Still no guidance on exception to appraiser penalty

As most business appraisers are keenly aware, the Pension Protection Act of 2006 broadened the penalty provisions of IRC Sec. 6695A to reach “substantial” and “gross” valuation misstatements contained in an appraisal and prepared by anyone who knew (or reasonably should have known) that the appraisal would be used for a federal income or estate and gift tax return. In the estate and gift tax arena, for instance, a “substantial” misstatement is one that is 65% or less than the amount later determined to be correct, and a “gross” misstatement is 40% or less of the determined value.

What’s still not clear is how to measure the exception to Sec. 6695A. Currently, if an appraiser can establish that the appraisal value was “more likely than not” correct, then the penalty will not apply. Shortly after the Pension Protection Act was passed, the IRS and the Treasury Department issued Notice 2006-96 (www.irs.gov/pub/irs-drop/n-06-96.pdf) as transitional guidance, with the promise that further regulations would be forthcoming.

As a result of the meeting, the IRS revised its notice requirements. Under current procedure, a field examiner will try to contact the appraiser before sending Letter 4477, which is now called an ‘appraiser appointment letter.’

But “there is not likely to be more guidance regarding the ‘more likely than not’ standard” any time soon, Jeffrey Myers, IRS manager, engineering & valuation, told summit attendees. (Myers also noted the traditional disclaimer on behalf of all the IRS participants, that their expressed views were their own and not that of the Service.) For now, whether an appraiser penalty applies to any given case will turn first on a mechanical application of the statutory definition; i.e., in E&G cases, whether the value on the return is less than 65% of corrected value.

The inquiry doesn’t stop just because the answer to this first question is “yes.” “It’s not just a bright-line, mechanical application,” Myers said. Instead, the revenue service will assess each case on its facts and circumstances to see how the appraiser reached the particular valuation and whether there are significant errors and omissions or departures from professional standards that led to an incorrect conclusion. For example, “Did the appraiser use the proper methods?” Myers said. “Did the conclusions stretch credibility?” If appraisers do their job, to the best of their ability, he said, “then it’s a high burden for me to establish liability.”

“We understand that valuation is not a specific science and that it can result in a range of numbers,” Kurzweil observed. In addition to the mechanical test, the IRS will conduct a qualitative assessment to address areas of concern such as whether the appraisal:

- Presented false information;
- Assumed facts that do not exist;
- Purposefully included or excluded valuation approaches;
- Ignored strong market evidence;
- Uses an incorrect standard of value; or
- Disregarded professional standards.

Many of these mistakes may seem straightforward and easy for most experienced business appraisers to avoid, but Kurzweil reiterated how important it is to “dig into” the facts and data of any given case to see how the fair market value standard applies.

Letter 4477: Appraisers spoke out, and IRS listened

Just over a year ago, the IRS distributed an internal memorandum that allowed examiners and agents—even those without BV credentials—to issue Sec. 6695A penalty citations via a “valuation misstatement letter,” or what was designated as Letter 4477 (see *BVWire #85-3*). The BV community immediately responded, led in part by Jay Fishman, member of the IRS Advisory Council and chair of the ASA’s government relations committee, who helped set up a meeting with the IRS last February (see *BVWire #90-1*).

“We pointed out—yes, hold appraisers accountable,” Fishman said, who also moderated the IRS Roundtable at the BVR/Georgetown Summit. “But do it in a better way. Take the emotion out of the issue.”

As a result of the meeting, the IRS revised its notice requirements. Under current procedure, a field examiner will try to contact the appraiser *before* sending Letter 4477, which is now called an “appraiser appointment letter,” Kurzweil said. The letter will request an appointment with the appraiser to review the matter without automatically invoking a penalty citation, she explained. More importantly, “in all fairness to the appraiser,” an IRS valuation specialist will now oversee the process to make sure it is timely and fair. The manager will also evaluate the appraisal according to any relevant professional standards and review the work file and engagement letter, including any limiting conditions.

Finally, the interview will give the appraiser an opportunity to present “the full picture of the case” and discuss whether the “more likely than not” standard applies, Kurzweil said. If the appraiser cannot establish that the exception applies, the examiner *must* propose an IRC 6695A penalty, according to IRS Manual §§ 20.1.12, “Penalties Applicable to Incorrect Appraisals.” Kurzweil recommended that all appraisers read the manual, available at www.irs.gov/irm/part20/irm_20-001-012.html#d0e185.

Before appealing, ask ‘What would Judge Laro do?’

The third speaker at the IRS Roundtable was Diane Ryan, IRS Chief of Appeals, who wanted to give appraisers practical tips that they could actually use. Ryan and her department stand at the crossroads between IRS field representatives and the federal courts, and they “see everything,” she said, from the appeal of large business and international tax issues to everyday estate and gift and income tax issues. As an independent forum, the Office of Appeals can take an independent approach and typically engages in a predictive analysis. “We try to read the minds of the tax judges,” Ryan said, about any given case: “What would the court do?”

Appeals also focuses on the “hazards of litigation”—the expenses as well as the legal and evidentiary pitfalls. Cases usually revolve around one or two disputed items or “friction points,” such as the discount rate or marketability discounts. Family limited partnerships continue to cause a lot of friction in appeals, Ryan said, especially given the recent *Holman v. Commissioner* decision, which held that the partnership’s right of first refusal might provide a natural cap on any marketability discounts. (For the digest of the 8th Circuit decision in *Holman*, see the June 2010 *BVU*.)

What should an appraiser do before taking a case to appeals? First, check the IRS web site to see if you have an Appeals Coordinated Issue (ACI), defined as one with “service-wide impact or importance that requires coordination to ensure uniformity and consistency nationwide.” (For a current, complete list of ACIs and their assigned coordinators, see: www.irs.gov/individuals/article/0,,id=108652,00.html.)

“Consistency is the cornerstone of the appeals process,” Ryan said, “so that the ‘art of valuation’ and the ‘art of litigation’ don’t lead to different conclusions. This means that we have an appeals officer who is coordinating the topic across the appeals process, even if an officer in California feels differently than one in New York.” For instance, family limited partnerships (FLPs) are coordinated as “categories of cases,” and the appeals web site provides a link to the 2006 Appeals Settlement Guidelines (www.irs.gov/pub/irs-utl/asg_penalties_family_limited_pships_finalredacted10_20_06.pdf). As most business appraisers know, the guidelines provide a range of FLP settlements in redacted form. Of special note: The Service is currently revising the appeals guidelines and the updated version should be available soon.

What’s also new: The Office of Appeals has just centralized its staff into two teams, each with a close connection to its manager. “This has given us a synergy in estate and gift tax cases that we didn’t have before,” Ryan commented. The recent change, just effected at the end of the summer, has also given appeals a more specialized, institutionalized focus, enabling officers to examine valuation reports for the credibility of their analysis and the overall reasonableness of their approach. Some business appraisers might still believe it’s better to conclude toward the far end of the valuation spectrum, because any appeals process involves a negotiation toward the middle, but that approach may backfire, Ryan pointed out. “Appraisals that take an extreme position may actually raise a red flag to the IRS officer.”

Appraisal quality has declined

The Office of Appeals is still seeing an “extraordinary variation” in the quality of appraisals, Ryan said, and that level is unfortunately deteriorating, perhaps due to the current economic circumstances. To make sure any business appraisal meets IRS quality and credibility standards, it should contain the following, Ryan said:

- A strong, consistent factual development;
- All three valuation approaches (or an explanation why one does not apply);

- An income stream that's adequately and appropriately matched to any adjustments (discounts);
- Mathematical accuracy—no errors;
- Complete tax rate analysis;
- Exhibits and computations that follow the analytical narrative and are complete; and
- Compliance with all relevant professional standards.

If your appraisal is subject to an appeals audit, consider the fast track settlement (FTS) program, Ryan suggested. Jointly administered by her office and the Large and Mid-Size Business Division (LMSB), the program expedites case resolution and expands the range of resolution options by assigning an appeals official to act as a neutral third-party mediator; see *Rev. Proc. 2003-40* at www.unclefed.com/Tax-Bulls/2003/rp03-40.pdf. There is also a parallel fast track mediation (FTM) program related to the Small Business/Self-Employed Compliance Division; see *Rev. Proc. 2003-41* at www.unclefed.com/Tax-Bulls/2003/rp03-41.pdf.

The voluntary fast tracks program is proving to be more efficient and less costly than the traditional appeals process. Structured to resolve cases within 120 days of application, the SB/SE program actually closes the vast majority within 80 days, Ryan reported. Compare this to the 139 days, on average, that it takes for a formal appeals application to reach an officer's desk, "and the file hasn't even been opened yet," she said. Further, approximately 85% of fast tracks cases reach an agreement, which is the same percentage as cases following the traditional route. If the parties are not able to resolve the matter in fast tracks, they still retain all their statutory rights of appeal.

Ryan offered a specific case study to highlight the advantages of the program. The "friction point" of the parties' dispute focused on the use of a particular valuation method developed by a London specialist. When they reached an

impasse, the fast tracks mediator was able to get the London expert on the phone to provide further insight and analysis. "The parties were able to work through the issue collaboratively and resolved the matter with surprising rapidity," Ryan said. "We can all become entrenched in our positions—you, the taxpayer, the appeals officer," she told the summit audience. The fast tracks alternative offers a "fresh set of eyes" on the issue, and as a result, she's even seen an IRS representative say, "oh—now I get it."

The fast tracks program is just one more example of the IRS's continued efforts to reach out to the business appraisal and taxpayer communities. The revenue service is holding more meetings and inviting more public discussion on disputed issues to foster better understanding and shared views. Its response to appraisers' concerns over Letter 4477 is just one example, Ryan noted. The IRS is also conducting outreach on cost-sharing arrangements and S corp taxation.

No benchmarks, but continuing guidance

With regard to S corp valuation, "we realize there's a perception that the service has taken inconsistent approaches," Kurzweil conceded, "and we are trying to change that. Tax-affecting is a misnomer," she added. "It should be called 'an adjustment for the difference between S and C corp values.'" To help clarify any confusion or perceived inconsistencies, the IRS has just approved a project to study the valuation of S corporations, which should take at least a year to complete.

Until then, the revenue service doesn't have a particular benchmark for an S corp discount or a discount for lack of marketability, Meyers said. "We simply need to know how you got to your discount, what adjustments you made, what data you used, and what law you relied on, to see if they fit the facts and circumstances of the case. We do not have a threshold [DLOM]," he added, "but I can guarantee you, the higher your discount rate is, the more likely it is to draw the attention of an IRS agent or examiner."

Fresh Start Reporting: A Growing Opportunity for Appraisers

...continued from front page

to be confirmed and the reorganization proceedings thereby concluded, the consideration to be received by parties in interest under the plan must exceed the consideration they would otherwise receive on liquidation of the entity under Chapter 7 of the Bankruptcy Code. The court may confirm a plan even if some classes of creditors or some of the stockholders have not accepted it, provided it meets standards of fairness required by Chapter 11 to the dissenting class of creditors or the dissenting stockholders. In general, except as provided in the plan or in the order confirming the plan, confirmation of the plan discharges the debtor from all pre-confirmation claims and terminates all rights and interest of equity security holders or general partners as provided for in the plan.

An important part of the process of developing a plan is the determination of the reorganization value of the entity that emerges from bankruptcy. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of post-petition liabilities and allowed claims and interest, as negotiated or litigated between the debtor-in-possession or trustee, the creditors, and the holders of equity interests. Reorganization value includes the sum of the value attributed to the reconstituted entity and other assets of the debtor that will not be included in the reconstituted entity.

Several methods are used to determine the reorganization value; however, generally it is determined by discounting future cash flows for the reconstituted business that will emerge from

Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved.

The financial reporting consequences of the Absolute Priority Doctrine

The Absolute Priority Doctrine provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the cram-down provisions of the Bankruptcy Code. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on. Under the absolute priority doctrine of the Bankruptcy Code, if the amount of post-petition liabilities

and allowed claims exceeds the reorganization value of the emerging entity, existing shareholders lose their legal right to any economic interest without the consent of creditors. Therefore, any equity interest in the emerging entity ultimately held by existing shareholders is given to them by the creditors. Among the reasons the creditors might give such shareholders equity interests in the emerging entity are to avoid the expensive and time-consuming legal proceedings necessary to implement the cram-down provisions of the Bankruptcy Code or to preserve continuity of management. Consequently, in this situation, upon an entity's emergence from Chapter 11, the entity is required to adopt fresh-start reporting.

Fresh start reporting

The exercise of determining the emerging company value is not as simple as it sounds. ASC 852 specifically mentions the use of the discounted cash flow method of determining the value of the emerging entity. One of the primary components to the discounted cash flow method

The exercise of determining the emerging company value is not as simple as it sounds. ASC 852 specifically mentions the use of the discounted cash flow method of determining the value of the emerging entity.

of valuation is the development of forecasted financial statements of the emerging entity. The use of pre-petition financial statements may not be a good starting point for this exercise as the pre-petition entity is thought to be radically different from the emerging entity. The following elements should be considered when forecasting the financial statements of the emerging entity:

- Corporate restructuring and other operating program changes;
- Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events;
- The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period;
- Market share and position;
- Competition and general economic considerations;

- Forecasted sales growth;
- Potential profitability; and
- Seasonality and working capital requirements.

Fresh start reporting is not an exercise for the weak appraiser. It requires technical ability in the form of understanding the value drivers of a business, being able to translate those drivers into meaningful relationships that are ultimately used to forecast the future financial statements of a business, as well as the GAAP treatment of the issue. As if that were not enough, the ultimate determination of value is subject to the scrutiny of the Bankruptcy Court, as it must be measured against the post-petition debts and claims of the petitioner. Only if the post-petition debts and claims exceed the fair value of the emerging entity may the Absolute Priority Doctrine apply.

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How Fast Do DLOMs Change?

By Ronald M. Seaman, FASA

Our studies of LEAPS and the costs of price protection show clearly that discounts for lack of marketability (DLOMs) change over time. But how much do DLOMs change? The answers are: quickly, often, and a lot. The factors causing change appear to be conditions in the company, or in the industry, or in the general economy.

For this study, we chose 10 U.S. stocks and recorded the costs of their LEAPS put options on approximately the same dates each month for the first nine months of 2010, beginning on Jan. 19. The 10 stocks appear in the accompanying list.

We chose BP to see the effects of the Gulf oil spill on the costs of its LEAPS. We chose SLB (Schlumberger) to see what if any effects the oil spill had on companies related to petroleum

Stocks included in the LEAPS DLOM Study

Stock Symbol	Company/Business
BP	British Petroleum, PLC Petroleum production and marketing
SLB	Schlumberger Ltd. Petroleum equipment and services
BBY	Best Buy Co. Electronics retailer
CAL	Continental Airlines International airline
GPS	GAP, Inc. Apparel retailer
KBR	KBR, Inc. Engineering and construction services
MYGN	Myriad Genetics Manufacturers of healthcare diagnostics
RDN	Radian Group Surety and title insurer
TCK	Teck Resources Ltd. Minerals mining and processing
ZION	Zions Bancorp Regional bank holding company

producers. For the remaining eight companies, we selected each multiple of 91 companies, alphabetically, from all remaining LEAPS.

We studied only LEAPS expiring on Jan. 21, 2012. In January 2010, those LEAPS had 24 months before expiration. Over the nine-month period from January through September, one would expect some decrease in the cost of price protection (i.e., decrease in the discount percentages) as the holding period (the time to expiration) grew shorter; however, the amount of that decrease cannot be identified.

Discount percentages were calculated in the same manner as in all previous studies¹; that is, by dividing the cost of the put option by the price of the underlying common share on the same day.

The accompanying chart shows the results. As would be expected, the change in cost of price protection on BP stock was dramatic, with a

difference between the highest and lowest option costs during the nine-month period of 75%. Discounts for Schlumberger (SLB) showed little impact from the BP accident.

Within the nine-month period, it was common for the change in the costs of price protection/discounts to vary from 20% to 30%. In distressed industries or companies (RDN or ZION, for example) the variations could be much greater.

So, what does this mean for appraisers?

It simply means that the dates of the data on which you base your DLOM conclusion are important because conditions change fast and often. Your data should be contemporary with your valuation date. In addition, from this and other studies, it is clear that industry and company comparability is important.

Ronald M. Seaman, FASA, is the founder of Southland Business Group in Tampa, Fla.

¹ For earlier studies, see www.dlom-info.com.

LEAPS Costs As % of Stock Prices of Selected Companies During 9-Month Period of 2010

	BP	SLB	BBY	CAL	GPS	KBR	MYGN	RDN	TCK	ZION	Months to Expiration of Option
Jan. 19	17.6%	19.2%	18.9%	29.4%	19.5%	23.3%	25.5%	49.1%	23.0%	28.2%	24
Feb. 17	18.6%	19.2%	18.5%	31.1%	18.8%	23.3%	27.8%	46.7%	24.9%	30.6%	23
Mar. 17	16.9%	17.7%	16.8%	29.0%	17.2%	20.6%	23.8%	40.4%	20.0%	24.5%	22
Apr.16	16.3%	17.7%	16.8%	27.1%	15.6%	20.3%	23.1%	37.6%	20.8%	25.1%	21
May 17	19.7%	21.5%	21.8%	31.1%	19.8%	21.6%	24.8%	41.8%	26.5%	31.9%	20
June 17	28.5%	20.3%	21.1%	29.0%	18.8%	21.2%	23.6%	41.9%	26.6%	25.9%	19
July 16	24.1%	20.9%	20.9%	29.3%	19.6%	20.8%	22.5%	39.9%	26.0%	25.0%	18
Aug. 17	19.5%	19.1%	19.6%	27.5%	18.6%	20.2%	23.4%	39.8%	24.3%	23.2%	17
Sept. 17	22.4%	17.7%	17.4%	25.3%	17.3%	19.0%	24.9%	34.8%	22.5%	21.3%	16
Difference: Highest Option Cost ÷ Lowest Option Cost											
	75.3%	21.6%	29.9%	22.8%	26.8%	22.7%	23.4%	41.2%	32.9%	49.7%	
Standard Deviation											
	3.97	1.42	1.90	1.86	1.39	1.42	1.59	4.37	2.43	3.44	
Coefficient of Variation											
	18.5%	7.4%	10.0%	6.5%	7.6%	6.7%	6.5%	10.6%	10.2%	13.1%	

Patent Claims Are Determinative of Patent Value

By David Wanetick

Two seminal studies report that the single most important determinant of patent value is the number of independent claims.¹ Reasons for these findings include:

- Claims are expensive to draft and prosecute. Filing fees are becoming even more expensive for patents that contain many claims.
- The more claims a patent family has, the more freedom of operation the patentee seeks. Similarly, the more claims a patent family has, the more assertion opportunities the patentee has.
- The more claims a patent has, the more difficult it will be to invalidate the patent due to the expense of attempting to invalidate the claims (each claim can cost between \$5,000 and \$20,000 to attempt to invalidate) and the diminishing probabilities of being able to invalidate all of a large number of claims.

In this article, I would like to offer two refinements to the well-researched rule of thumb that there is a direct relationship between the number of independent claims a patent has and the patent's value.

The first refinement is that the relationship of independent claims to patent family value seems to be curvilinear: While more independent claims seem to be a consistent indicator of patent value, there are diminishing or even negative returns associated with patents that contain excessive claims. According to our surveying of patent lawyers, it seems that there is a direct relationship between independent claim count and patent strength until there are between 40 and 70 claims per patent. After that, additional claims are not instructive as to incremental or decremental patent strength.

¹ Worthless Patents, Kimberly A. Moore, George Mason University, 2005; Probabilistic Patents, Mark A. Lemley (Stanford Law School) and Carl Shapiro (University of California at Berkeley), 2005

According to Lynda Calderone, chair of the intellectual property group at Flaster/Greenberg, P.C., if there are too many claims, there are likely to be a lot of redundant claims. Further, too many claims obscure the art of the invention—and the whole purpose of a patent is to put the public on notice as to what the invention is. If competitors cannot determine what your invention is they will not be dissuaded from (inadvertently) infringing your patent. The key is to have meaningful claims of varying scope without making the patent overly complex to understand.

Of further concern is that inventorship becomes problematic when there are too many claims on one patent. During prosecution, examiners are likely to separate superfluous claims on the submitted patent into a variety of patents. When this happens, it becomes difficult to determine who should be listed as inventors on the particular patents that devolved from the one initially submitted. If the inventors are associated with patents for which they did not conceptualize the innovation or there is a failure to list all of the true inventors, the patents can be rendered unenforceable after they issue.

While the number of independent patent claims may be the single most telling indicator of patent strength, it is not the only metric to be applied. Patent claims analysis is the other category of factors to consider in determining patent strength, and it is an important element in our patent valuation gauntlet. Patent claims analysis consists of the following issues, among others:

1. *How well do the patent's claims cover a commercially viable product?* It doesn't matter how many claims a patent has if such claims do not cover a commercially viable product or a product that could become commercially viable.
2. *How easy is it to detect infringement of the claims?* If infringement cannot be detected, the claims have little value because the patentee will not know when to enforce his patent rights. It is easier to detect

When there is a low level of exactitude required to produce the embodiment—and the claims are too narrow or too complex—the claims are typically less powerful.

infringement when patents describe apparatuses rather than processes since the former can be detected by observing how the end product (e.g. machine) works while the latter are harder to observe since the processes occur at a factory during the production process.

3. *How difficult is it to design around the claims?* When there is a low level of exactitude required to produce the embodiment—and the claims are too narrow or too complex—the claims are typically less powerful. For instance, a dessert or software program can be produced in a variety of ways that will approximate the patented recipes or software codes without infringing the patents.
4. *How clear is the language used in the claims?* Your claim must be clear so that you do not cause the reader to speculate about the claim. If you use words such as “thin,” “strong” or “when required,” then you are probably not being clear enough, unless such words are clearly defined in the specification. Such comparison words or general adjectives that are not well defined in the art may force the reader to make a subjective judgment, not an objective observation, making them potentially “indefinite” as a matter of law and causing the claim to be held invalid after litigation.
5. *Are the claims complete?* Each claim should cover the inventive feature and enough elements around it to put the invention in the proper context.
6. *How well is each of the claims supported?* There should be consistency between the claims and the description in terms of terminology and scope. The claims have to be supported by the description. This means that all the characteristics of your

invention that form part of the claims must be fully explained in the description. In addition, any terms you use in the claims must be either found in the description or clearly inferred from or defined in the description.

The patent family will be stronger if it contains complementary claims, says Joel H. Bootzin, partner at Fitch, Even, Tabin & Flannery. Thus, some claims should cover a novel component, others the whole product, while others should be method claims to stop infringers that do not sell or use the final product.

While longer prosecution times indicate that the patentee believed there was value in the patent (thus justifying the time and expense of navigating a long prosecution), there are other issues to consider when reviewing prosecution history. For instance, a relatively high number of office actions may indicate that the examiner was unreasonable, the patent attorney was overly unyielding, or that the invention was very difficult to describe. When the examiner made repeated rejections because he cited new pieces of prior art, this tends to show that the patent claims are strong. If the examiner was making repeated rejections when citing the same prior art, it is difficult to gauge the general strength of the patent claims without knowing the specific details of the reference in light of the factors mentioned above.

There is always tension between drafting broad claims that better ensure that the invention and improvements to the inventions are covered by the claims and narrower claims that present less risk that prior art will be discovered. However, Bootzin offers this perspective on the broad/narrow patent claim issue: “A broad claim is always desirable but especially for a patent addressing a new industry, while a narrow claim can still be very valuable when competitors must have the claimed technology to compete.”

Finally, after the claims are drafted, the conduct of the inventors, applicants, and the lawyers handling the case can impact patent value. Alfred W. Zaher, partner at Blank Rome, points out that patent lawyers can get into serious trouble for being overzealous in prosecuting the claims and may expose themselves and clients to a claim of inequitable conduct by intentional examiner shopping or making misleading comments in prosecution. This happens most when lawyers file the same application multiple times and fail to disclose the same or related pending applications to every examiner assigned to these applications. Although at

times an overused defense, it is nonetheless a potent attack on the enforceability of the issued patent. Similarly, lawyers who overreach and persuade an examiner to issue the patent claims through an interview, may end up watching such claims implode when challenged in subsequent litigation or reexamination.

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Draft Expert Reports No Longer Discoverable in Federal Court

The proposed changes to Rule 26 of the Federal Rules of Civil Procedure went into effect on December 1. These changes apply the work-product protections of Rules 26(3)(A) and (B) to drafts of expert reports and expert-attorney communications.

Judges, trial attorneys, and professional associations such as the AICPA welcome the change. “The judges I’ve spoken with say it’s long overdue,” says Ron Seigneur, a partner with Seigneur Gustafson. “They’ve seen way too many arguments over prior drafts of material.”

“The prior rule led to gamesmanship,” explains Linda Dakin-Grimm, a partner with Millbank. For example, “when drafts were discoverable, attorneys could look over poorly prepared and marked-up drafts and then cross-examine the experts on them. But the lawyers and experts figured a way around this by sending drafts back and forth in virtual data rooms so there wouldn’t be any tracks.” This and other antics to avoid creating discoverable reports added to the cost of discovery, created longer than needed depositions, and took attention away from the merits of the cases.

Nevertheless, “don’t take too much comfort from the rule change,” advises Dakin-Grimm. “The rule says the drafts are no longer discoverable, and communications are not discoverable, but there is a big ‘unless’ in the rule.” There are three types of communications between the attorney and the expert that are still open to discovery:

- Compensation for the expert’s study or testimony;
- Facts or data provided by the lawyer that the expert considered in forming opinions; and
- Assumptions provided to the expert by the lawyer that the expert relied upon in forming an opinion.

“When you are examining experts, you are supposed to know what the bases are for the assumptions in their reports,” Dakin-Grimm adds. “If they got those assumptions from an attorney they can be discoverable.”

Seigneur reminds BV practitioners that the rule change applies to federal court. “Whether or not state and district courts adopt the rules will be something to keep an eye on.”

Proposed DOL Regulation Includes Appraisers as ERISA Fiduciaries

Since 1976, U.S. Department of Labor policy has held that independent appraisers valuing ESOP stock are not considered fiduciaries. However, that policy could be reversed by a proposed DOL regulation announced last month (October 22) in the *Federal Register*. The proposed regulation expands the definition of fiduciary to include those who give “investment advice,” and one type of such advice is “advice, appraisals or fairness opinions concerning the value of securities or other property.”

The DOL believes that this change will enable the it to cut down on purported abuses in the market. In a recent blog post the ESOP Association questions the DOL’s allegations relating to valuations¹:

DOL, in four instances in its 51 page regulatory proposal expanding the agency’s definition of who is a fiduciary to an ERISA plan, says its audits of ESOP companies “proves” that valuations of company stock of private companies sponsoring ESOPs are commonly “incorrect.” Yet nowhere does the DOL document provide any data to support its claim that ESOP private company stock valuations are commonly incorrect, and are therefore hurting ESOP participants’ retirement savings.

Does DOL believe the valuations are incorrect because they are too low, or too high? If too high, employees are reaping the benefits with higher retirement savings. If too low, then DOL should bring an enforcement action against the current trustees/fiduciaries of the ESOP, not attack the problem by saying valuator are

fiduciaries and thus will be “juicy” lawsuit targets by an aggressive group of trial lawyers who have generally lost their lawsuits against public companies with company stock plans.

BVUpdate worries that, in its efforts to protect beneficiaries of pension plans, the regulation will have a negative effect on the market. We recall the example of the trust firms like U.S. Trust, which abandoned the ESOP market after being exposed to lawsuits. Will the larger valuation firms (such as Duff & Phelps and Houlihan

Lokey) that perform ESOP fairness opinions and appraisals similarly decide to forgo these generally low-margin engagements in order to protect themselves from the increased liability exposure?

Those appraisers who opt to stay in the market would need to purchase fiduciary liability insurance. And “less competition among valuation firms doing private ESOP company valuations

also mean higher costs, and more hassles finding competent valuation firms,” says the ESOP Association. This would mean that the new DOL reg, if approved, would potentially *reduce* the quality of ESOP work.

There is already a backlash against the proposed regulation, at least from the ESOP Association, and we won’t be surprised to hear of further responses from other related groups including the ASA BVC.

Individuals can submit their written comments on the proposed regulation to the DOL on or before Jan. 20, 2011, by e-mail to e-ORI@dol.gov (enter in subject line: Definition of Fiduciary Proposed Rule) or by using the Federal eRulemaking portal at www.regulations.gov.

The proposed regulation expands the definition of fiduciary to include those who give ‘investment advice,’ and one type of such advice is ‘advice, appraisals or fairness opinions concerning the value of securities or other property.’

¹ www.esopassociation.org/blog/template_permalink.asp?id=332#332

Issues and Controversies in Damage Claims

By Nancy J. Fannon, ASA, CPA/ABV, MCBA

The need for a lost profits damages calculation begins with the plaintiff's allegation of a damaging act or actions. The financial experts and attorney should be well-versed in all aspects of the claim, including the method that the experts use to gather evidence in support of their opinions and the key financial and other assumptions that the experts make.

However, there are some areas where financial analysts may differ in their approach, analyses, and calculations, and there are areas that cause financial expert reports to be excluded. Examples of three of these areas are:

- Link to causation;
- Deduction for expenses: owner compensation; and
- Consideration of subsequent events

Link to causation. Many claims for economic damages are excluded for lack of relevance. In some cases, this is because the damages are not sufficiently tied to the alleged actions of the defendant. "The damages . . . must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes," according to *Coastal Aviation v. Commander Aircraft* (937 F. Supp. at 1064).

The attorney should not assume that the expert has tied the plaintiff's alleged losses to defendant's actions; and conversely, the expert should not assume that the attorney has tied the financial expert's calculations to the defendant's behavior. For example, in *PharmaNetics, Inc. v. Aventis Pharmaceuticals, Inc.* 182 Fed. Appx. 267, 272-73 (4th Cir. 2006), the court excluded the expert's lost profit testimony because it was not sufficiently tied to defendant's conduct, but assumed that the defendant was liable for all claims and no other factors contributed to lost profits.

In appropriate cases, the expert should also consider other possible causes for the loss, such as in

Isaksen v. Vt. Castings, Inc. 825 F.2d 1158, 1165 (7th Cir. 1987), in which expert testimony may be excluded when the expert fails to consider other causes for the lost profits, such as market saturation and reduced prices of alternate products. Attorneys should be aware that some experts adjust their *discount rate* for issues relating to causation. The expert and attorney should discuss whether such an adjustment sufficiently proves causation.

Deduction for expenses—owner compensation. As described earlier, lost profits damages are based on net profits. This requires the deduction of avoided variable costs from the incremental revenue stream. What, then, to do in the case of a company that pays out most of its profits to its owners?

Some cases treat owner compensation as an expense deductible by the corporation; others view it as an expense to be normalized in lieu of what the corporation has deducted. Still other cases have held that where earnings were distributed to the owners, deficiencies in owner salaries over the loss period should be added into the total lost profits amount.

For example, in one case, the plaintiff sued for \$1,030,000 in lost profits, including wages lost by its anesthesiologists under a contract their practice had with the hospital. The trial court awarded only \$14,883, which represented the practice's lost income, net of expenses saved. "*We therefore conclude that professional corporations must be treated like other corporations for purposes of calculating damages. Unpaid salaries of corporate shareholders ought to be treated as saved expenses.*" *Anesthesiologists Assocs. of Ogden v. St. Benedict's Hospital*, 884 P.2d 1226, 1238 (Utah 1994). In this case, the plaintiff failed to offer an alternative damages calculation based on the court's findings regarding the deduction of the doctors' wages; thus the court had no other option than to choose the defendant's calculation of damages.

Similarly, the Florida Court of Appeals rejected in *Guillermo Sostchin v. Doll Enterprises, Inc.*, 847 So.2d 1123, 1125 (Fla. 2003), a lost profits calculation specifically because it included the owner's salary:

[Plaintiff's] tax returns and its accountant's trial testimony and demonstrative exhibits clearly show that officer compensation paid to the corporation's owner was not excluded from the calculation of net profits as it is required to be, and these improperly inflated figures were used as a jumping off point to extrapolate continued rapid growth.

By contrast, in *Spring Windows Fashions Div., Inc. v. The Blind Maker, Inc.*, 184 S.W.3d 840, 885 (Tex. App. 2006), a Texas court accepted the expert's theory that deficiencies in owner salaries over the loss period should be added into the total lost profits amount. In particular, the court found that where a significant portion of plaintiff's net income was distributed to its owner through compensation, a reduction in compensation due to the defendant's conduct was a valid measure of lost profits.

In many small to mid-sized companies that pay a significant amount of their profits out as owner compensation, this could be a very significant issue. The attorney may want to consider naming both the corporation and owner/employee as plaintiffs, if such alternative might make a difference in the ability to successfully make the claim. This subject is discussed further in my book, with related case abstracts.

Consideration of subsequent events. Lost profits claims can be calculated alternately as:

- Actual damages for a limited number of years in the past (beginning with the date of breach and ending at the time the company recovers from the loss);
- Actual damages for a period of time in the past, and consequential damages for a limited number of years into the future (beginning with the date of breach and ending at the time the company is expected to recover from the loss); or,
- The loss of the entire business (as of the date of the breach, assuming the company is a total loss and is never expected to recover).

Beginning at the date of breach and continuing throughout the loss period, the expert will typically

find other occurrences that impact the plaintiff's financial results, in addition to the damaging effects of the defendant's actions. The financial expert should consider these other events when making the damages calculation. For example, there may be changes in competition, pricing, economic conditions, or myriad other factors that might affect the plaintiff's success or failure during the damages period. On further examination, these factors could, at least in part, explain the plaintiff's financial results (cause). They could also explain the financial results of the peers used as comparables (yardstick); or they may help explain why a company was able to recover when it did (before and after). In addition, they can help illustrate the plaintiff's ability (or inability) to mitigate losses during the damage period.

In a lost profits calculation, case law provides little support for ignoring factors that may affect the damages claim, including those that occur post-breach. Analysts sometimes adopt an approach referred to as "ex-ante," in which they calculate damages using only information that was known or knowable at the date of the damaging action. If such an approach is undertaken in a lost profits claim, the expert and attorney should agree that it is appropriate and supportable given the particular facts and circumstances of the matter.

The expert should consider other possible causes for the plaintiff's financial results, including general economic factors such as inflation, growth, or market demand. In *Penn Mart Supermarkets, Inc. v. New Castle Shopping, LLC*, 2005 WL 3502054 (Del Chan 2005), the Delaware Chancery rejected an event study analysis that failed to consider all possible economic events that could have resulted in the lost profits in this breach of a protective covenant in a lease case.) Experts should also assess items specific to the industry or the subject business, such as price-cutting or changes in distribution methods.

Each of the methods to calculate lost profits supports the use of information subsequent to the date of the loss. The before-and-after method seeks evidence related to how the business performed both before and after the loss period; the yardstick method seeks information regarding

how guideline or similar companies performed during the damage period. The market model method uses guidance from the share of the market the company would have enjoyed, but for the actions of the defendant.

Even in the sales projection method, at least one court has found that the expert should try to conduct additional, independent analyses of management projections and business plans to determine whether they are consistent with industry, guideline company, or other benchmark data that might be available. For example, the expert's wholesale acceptance of management projections without any verification of the estimates or any independent market analysis were too speculative in *U.S. Salt, Inc. v. Broken Arrow, Inc.*, 2008 WL 2277602, *2 (the record was devoid of any evidence showing that a proven market existed for this product or that comparable businesses were successful). In *Telxon Corp. v. Smart Media of Delaware, Inc.*, 2005 WL 2292800 (Ohio App. 2005), the expert's opinion and report based entirely on a business plan that plaintiff developed some three years after the breach and almost 15 months after filing the lawsuit were unreliable and speculative.

The expert should therefore examine the effects of market and other factors on the sales projections, isolating harmful ones from those that

resulted from factors other than the defendant's behavior. In *Saks 5th Ave., Inc. v. James, Ltd.*, 630 SE 2d 304 (Va. 2006), the expert failed to connect the lost profits that plaintiff claimed to anything other than the mere fact that defendant was no longer working for the plaintiff.

In addition, in tort claims such as misappropriation of trade secrets, breaches of fiduciary or confidential relationships, and breaches of non-competition agreements, some states have found that an accounting of the defendant (tortfeasor's) profits is appropriate to use in calculating the plaintiff business's damages and lost profits.

One cannot use any of these methods without consideration of events subsequent to the date of loss. Similarly, in calculating possible mitigation of damages, the analyst must also consider subsequent events, and whether and to what extent the plaintiff took steps to mitigate the loss.

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Editor's Note: This analysis by Nancy is excerpted from the new edition of The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys, updated this month.

Ambulatory Surgery Centers, Diagnostic Imaging Centers, and Skilled Nursing Facilities: Sources of Free Industry Data

The ever-changing healthcare environment makes researching ancillary healthcare providers (such as ambulatory surgery centers, diagnostic imaging centers, and skilled nursing facilities) challenging. These healthcare providers face an intense regulatory environment, reimbursement and payment concerns, cost containment pressures, increasing competition—and now even the constitutionality of the current healthcare reform has been challenged successfully in court.

Most industry research providers (BizMiner, First Research and IBISWorld) offer off-the-shelf reports on these industries, but appraisers may want or need to research more specific information to match your particular subject company. Trade associations, magazines, consulting firms and the SEC filings of the major industry players are the best sources of current industry information.

Ambulatory Surgery Centers

Ambulatory Surgery Center Association
(www.ascassociation.org)

- The web site's section "legal and regulatory" has current updates on how the regulatory environment is affecting the industry.
- The FAQ "Frequently Asked Questions About Ambulatory Surgery Centers" has good background data on the industry.
- The "Publications and Services" section contains a page with links to all state associations, which is useful since most states require ASCs to be licensed in order to operate, and each state determines the specific requirements ASCs must meet for licensure.

American Association for Accreditation of Ambulatory Surgery Facilities Inc. (www.aaaasf.org/)

- Its quarterly newsletter contains a legislative update.
- Its "State Governing Entities & Regulations" file is a chart listing the name and web site of each state's governing entity and links to regulations and guidelines. The website also has a directory of accredited ASCs that is searchable by facility name, city, state, or ZIP code.

Becker's ASC Review (www.beckersasc.com)

- This publication contains "practical business, legal, and clinical guidance for ambulatory surgery centers."

Centers for Medicare & Medicaid Services' Ambulatory Surgical Centers (ASC)
(www.cms.gov/center/asc.asp)

- Geared toward the providers themselves, this government site offers up-to-date information on coding, billing, enrollment, participation, certification, policies, and regulations.

HealthCare Appraisers Inc.
(www.healthcareappraisers.com)

- This valuation and consulting firm publishes an annual *ASC Valuation Survey* that documents trends in the value and characteristics of ASC ownership interests and management fees charged to ASCs.

VMG Health (www.vmghealth.com)

- This valuation and transaction advisory firm publishes an annual *Intellimarker ASC Benchmarking Study* that provides detailed financial benchmarking information and analysis on U.S. ASCs.

American Medical News
(www.ama-assn.org/amednews)

- Search this American Medical Association publication by keyword and phrase (such as "ambulatory surgery") to find current news on the industry and individual surgery centers.

Check the web sites and Forms 10-K of these public companies:

- Amsurg (www.amsurg.com) operates 200 outpatient surgery centers throughout the U.S.
- NovaMed Inc. (www.novamed.com) runs 37 outpatient locations in the U.S. and is seeking to acquire more.

Diagnostic Imaging Centers

Imaging Economics (www.imagingeconomics.com)

- This magazine provides articles on the industry in a variety of formats: print, video, and audio.

HealthImaging.com

- This web portal provides articles from *Health Imaging & IT* magazine and *Health Imaging* newsletter. While technology focused, many articles provide insight into current industry conditions.

Diagnostic Testing & Technology Report
(www.g2reports.com/issues/DTTR)

- Washington G-2 Reports publishes this report for a fee, but pieces of its articles can be gleaned from the tables of contents and article introductions.

Check the web sites and 10-Ks of these public companies:

- Alliance Imaging (www.allianceimaging.com). This division of Alliance HealthCare Services Inc. operates 478 diagnostic imaging systems in 120 locations across the country.
- Insight Imaging (www.insighthealth.com) operates about 60 fixed-site imaging centers and more than 100 mobile diagnostic imaging units in the U.S.
- Radnet (www.radnet.com) is a network of 198 owned and operated outpatient imaging centers in seven states.

Nursing Homes and Assisted Living Facilities

American Health Care Association
(www.ahcancal.org)

- Check the “research and data” tab then “trends and statistics” for its yearly publication *Trends in Nursing Facility Characteristics*.
- The association’s *Provider* magazine contains current news and reports, such as “The Changing Landscape: From Long-Term Care to Short-Term Stay.”

MetLife Mature Market Institute
(www.metlife.com/mmi)

- MetLife’s research organization publishes an annual “Market Survey of Long-Term Care Costs.”

Check the web sites and 10-Ks of these public companies:

- Kindred Healthcare (www.kindredhealthcare.com). According to the company, its hospital division operates 83 long-term acute care hospitals in 24 states, and its health services division operates 222 nursing and rehabilitation centers in 27 states.
- Sun Healthcare Group (www.sunh.com). According to the company, its subsidiaries provide nursing, rehabilitative and related specialty healthcare services in 25 states.
- Skilled Healthcare Group (www.skilled-healthcaregroup.com) is a holding company with subsidiaries that operate skilled nursing facilities, assisted living facilities, and a rehabilitation therapy business in seven states.
- National HealthCare Corporation (www.nhccare.com) operates 77 long-term health care centers and the company’s affiliates operate 36 homecare programs, seven independent living centers and 16 assisted living communities in 12 states.
- The Ensign Group’s (www.ensigngroup.net) independent operating subsidiaries provide a broad spectrum of skilled nursing and assisted living services; physical, occupational, and speech therapies; home health and hospice services; and other rehabilitative and healthcare services at over 81 facilities in seven states.
- Advocat (www.advocatinc.com) operates skilled nursing facilities in eight states through its subsidiary, Diversicare Management Services Co.
- Capital Senior Living Corporation (www.capital senior.com) operates 77 senior living communities in 23 states.

LEGAL & COURT CASE UPDATES

Industry and I-Banking Expert Admits Even He Wouldn't Rely on His Own Report

R&R International v. Manzen, LLC, 2010 WL 3605234 (S.D. Fla.) (Sept. 12, 2010)

The plaintiff was relatively new to the beverage industry when, in 2008, it entered into a five-year contract to distribute the defendant's "Xience" energy drinks in Florida and Georgia. Within months of the parties' agreement, however, the defendant found another distributor, and the plaintiff sued for breach of contract, alleging over \$8 million in damages based on its expert's findings. Prior to trial, the defendant challenged the expert under the *Daubert* standard, claiming he was not qualified to testify and his opinions lacked reliability and replicability.

As to the first claim, the court found that the expert held no degree in finance, accounting, or economics. Nevertheless, as an investment banker, he had "substantial experience" in the beverage industry. Specifically, banks relied on his analysis of beverage companies—their financial statements and profit projections—to make lending decisions. This background qualified the expert to analyze lost profits, the court held—but ironically, his experience also became the benchmark by which the court ultimately tested his report's reliability.

Expert relies on informal studies and sampling. To calculate damages, the expert began with the five-year contract term as the applicable lost profits period. Next, he predicted the plaintiff's market share, growth rate, sales, and net profits as follows:

1. *Market share and growth rate.* To determine the size of the applicable market in year 1 of his lost profits projections, the expert took the national per capita consumption of energy drinks from an industry publication, and multiplied this number (4.2 drinks per person) by the populations of Florida and Georgia, which

he derived from marketing statistical reports. For years 2 through 5, the expert assumed the market would increase by 15.1%, based on a 2007 article in an industry publication. By year five, the plaintiff would hold a 4.5% market share, the expert said, based on his interviews with several "major" distributors of the defendant's energy drink.

2. *Projected sales.* To estimate the number of cases sold during year 1, the expert took the plaintiff's six months of operating figures and increased them by 60%, based on an estimated rise in seasonal sales, for a total of 51,432 cases sold in year 1. For years 2 through 5, he projected sales of 150,000, 320,000, 510,000, and 706,150 cases, respectively, which culminated in a 4.5% market share.
3. *Net profits.* During its six months in operation, the plaintiff grossed profits of \$5.50 per case. Based on his interviews with distributors, the expert found their distribution costs ranged from \$1.50 to \$2.75 per case, depending on the market. Because the plaintiff was a non-union, non-urban distributor, the expert believed it would have an average distribution cost of \$2.25 in the "build-out stage of the brand years 1 through 3 and \$2.00 per case for years 4 and 5 to allow for efficiencies." He then deducted some marketing costs, noting that, per the distribution agreement, the defendant had promised to contribute \$9 for every \$11 of cases (gross) the plaintiff purchased.

Finally, the plaintiff's expert looked at the sales of several non-alcoholic beverage companies, noting that they had "commanded significant multiples . . . in recent years," ranging from 4X to 11.5X revenue. Based on this data, he believed the plaintiff would have been worth over \$11 million in 2010 but for the defendant's breach of the distribution agreement.

Turns out, research was from Wikipedia. In assessing the reliability of the expert's opinion, the court found that the plaintiff was a relatively

new business, with little more than those six months of operating figures. This did not bar the plaintiff from claiming lost profits under applicable (Florida) law, the court held, so long as it presented reliable financial data from comparable “yardstick” companies. In this context, however, the expert’s report suffered numerous flaws and unsupported assumptions. In particular:

- The industry studies he used to calculate market share were from Wikipedia, a source of “mixed” reliability, the court said. Moreover, he did not independently check the articles or attach copies to his report. Finally, the 2007 article on industry growth did not account for the subsequent economic downturn.
- The expert’s report also failed to identify any of the “major” distributors he interviewed to calculate market share, such as their location, type of beverage distributed, length of operations, etc. Some were in the alcohol industry, and of the two non-alcoholic drink distributors, one had gone out of business. The expert did not obtain backup data from any of his contacts or tell them he was collecting information to use in litigation.
- The report also did not explain how the expert developed the plaintiff’s sales figures, other than that the sales in year 5 would equal a 4.5% market share.
- Aside from noting that the plaintiff was non-union and non-urban, the expert did not specifically explain how he reached his range of distribution costs.
- In calculating marketing costs, the expert failed to include the plaintiff’s receipt of one free case for every four cases ordered. In his deposition, the expert said that free case giveaways were standard industry procedure, but at trial, he said it was not.
- During his deposition, the expert admitted that in calculating an \$11 million enterprise value under the market approach, he compared the plaintiff, a beverage distributor, to several national beverage *companies*.
- During his *Daubert* testimony, the expert said he did not conduct any market or consumer surveys to determine the strength of the Xience brand. Instead, he had gone to grocery, gas, and convenience stores over the years to keep up with what was on the shelves—a method he admitted was “not scientific.”
- The expert conceded that the only way to test or replicate his sampling would be to conduct the same informal telephone conversations with distributors.
- The expert also admitted that—based on his prior role as an investment banker in the beverage industry and the materials used in his report—he could not have made a reliable recommendation whether to invest in the plaintiff.

This last admission was particularly significant, the court said. When an expert offers his years of experience in a particular industry spent evaluating the financial viability of certain businesses, but then “is unable to attest to the reliability of his own lost profits analysis, this court is hard-pressed to reach a different conclusion.”

The court also found the expert failed to employ any scientific or “otherwise reliable” method to calculate the plaintiff’s lost profits. “No indication exists that the [underlying] assumptions . . . have any validity at all,” the court said. The expert’s self-described sampling methods, his reliance on what appeared to be arbitrarily selected numbers, and his informal research methods “fatally undermine the reliability of his report and analysis,” the court ruled.

Finally, under the applicable “yardstick” test, the sampling choice lies at the “heart of an expert’s methodology.” His selection of several “sample” distributors based solely on “the limited universe of his personal contacts” without any specific comparison to the plaintiff substantially undermined his conclusions, the court held. The expert not only failed to compare apples to apples. “Instead, he compared apples with oranges, bananas, raspberries, and rotten apples [the one defunct company],” the court said, and struck his entire report and lost profits conclusions.

Marketing and Financial Experts Clear First Hurdle in Copyright Infringement Case

Brighton Collectibles, Inc. v. Coldwater Creek, Inc., 2010 WL 3718859 (S.D. Cal.) (Sept. 20, 2010)

The plaintiff and defendant are direct competitors in the women's handbags and accessories market. The defendant, in particular, used to carry the plaintiff's designs in its catalogs. In 2008, the plaintiff sued the defendant for selling three "knock-off" products. The defendant filed a motion for summary judgment, alleging among other issues that the plaintiff failed to state a claim for copyright infringement damages. Further, the defendant filed a *Daubert* motion to strike the plaintiff's damages expert.

Good use of dual experts. To support its copyright infringement claims, the plaintiff presented two experts. The first, a marketing expert, noted the "striking" similarity between the plaintiff's three designs and the defendant's counterparts. He then relied on two recent scientific studies to show the impact of counterfeiting on original designs, including consumer confusion, which would impact the plaintiff's sales in several ways. For instance, a direct loss would arise anytime a consumer bought the defendant's product, mistakenly believing it was the plaintiff's. Direct losses might also occur when a consumer chooses the defendant's less expensive design over the plaintiff's. In either case, once the purchase is made, "this consumer is very unlikely to buy another similar item with the same design again," the marketing expert said, and the plaintiff would be unable to recapture the loss.

In addition, the availability of infringing products creates a negative consumer response to the original designs, decreasing their "perceived uniqueness and distinctiveness," the expert said. Finally, he found that consumers typically bought between 1.7 and 2.3 items from the plaintiff per transaction and owned, on average, 12 or more of the plaintiff's items. For every lost sale,

the plaintiff also lost the opportunity to sell its other products, thus multiplying the effect of the alleged infringement.

Based on this marketing evidence alone, the court found a material dispute on damages, sufficient to preclude summary judgment. It turned next to the defendant's motion to exclude the plaintiff's second expert under the *Daubert* standard. As a litigation consultant with 15 years' experience in economics, financial, and accounting issues, the court quickly found he was qualified to testify.

It also examined the expert's 65-page damages report, which applied the "common economic theory of marginal profit to marginal revenue" to the plaintiff's and defendant's retail sales reports. He also relied on the 45-page report by the plaintiff's marketing expert, assuming that on average, the plaintiff sold 1.7 items per transaction (the lower of the marketing expert's range). In other words, every time the defendant made an infringing sale, the plaintiff lost the sale of that item (on a one-to-one ratio) plus 0.7 units of an additional item.

The defendant claimed the expert's assumptions were speculative, but the court noted that lost profits calculations involve some degree of estimation that cannot be shown "with mathematical precision." Here, the plaintiff's financial expert quantified the alleged losses based on a review of the parties' financial data as well the expert marketing evidence. "In any event," the court said, the plaintiff's expert did not seek to tell the jury what ratio to apply to any lost profits, "but how to calculate damages reliably once they have determined the proper ratio." In fact, the plaintiff's financial expert specifically suggested that should the jury or the court wish to consider any other than a one-to-one ratio of lost sales, "they could simply multiply my calculation of lost profits by an alternative lost sales transaction ratio."

The court did not necessarily agree with the one-to-one substitution rate, but deferred to the jury to weigh the evidence as the trier of fact and denied the *Daubert* motion without prejudice, a ruling which specifically permits the defendant to renew its objections to both experts and their evidence at trial.

Expert's Analysis of Business Interruption Loss Breaks Over Selection of Growth Rate

Manpower, Inc. v. Insurance Co. of Pennsylvania, 2010 WL 3730968 (E.D. Wisc.)(Sept. 20, 2010)

When its office building in Paris, France, partially collapsed, the plaintiff's operations were shut down for 14 months until it eventually relocated. In a suit against its insurance company for business-interruption losses, the plaintiff's damages expert asserted over \$5.1 million in lost profits and \$2.4 million in extra expenses. The defendant attacked the expert's calculations as unreliable under *Daubert*.

Growth rate nearly doubles under new management team. The expert began by forecasting the amount of revenues the plaintiff would have generated but for the building collapse and then subtracted its actual revenues during the damage period. He then projected total expenses incurred, minus actual continuing expenses (those the plaintiff still had to incur despite the cessation of operations), to arrive at the net, non-continuing expenses saved as a result of the collapse. So far, his calculations were "straightforward," the court said. However, the credibility of his conclusions turned on whether the expert selected the appropriate basis for his projections.

To project revenues, the expert used a basic growth rate extrapolation, described by a treatise on business interruption losses (Gaughan, 2004) as "the simplest and most frequently used revenue forecasting method." Under this approach, an expert selects an appropriate revenue base and applies an appropriate growth rate. In this case, the expert used the revenue period for five months preceding the collapse. He then compared total revenues from this base period to the same period in the prior year, and found a 7.76% growth rate, which he applied to his revenue projections.

This was the heart of the defendant's challenge to the expert's damages calculations: Despite historical data showing that the plaintiff had grown an

average of only 4.8% during the four years prior to the collapse—and only 3.8% during the year before, the expert chose the much higher rate from the much shorter period. In his deposition, he explained that the company had recently been acquired and new management installed to turn its performance around. After speaking with these new managers, the expert concluded that by the time the collapse occurred, they had indeed succeeded in flipping the company's fortunes and thus decided the 7.76% growth rate appropriately applied to the entire 14-month loss period.

"Here is where [the expert's] analysis breaks down," the court said. The choice of the growth rate is "one of the most important parts of the business-interruption calculation," yet the expert "did little more" than assume that the growth rate just before the collapse would continue unabated, all due to the new management. "But [the expert] is not an expert on business management," the court said, and thus his interview with management could not form a reliable basis for his forecasts. Further, he did no economic analysis of the factors that could have affected the plaintiff's revenues during those five months, such as industry conditions or some company-specific aberration.

The plaintiff tried to argue that the expert's selection of the growth rate was a factual assumption, to be weighed by the jury along with testimony from the managers about their efforts to turn the company around. "But an ordinary trier of fact lacks the expertise necessary to judge how the actions of . . . managers impacted company growth," the court said. Absent competent expert testimony, a jury would have to speculate whether the plaintiff's new managers or other factors caused its increased growth.

Expert treated the company like a new business. Importantly, had the plaintiff's expert chosen a longer base period for his revenue forecasts, the court might have found his analysis reliable. "When a business has a long track record, revenues can be forecasted with greater certainty, and the need to perform a finely calibrated analysis of the various factors affecting revenues may not be as acute," the court said. More than five years of historical data showed

declining monthly revenues, but by ignoring the plaintiff's long-term track record and focusing solely on the five months before the injury, the expert "essentially treated [the company] as a new business. And projecting revenues for a new business is "notoriously difficult," the court added, noting that such an analysis requires reliable indicators from comparable companies.

Once again, the plaintiff's expert did not examine such financial indicators or comparables, nor did he perform any sensibility check on his projections. As a result, the court found his calculations unreliable and excluded his opinions regarding lost revenues. Because the loss of this evidence was fatal to the plaintiff's claims for business-interruption damages, the court did not need to determine the reliability of the inherent net expense calculations. At the same time, the defendant did not challenge the expert's calculation of \$2.4 million in extra expenses, and the court made no ruling regarding its admissibility.

Successful Restaurant Lost Profits Analysis Turns on Comprehensive Research

LB 4 Fish, LLC v. Developers Diversified Realty Corp., 2010 WL 2723545 (Cal.App. 2 Dist.)(July 12, 2010)(unpublished)

The plaintiff owned a restaurant located along a Pacific shoreline drive, leased from the defendant. Because surface parking lots were scarce, the parties' 20-year lease provided for four valet stations along the drive, including one directly in front of the restaurant, and that the stations would remain open continuously during operating hours.

By the time the restaurant opened, however, the valet parking was "insufficient, understaffed, unorganized, and inadequate," according to court records. The plaintiff sued the defendant landlord for breach of the lease, claiming over \$8.3 million in lost profits and lost goodwill. A jury awarded the plaintiff over \$4 million for lost profits and \$7.8 million for fraud, and the defendant appealed, claiming the verdict lacked sufficient evidence.

Parking was sole cause of lost profits. After confirming the defendant was liable for fraud, the appellate court also found that the parking difficulties were the sole cause for the plaintiff's lost profits, based on evidence from a restaurant consultant as well as the plaintiff's financial expert. When the restaurant opened in 2004, the economy was robust and revenues should have been strong. But by 2006, 41% of customers surveyed by the consultant complained about the parking, and in 2008, the percentage increased to 48%. In addition, the restaurant's president testified that it had lost 100,000 to 200,000 customers as a result of the parking problems.

The plaintiff's economic expert relied on these findings to assume that lack of parking was the only source for the restaurant's loss of expected revenues. By the time of trial, the restaurant had been open for four years, providing a sufficient financial track record by which to calculate lost profits. The expert also examined numerous sources of data, including the pleadings, discovery, the parties' lease, the restaurant's forecasts and investment memoranda; its monthly financial reports and daily sales reports; several comprehensive commercial databases regarding restaurant statistics and industry intelligence; and forecasts from the National Restaurant Association. From the research, he culled data on restaurant financial ratios, working capital, return on investment, and sales as a percentage of assets and liabilities. The expert also consulted with the plaintiff's management team, which had successfully run sister restaurants in nearby locales for over 30 years.

Of equal importance, the expert testified extensively to his methodology for calculating lost profits, in particular, his reliance on comparables. He reviewed more than 1,000 restaurants regarding their financial metrics and number of seats, eliminating fast food and gourmet establishments for those with seating and casual dining operations similar to the plaintiff's. He identified 100 top restaurants around the country and their financial information from an industry publication; he looked at Zagat ratings to conclude that the listed restaurants performed moderately. He selected nine from the list because they were independent, waterfront restaurants with a seafood format, and added several

more, including a large establishment close to the plaintiff because it offered a seafood menu in addition to traditional fare. He ranked his comparables according to sales per seat and determined that the plaintiff belonged in the 25th percentile, or about \$24,000 per seat per year, which fell between the low and average in the region (California).

“At each step of the process, [the expert] took a conservative approach,” the appellate court explained. He did not consider the losses that plaintiff suffered in its first two months of operation or its revenues right before trial. If some of the comparables were not conceptually similar to the plaintiff, he nevertheless kept them in the pool because they depressed the overall projections. The expert “explained his selection process, as well as where he obtained his data and how the information affected his analysis,” the court ruled. Accordingly, the evidence was sufficient to provide a foundation for the lost profits calculations and the jury’s award.

Likewise, the expert had supplied a “long analysis, including an examination of a number of factors,” to support his lost goodwill calculations, and the court confirmed the same, upholding the entire jury award.

Lack of Due Diligence and Industry Experience Lead to Loss of \$4 Million in Damages

Total Clean, LLC v. Cox Smith Matthews, Inc., 2010 WL 4108820 (Tex. App.) (Oct. 20, 2010)

Compare the damages expert’s analytical resources and application in the *LB 4 Fish* case ([on page 22](#)) to the expert’s in this one, for an illustration of the difference that careful due diligence and industry experience can make.

Here, the plaintiff purchased an automated commercial truck wash in 2000, but was dissatisfied with the seller’s performance and sued for breach of contract. A jury trial was set to begin in 2003, but on the advice of counsel—who said the judge in the case confided that he would limit

the trial to only five days—the plaintiff settled the case for \$4.5 million, allowing it to recoup its purchase price, attorneys’ fees, and just about \$375,000 in lost profits.

The plaintiff later came to believe that the attorney had lied to prompt the parties to settle and sued the law firm for breach of fiduciary duty and fraud. Based on expert evidence, the plaintiff claimed over \$8 million in the lost profits that it would have won but for the breach. The defendant filed a motion for summary judgment to the trial court, alleging that the plaintiff’s expert evidence was unreliable. The trial court granted the motion, and the plaintiff appealed.

Attorneys and industry expert provide assumptions. The expert, an economist, first prepared a report assuming that the plaintiff would wash 27 trucks per day in the first year, increasing to 129 trucks per day in the second, 201 per day by the third year, and 296 per day by the fifth. After calculating the anticipated sales volumes, he subtracted costs and operating expenses, calculated a terminal value, and applied a 30% discount rate, to account for the risks of a start-up enterprise. The present value of his calculated lost profits equaled \$4 million.

On request of counsel, the expert prepared a second report assuming that the plaintiff had operated for 18 months. The attorneys also asked him to assume that the company would be washing either 296 or 400 trucks per day by the end of the fifth year. The expert revised his calculations, including adjusting the discount rate to 20%, and concluded total lost profits between \$8 million and \$10 million.

The defendants contended the calculations contained in both reports were subjective, without any relationship to the specific business, industry, or market data, and, moreover, that the expert lacked sufficient expertise. In particular:

- The expert testified that he had no experience in the truck wash industry and had no analogous data available to formulate his projections; he had relied on unverifiable private company information that he’d found on the Internet.

- Although he knew of several automated truck washing operations, he had never seen any data showing their actual performance or profitability.
- In formulating his projections about the number of trucks washed per day, the expert relied on a fax from the plaintiff's "truck wash industry expert," which said that he expected volume to average 150 to 300 trucks per day. But the industry expert admitted that he'd sent the fax at the insistence of the owner, who needed high volume numbers to secure financing, and that he was uneasy about the figures. The damages expert later admitted that the industry expert "was making the numbers up."
- Instead of reviewing actual performance data, the damages expert relied on anecdotal evidence provided by the industry expert, which suggested that truck washes could handle up to 200 trucks per day. But the industry expert could only confirm facilities that washed between 30 and 100 trucks per day, and one was losing money. Plus, he said the high-volume facilities were managed by highly skilled personnel and/or were better situated than the plaintiff's site.
- The plaintiff's proposed site had one of the highest volumes of truck traffic in the country. However, the damages expert admitted that his projections did not factor in how much of the traffic belonged to fleets with their own washing facilities.
- His projections relied on a high volume of diesel sales in the area, but the expert failed to confirm any correlation between diesel sales and truck washes. In fact, the industry expert said he would "strongly deny" any such correlation.
- The damages expert conceded that the assumption underlying his second report (i.e., that the plaintiffs had been in operation for 18 months) was untrue. When asked if he would buy the plaintiff for between \$8 million and \$10 million, he responded "No, because it had not been operating."

Further, the plaintiff produced no evidence that its owners had any experience in the truck washing business, or that there was sufficient market demand to make its facility profitable. For all these reasons, the court found that the expert's estimates were not based on objective facts, figures, or calculations. The assumptions in his second report were simply untrue, and his original estimates of lost profits were "without any evidentiary foundation, and therefore purely speculative and conclusory," the court held, and confirmed summary judgment of the plaintiff's claims.

KY Adopts 'Modern Rule' Re: Minority & Marketability Discounts in Stat. Fair Value

Brooks v. Brooks Furniture Mfgs, 2010
WL 4290068 (Ky. App.)(Oct. 29, 2010)

Until this decision, Kentucky was one of a handful of states that still approved marketability and minority discounts when determining the statutory value of an oppressed shareholder's interest in a closely held company. However, strong dissents by four judges on the appellate panel—based on the circumstances of this case—have almost certainly laid the foundation for a final appeal to the state Supreme Court.

A company divided. A father was the sole shareholder and director of a furniture company, founded in 1954. During the late '70s, the father gifted shares of company stock to his two sons in disparate amounts. The eldest, who also helped manage the company, received over 80 shares, and the youngest, who'd pursued a medical career, received 36. (Smaller gifts also went to his wife and daughter.) The company was profitable until the 1990s, and when revenues still hadn't rebounded by 2004, the board of directors approved a restructuring by which any shareholder owning at least 80 shares would receive one share of stock in the new entity, and those with fewer than 80 would receive a cash payment. The proposal effectively left the father and older son in control of the company and "squeezed out" the younger son.

Based on a 2004 appraisal prepared for gift planning purposes, the company paid the younger son \$10,600 per share for his interest. He requested more than three times that amount, and the company retained a second appraisal in 2005, which valued the company at \$15,800 per share. The son still insisted that his shares were worth twice as much. The company retained a third appraiser, who used the valuation date of November 2004 (the date of the merger) and a net asset method to reach a per-share “fair value” of \$17,700. The report did not apply specific discounts for lack of control or lack of marketability; however, based on certain risk factors, the appraiser adjusted the net book value of the assets by 30%.

In particular, the third appraisal discounted the company’s going concern value based on the assumption that a willing buyer/willing seller would negotiate a fair market value price base on 1) working capital requirements; 2) alternative investment risks; 3) potential shutdown costs; 4) liquidation costs; and 5) time to complete a sale (estimated at 12 to 24 months). The appraisal also made several adjustments to normalize the controlling shareholder’s compensation and to value equipment below book value.

Still dissatisfied, the younger son retained his own appraiser, who also used the 2004 valuation date and net asset method, but believed any discounts would be inappropriate. This appraisal valued the company at just over \$30,800 per share and, unable to resolve their differences, the parties went to court. The trial court essentially adopted the company’s appraisal but reduced the applied discount to 20% for a per-share value of \$24,156 (essentially splitting the difference between the parties’ respective valuations), and the son appealed.

Issue controlled by old precedent. Although the parties disputed the appropriateness of the equipment and compensation adjustments, the appellate court confirmed these in deference to the trial court’s factual findings. This left the larger and “most complex” issue of whether the trial court properly applied the 20% discount to the value of the dissenting shareholder’s interest under the applicable statutory scheme.

Like many states across the country, Kentucky first enacted a dissenters’ rights statute in 1972 as part of its adoption of the Model Business Corporation Act (MBCA). The statute entitled dissenting shareholders to the “fair value” of their shares without specifically defining the term and was silent regarding the application of discounts. In 1982, *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. App. 1982) held that the application of a marketability discount to the net asset value of a closely held company was within the trial court’s discretion, based on the facts and circumstances of the case. Because, unlike many states, Kentucky did not adopt the 1999 amendments to the MCBA that specifically precluded the application of minority and marketability discounts to a dissenter’s shares and the state Supreme Court had yet to address the issue, *Ford* remained the controlling precedent in Kentucky.

Since *Ford*, however, there has been a “plethora of judicial decisions regarding the meaning of ‘fair value’ and, consequently, the application of a marketability discount,” the appellate court began, in its *de novo* review of the legal issue. Although courts have yet to reach a consensus, the Colorado Supreme Court has identified a “modern trend” against applying marketability discounts among states with “fair value” dissenters’ statutes. (See *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P.2d 353 (Colo. 2003)(court opinion and case digest available at *BVLaw*.) Additional authorities such as the American Law Institute have supported this trend.

In addition, in 1989 the Maine Supreme Court modified precedent to recognize that the transfer of dissenting shareholders’ interests is involuntary, and “any rule of law that gave the shareholders less than their proportionate share of the whole firm’s fair value” would effectively permit a windfall to the majority at the minority’s expense.” (*In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989) (relying on *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989)(both court opinions and case digests available at *BVLaw*). Because the Kentucky appellate court relied on the original Maine precedent to formulate the *Ford* decision,

the court felt it was appropriate to rely on Maine's revision of that precedent in *McLoon* to formulate its opinion in the current case. Moreover, since then, decisions that have considered the issue have generally followed the lead of the Delaware and Maine courts.

Accordingly, the court found "no facts to justify a deviation from the rule prohibiting a marketability discount in a dissenters' rights action in a closely held corporation." The goal of the company's restructuring was to exclude the younger son from ownership at a price considerably less than his proportionate share in the entire corporation. Although the company's appraisal purported to apply the discount at a corporate level, it nevertheless diminished the value of the younger son's interest "based on the fiction of the corporation's marketability on the open market," the court held. The majority owners essentially used the discounted value to accomplish indirectly what it could not otherwise do directly; that is, to effect a "squeeze out" oppression.

In sum, after a review of the law and commentary, the Kentucky appellate court concluded that—except under extraordinary circumstances—the approval of marketability discount is inconsistent with the current majority rule precluding such discounts in the context of a squeeze-out merger. To the extent prior state precedent (*Ford*) held otherwise, the court overruled it.

Separate concurrences and dissents. The majority decision was not without controversy. Four judges on the panel dissented. In particular, three judges agreed with the basic premise, but disagreed with the application of the majority rule to the particular facts. In this case, the trial court's appraisal did not apply a marketability discount at the shareholder level. Instead, it discounted the value of the entire corporation due to the inherent risks of the business, believing that any potential buyer would consider the increased competition, declining revenues, and other risks when acquiring the company.

Moreover, in this case, the father had gifted shares of stock to his children when estate taxes were high. This fact alone distinguishes the case

from the "vast majority" of shareholders' rights cases, the dissent observed. The younger son's "investment" in the company did not arise from a *quid pro quo* exchange, but "merely by virtue of his father's largesse." That he would realize any value from the company was due entirely to his father's and older brother's efforts, and the application of the majority rule "punishes [the father] for doing nothing more than estate planning." In this instance, even under the majority rule, the dissent would recognize "exceptional circumstances" permitting the application of discounts to the company's value as a whole.

A separate, concurring, opinion by three judges specifically addressed the dissent's reasoning. "I see no justification for polluting a 'fair value' appraisal under any circumstances, but particularly where no market exists, by incorporating in the analysis an antithetical factor—'fair market value,'" the concurrence stated. Once the stock's value to third parties is introduced in a dissenters' suit, then it effectively "trumps" all other factors, thereby altering the premise from "fair value" to "fair market value," which has little or nothing to do with determining the minority shareholder's loss of veto power against the controlling majority, the concurrence said.

Applying the fair market value standard at the corporate level does not moot its troubling side effects. In fact, *McLoon* and other precedent cited by the majority reinforces the conviction that once the entire corporation has been valued as a going concern by an appropriate methodology, then discounting "for any reason taints the analysis and deprives the dissenters of the fair value of their stock, whether the discount is applied at the enterprise level or the shareholder level," the concurrence noted. Moreover, this company was family-owned, and various case law and academic authorities have determined that marketability discounts should never apply to intra-family transfers of closely held interests.

For all these reasons, the concurring judges agreed with the majority opinion, but would tighten it further by prohibiting the trial courts from entertaining any exception to the rule against applying discounts to dissenters' shares.

Experts Need to Link Copyright Infringement to Specific Lost Revenues

Interplan Architects, Inc. v. C.L. Thomas, Inc., 2010 WL 3982273 (S.D. Tex.)(Oct. 8, 2010)

The plaintiff submitted architectural drawings and designs to the defendant to build nine different convenience stores in Texas. Three years later, the plaintiff discovered that the defendant had given the drawings to two other architectural firms to build several stores, and the plaintiff sued all three parties for copyright infringement under federal copyright laws, 17 U.S.C. § 501 *et seq.*

In general, a copyright owner may recover actual damages as well as the infringer's profits that are specifically attributable to the infringement. That is, the owner must demonstrate a direct causal link between the infringement and the particular profit stream. Only then does the burden shift to the infringer to prove that the revenues were attributable to factors other than the copyrighted work.

Difficult to parse revenue streams of major infringer. In this case, the plaintiff's expert estimated that one of the infringing architectural firms had earned \$157,000 from designing three infringing stores and the firm had earned \$664,000 from designing eleven stores. The court quickly found that the firms' realization of profits were "exactly the type of 'infringer's profits'" contemplated by the federal copyright laws, and admitted the expert's evidence pertaining to these two firms.

The plaintiff's expert also estimated that the primary defendant (the owner of the convenience outlets) had realized nearly \$512 million from eleven infringing stores. The defendant argued this failed to demonstrate the necessary causal link between its gross revenues and the alleged infringement of the plaintiff's architectural plans—and the court agreed that these particular calculations presented a "more difficult issue." Unlike the calculations for the infringing architectural firms, these did not involve assessing the direct profits that the store owner

made by selling the infringing works. Rather, this case required the plaintiff's expert to assess the owner's "indirect profits" from using the infringing stores to sell other products, including food, drink, and general merchandise that it might have sold "irrespective of the plaintiff's designs," the court said.

As a result, the court found that the plaintiff was required to do more than "simply identify the infringing stores" and then designate all revenues as resulting from the alleged copyright infringement. The plaintiff must also provide some "non-speculative evidence" that the store owner's revenues were caused or in some way affected by the particular architectural design of the stores:

Most helpful to the court would be a comparison between [the] defendant's projected revenues for the infringing stores and the realized revenue (which may provide some support for the proposition that store design had an effect upon the revenue), or between [the] defendant's non-infringing stores and the infringing stores that controls for variable such as location, traffic, and pricing.

Because the expert's \$512 million damages calculations did not identify or attempt to quantify the impact the design had on the infringing stores' profitability, the court granted the defendant's *Daubert* motion without prejudice, thereby giving the plaintiff (and the expert) an opportunity to resubmit evidence that satisfied the causal requirements of the copyright laws. Given this ruling, the court also excluded any evidence from the defendant's rebuttal expert that pertained to the plaintiff's expert's estimate of gross revenues, including his calculation of deductible expenses.

Defendant's independent experts also challenged. The defendant presented a second expert, a CPA with a specialty in the gasoline and convenience store industry, to provide independent evidence that 1) the defendant's store layout and elevation had "significantly small" impact on shoppers' purchases, compared to other store features; and 2) the portion of profitability related to store design was nominal.

The plaintiff challenged this expert's evidence as improper *ipse dixit* ("because I say so"), and the court agreed. The expert didn't just render an opinion on the factors that affect a convenience store's profitability. He attempted to estimate "the *degree* to which store layout and elevation affect either a shopper's buying experience or a store's profitability," the court explained, with emphasis. Presumably, he relied on some data to reach this opinion, and in fact, during his deposition he admitted developing some "balance scorecard programs" to assess the operational deficiencies of the subject stores from site design to internal operation, merchandising, and product sets.

However, the expert simply arrived at his conclusions without specifically describing the data or his quantitative analysis, the court held. "He does not even describe the other 'far more important store attributes' that affect shoppers' habits." Moreover, to the extent the expert based his opinions purely on his background and experience without using any scientific or technological methodology or providing any means to question how he arrived at his conclusion, his opinions were unreliable, and the court excluded them without leave to amend.

Finally, the defendant's third financial expert, also a CPA, attempted to show that plaintiff's project profit percentage from the specific designs at issue should be 15.5%, which would limit its damages claims to no more than \$25,000. The expert derived this margin by adding the plaintiff's gross revenues on three years of tax returns and then subtracting project expenses and overhead. However, these gross revenues applied to *all* of the plaintiff's projects during those years, not just those related to the defendant's convenience stores. When he calculated this percentage, it amounted to 42.5%, thereby reducing the margins on the plaintiff's remaining projects to 10.6%. This was unreasonable, he believed. By selecting the 15.5% margin, he could keep the plaintiff's profits for the infringing stores in line with its other projects.

Further, the expert declined to use the plaintiff's profit and loss statements as a basis to derive its project profit percentage, because they were inaccurate and omitted certain costs from the

project expenses category, which in turn inflated the plaintiff's project profitability. But none of these objections attacked the expert's methodology. Instead, the dispute focused on which data would support the most reliable calculation of a profit percentage. "The court does not find [the expert's] opinion unreliable simply because he chose to use [the] plaintiff's tax returns as opposed to [its] profit and loss statements." Ultimately, the jury would determine which measure it found more persuasive after hearing from both the plaintiff's and defendant's experts, the court held, and admitted the evidence from the defendant's financial expert.

More Support for Using More Than One Method (DCF) in Current Valuations

In re Chemtura Corp., 2010 WL 4272727 (Bkrtcy. S.D. NY.) (Oct. 29, 2010)

The Chemtura Corporation, a specialty chemical maker and its affiliates, filed for bankruptcy in March 2009—becoming the third major U.S. chemical manufacturer to succumb to the recession. A year later, the debtors proposed a plan of reorganization and settlement of claims. No creditors objected except the equity shareholders, who claimed it substantially undervalued the company.

The bankruptcy court held an independent valuation hearing, in which both the equity committee and the debtors presented expert evidence of total enterprise value (TEV), and the creditors presented a rebuttal expert to critique their approaches. The debtors' expert valued the company from \$1.9 to \$2.2 billion, with a midpoint at \$2.05 billion, and the shareholders' expert concluded a range of TEV from \$2.3 to \$2.6 billion, with a midpoint at \$2.45 billion. All the experts were from large investment banking firms, which played various advisory roles during the restructuring. In a 78-page opinion, the court discusses each expert's approach, their assumptions as well as their possible bias, to determine whether the debtors' TEV exceeded the value underpinning the proposed reorganization plan.

Adjustments to DCF for aggressive forecasts.

To reach their respective total enterprise values, both the shareholders' and the debtors' experts used a discounted cash flow (DCF) analysis, with a similar range of discount rates, from 11.6% to 13.75%. Both relied on forecasts from the debtors' long-range plan (LRP), which assumed the national economy would recover to pre-crisis levels by 2011 and the company's earnings would grow during all five years of the forecast period. In their terminal value calculations, however, the experts differed significantly in selecting the earnings to which their multiples applied.

The shareholders' expert applied its multiples to the earnings for the final forecast year, to reach a DCF value between \$2.47 billion and \$2.9 billion. By contrast, the debtors' expert applied multiples of 6.5x to 7.5x from peer group averages and mid-cycle and normalized EBITDA to reach a TEV of \$2.175 billion to \$2.57 billion. The experts debated the extent of the debtors' cyclical nature, with the shareholders' expert claiming that normalized earnings drove the present value down and the debtors' expert saying the final year forecasted EBITDA—which exceeded all historic levels—led to a significantly overstated value. The creditors' rebuttal expert agreed, believing the long-range forecasts were “overly” aggressive, based on unsupported assumptions of short-term economic growth, and requiring appropriate risk adjustments.

The court shared this skepticism regarding the company's and the country's growth. Although it might be more common to use final year cash flow projections to calculate terminal value, it said, in this case, the slow economic recovery plus the cyclical nature of the debtors' business (or at least, the seasonality of its customers for agricultural and pool chemicals) supported the use of adjusted cash flows. “Taking the business cycle into account makes for a better analysis,” the court added, quoting Prof. Aswath Damodaran (NYU Stern School of Business) (*Ups and Downs: Valuing Cyclical and Commodity Companies*, 2009 ed.).

At the same time, the best normalization analysis would capture an entire business cycle—which the debtors' expert did not do, the court pointed out. Despite this flaw, it found the debtors' DCF

analysis to be, on balance, more persuasive. If the economy were more stable, then it might consider the use of the final year's cash flows to be “perfectly ordinary, if not preferred.” In the current economy, however, “relying on the very high terminal value in the last year of an admittedly aggressive string of growth projections is . . . too aggressive,” the court said. In addition, it was “troubled” that the shareholders' expert made no effort to “address cyclical nature at all.”

Market approach provides more than just a reality check. The court was also troubled that, unlike the debtors' expert, the shareholders' expert did not conduct a comprehensive analysis of comparable companies and comparable transactions to provide an independent value indicator, but simply used the market approach merely to test the reasonableness of its DCF.

“That's disappointing,” the court said, especially as it found the comparable companies analysis to be more meaningful in this case than either the DCF approach, which is generally susceptible to uncertain projections, or the comparable transactions approach, which can be subject to control premiums, synergies, bidding wars, and hostile deals. For these reasons the court assigned the comparable companies approach the greatest overall weight in the case. In particular, it found the debtors' analysis had “substantial” weight, based on the following:

1. The debtors' expert examined 10 domestic comparables and five foreign, because the latter operated in the same global markets as the debtors and were subject to similar tax and regulatory environments. In addition, 50% of the debtors' revenues came from foreign markets. Yet despite including foreign comparables in his “sum of the parts” and comparable transactions analysis, the shareholders' expert left them out, here, further undercutting his criticism of the pool selected by the debtors' expert.
2. The shareholders' expert included two large multinational chemical corporations in his pool, but excluded a smaller specialty chemical company, which effectively inflated

the overall multiples. The debtors' expert excluded the large multinationals, because their sales, earnings, and enterprise values "dwarfed" the debtors', but he included the smaller specialty company, which was more similar to the debtors in its size, product lines, and end-markets.

- Both experts conducted a "sum-of-the-parts" analysis, but the debtors' expert used the 2010 actual and projected numbers to derive its multiples and the shareholders' expert used the more reliable multiples derived from 2011 earnings forecasts.

In addition, both experts applied the comparable transactions approach. The debtors' expert reviewed 14 deals conducted between 2004 and 2010, worth between \$1 billion and \$10 billion. Given the material adversity caused by the global economic and capital markets crisis, however, the debtors' expert ultimately relied on only three transactions occurring after September 2008 (when Lehman Bros. collapsed). Using their mean EBITDA multiple of 6.2x as a midpoint, the expert determined the debtors' appropriate multiple range was 5.75x to 6.75x and applied this to Sept. 30, 2010, EBITDA to arrive at a range of TEV from \$1.97 billion to \$2.315 billion.

The shareholders' expert examined 19 deals, which all closed prior to September 2010 with a much wider range of value, from \$290 million to \$18.66 billion, and a mean EBITDA multiple of 9.7x. But he did not calculate a TEV range from these multiples; instead, he took its estimated TEV range for the debtors to back-out EBITDA multiples of 6.9x and 7.9x. Since these back-calculated multiples were less than the 9.7x multiple for the comparable transactions, the shareholders' expert concluded his TEV estimates did not exceed the debtors' actual value.

Overall, the court found the shareholders' expert's heavy reliance on pre-Lehman transactions "was a serious flaw." Advanced economies are "fundamentally different today," the court observed, and "relying on multiples from a time period before the crash is inappropriate." It also found flaws with the comparables selected by the debtors' expert,

noting that it included one with "dubious comparability" but omitted another which plainly should have been considered. However, with two post-Lehman comparables registering a 6.2x earnings multiple in the wake of the financial crisis, the court felt relatively comfortable in giving some weight to this methodology, especially since the upper end of the debtors' transaction analysis was still well below the shareholders' range of value under the DCF.

Market pricing and possible bias. If the court had to find a specific value for the debtors, it would have chosen an amount at the low end of the debtors' range, it said. But to confirm the proposed reorganization plan as fair and reasonable, it needed only to find that the debtors' TEV did not exceed the TEV underlying the plan, or \$2.05 billion.

Based on all the expert evidence and analysis, "I so find," the court said. Market information also supported its decision. During its restructuring attempts, the debtors cooperated with the equity committee in trying to find a buyer for the company, contacting nearly 20 potential investors using the committee's \$2.2 billion to \$2.7 billion range of value. "But there were no takers, or offers, at that price or at any price that might ultimately lead" to such a value, the court said. Nor were any members of the equity committee—mostly hedge funds—willing to invest their own money into the debtors at that or even a lower price.

Moreover, under the proposed plan, the overwhelming majority of creditors and bondholders elected to take their recovery in cash rather than company stock. Once again, these stakeholders were highly sophisticated hedge funds and other "distressed debt" investors with the ability to dispose of stock. If they thought the plan undervalued the company, they would have "snapped up" the stock at the price offered by the equity committee, the court said. If they believed the valuation offered by the committee's expert, "they *really* would have snapped it up," it added, with emphasis. Their failure to do so and their preference for cash suggested they didn't believe the stock was worth as much as the shareholders contended.

The court also found “exceptional” instances of witness bias in this case. The opinions of all the experts were influenced to some extent by their prior activities with the debtor, the circumstances under which they testified, and inconsistent testimony. In particular, the equity committee’s expert indicated a strong bias. To secure the engagement, he promised to be “aggressive in valuation” and to achieve “maximum value for the equity.” The terms of his engagement agreement provided, in addition to a monthly fee, a hefty “transaction fee” that turned on his ultimate valuation of TEV.

Similarly, both the debtors’ expert and the creditors’ experts received million-dollar fees upon the consummation of a plan. Although these fee provisions are fairly common ways to incentivize the investment bankers—and in this case, the court authorized their payment—the court couldn’t ignore the fees when the same bankers testified, finding the payment terms “materially” and “adversely” affected the experts’ credibility.

“Finally, failures by both [the debtors’] and [the shareholders’ expert] to change the midpoint of their valuations after the passage of time and in the face of seemingly different circumstances tend to undercut the persuasiveness of each,” the court held. For example, in June 2010, the shareholders’ expert valued the debtors within the range of \$2.2 billion to \$2.7 billion, with a midpoint of 2.45 billion. Three months later, it issued its trial valuation opinion within a narrower range—\$2.3 billion to \$2.6 billion—but with the precise same midpoint. The debtors’ expert likewise issued two separate valuations with the exact same midpoint, despite the company having achieved solid earnings in the interim coupled with the easing of uncertainty in national and global markets.

In both cases, the court found the coincidences were improbable, prompting it to be more “proactive in making [its] own valuation judgment rather than to accept [any] of the proffered ones.” As a final matter, in addition to finding the proposed reorganization plan fair and reasonable, the court declined to disband the equity committee, leaving it intact to appeal this decision, if need be. Stay tuned . . .

First-Time Lost Profits Expert Challenged for Using Ibbotson Multiples

Metro Tech Corp. v. TUV Rheinland of N.A., 2010 WL 4117123 (D. Puerto Rico.) (Oct. 18, 2010); and *Metro Tech Corp. v. TUV Rheinland of N.A.*, 2010 WL 4117115 (D. Puerto Rico.) (Oct. 18, 2010)

The plaintiff is a Puerto Rico corporation that specializes in laboratory calibration and preventive maintenance services. In 2002, it contracted with the defendant to conduct the necessary assessments to certify the plaintiff as ISO 17025 compliant. Over the next five years, the parties’ relationship deteriorated due to payment and certification delays. The plaintiff eventually filed suit, alleging the defendant breached the contract by delaying ISO 17025 re-certification and incorrectly informing the plaintiff’s customers that it lacked certification. The plaintiff alleged approximately \$35.6 million in economic losses, including lost profits and lost goodwill.

Before trial, the defendant moved for summary judgment on all claims except any damages flowing from the cancellation of plaintiff’s contract with a large Puerto Rican laboratory (IIBI), which it said were limited to no more than \$16,000. The defendant also moved to disqualify the plaintiff’s damages expert under *Daubert*. The court issued two separate opinions to address the respective motions.

Damages may not be remote. As a preliminary matter, the court held that a material factual dispute existed regarding the amounts due under the IIBI contract, sufficient for this question to proceed to trial. As for the remainder of its damages claims, the court permitted those regarding lost business in the Dominican Republic (\$15 million) and Puerto Rico (\$3 million). It granted summary judgment regarding its claims in the CAFTA countries (\$9 million), however, finding the alleged losses depended on too many speculative factors such as market-entry costs, the financial and political stability of the countries, and the plaintiff’s ability to compete with existing providers. The plaintiff also failed to present any independent evidence of lost goodwill in these countries.

After limiting the plaintiff's alleged damages, the court turned to the defendant's *Daubert* motion to exclude the plaintiff's expert, a Ph.D. who'd taught international trade and economics courses at the university level since 1977. The expert had also worked at several economist forecasting firms and written a chapter on the Puerto Rico economy for a United Nations publication. He'd served as an expert witness in 22 prior cases but had never calculated economic damages for a plaintiff corporation.

The defendant claimed these qualifications did not satisfy *Daubert*. The expert had never published any papers on business valuation techniques, valuation of economic damages, lost profits, "or any other relevant area." He had never taught any courses on valuing economic losses, and this was the first time he'd applied any method to assess a company's lost profits.

Nevertheless, the court qualified the expert. An expert with appropriate credentials and an appropriate foundation for his opinion "must be" permitted to testify if his evidence will tend to make the existence of any material fact more or less probable than it would be without the testimony, it said. The expert's testimony would aid the jury in determining the proper level of damages should they find for the plaintiff.

Ibbotson data not peer-reviewed? The defendant also claimed the expert's methodology was unreliable. In essence, his damages calculations consisted of three steps: 1) deciding the plaintiff's confirmed lost business; 2) deciding its lost deals, which he equated with losing the business (and all its potential profits); and 3) using business valuation techniques that required applying multipliers from Ibbotson's *Cost of Capital* 2008 Yearbook. The expert did not know whether this methodology has been subject to peer review or publication, the defendant argued. He did not know its potential rate of error, or whether the method for quantifying damages was generally accepted by the economic and legal community. Finally, he did not verify that he applied the Ibbotson multipliers from different SIC codes correctly, and his overall calculations failed to analyze such information as costs, expenses, cash flow, and book value of comparable companies.

The plaintiff countered that—even though it was the expert's first time using the Ibbotson price/sales equity valuation ratio to calculate damages, other experts have used this method in prior cases and published court opinions. The plaintiff also said that Dr. Ibbotson's work has been published and subject to peer review (although the court opinion does not set forth any citations). Further, the expert reviewed extensive regional data pertaining to each area of claimed damages, confirmed lost quotes and business contacts that arose from the cancelled IBII contract, and "followed Ibbotson methodology to calculate damages," the plaintiff said. For example, for damages related to lost opportunities in the Dominican Republic, he divided the claim into two parts, the first relating specifically to the loss of the IBII contract (\$1.8 million) and the second relating to lost quotes from other contacts, to which he applied the Ibbotson ratio.

The court considered the alleged weakness of the evidence, and found they were better suited to cross-examination at trial and consideration by the jury. Accordingly, it denied the *Daubert* motion and permitted the expert to testify to the damages claims remaining after summary judgment.

Lender Uses Debtor's Own Appraiser to Show Plan Lacks Financial Feasibility

In re Fairvue Club Properties, 2010 WL 4501959 (Bkrcty. M.D. Tenn.)(Nov. 2, 2010)

The owner of two semi-private golf clubs pledged to do "whatever it takes" to pull his properties out of bankruptcy. He and his management team put together an optimistic reorganization plan, which exceeded even his appraiser's projections, based on increasing membership, reducing tee times, and "any other necessary step" to make the plan work, the owner said. The primary secured lender objected to the plan, however, claiming it was neither financially feasible nor fair.

In particular, the owner projected annual cash flows approaching nearly \$2 million, when the clubs had never posted more than \$1 million

per year at any point in their operating history, the lender said. In fact, 2007 was the last positive cash flow year for the clubs. In addition, the owner's revenue projections were substantially higher than those forecast by its own business appraiser—whom the lender called as its own witness at the confirmation hearing.

In his original report to the debtors, the business appraiser had valued the clubs under the capitalization of income approach at \$7.7 million. In addition to considering the clubs' historic revenues and expenses, he considered those of comparable clubs in the area as well as general market trends in the golfing industry. Based on these three components, the appraiser developed revenue projections, discounted to present value, which were 14% to 23% less than the owner's projections in the plan, or between \$300,000 and \$500,000 per year. His three market comparables all had positive cash flows of only \$360,000, the appraiser noted—and compared to the debtors, they were all more established operations and none were in bankruptcy.

The bank also called its own expert appraiser, who said the owner's projections were unrealistic primarily because they called for increased membership and golf rounds beyond the clubs' capacity. The bank's expert also agreed "90%" with the financial projections by the debtors' appraiser, and said that any lender considering the owner's projections would be a "default waiting to happen." Finally, a third, a turnaround expert, analyzed the owner's projected revenues, income before capital expenditures, membership, and golf rounds played, and concluded the debtors would experience cash flow shortfalls in all the years of the proposed plan.

Hope and effort are not enough. The court had no doubt that the owner was committed "to trying to successfully reorganize these debtors." Unfortunately, it also found that the projections by all three experts proved more persuasive as to what the business could achieve. "Hope and effort alone cannot make the debtors' projections attainable," the court said, and rejected the plan as unrealistic, without a reasonable framework or assurance of success.

GA Adopts Majority Rule on Dividing Professional Practice Goodwill in Divorce

Miller v. Miller, 2010 WL 4704326 (Ga.) (Nov. 22, 2010)

With this decision by the Georgia Supreme Court, only one state in the country (Alabama) has yet to address how to determine and divide the goodwill value of a professional practice in divorce. See "Goodwill Hunting in Divorce," a state-by-state summary of the leading U.S. court cases deciding the disposition of goodwill in divorce cases, available at BVRresources.com.

Value of solo medical practice at stake. At the parties' divorce, the wife's expert, a CPA and business valuation analyst, used a weighted combination of the asset, market, and income approaches to value the husband's internal medical practice at \$331,214. The trial court adopted this value, awarding one-quarter to the wife and the remainder to the husband. The husband raised several challenges, which went on an expedited appeal to the state Supreme Court.

First, the husband argued that the market approach was inappropriate because a market for solo medical practices does not exist. However, the wife's expert said that she used two national transactions databases (the court does not name the sources), and utilization of this data is a commonly accepted method for valuing medical practices. The court also found that, in general, the market approach is one of several valid methods for valuing a professional practice and overruled the husband's objection.

Second, the husband said the trial court wrongly accepted the excess earnings approach when he was paying himself a "normal" salary. "This contention shows a fundamental misunderstanding of such capitalization of excess earnings, which is the most commonly relied upon method for valuing professional practices," the court held. Under this method, as applied by the wife's expert, the first step is to deduct the owner's reasonable salary, based on similarly situated professionals, from the

average net income of the *practice*, not from the practitioner's actual compensation. This properly adjusts excess earnings for those practices that increase or decrease their retained earnings by means of a lower or higher than normal salary, the court explained. "The mere fact that the practitioner is paid a normal salary hardly means that there are no excess earnings in the practice."

Third, the trial court's use of the capitalization of earnings approach did not improperly include the husband's future earnings. By capitalizing only the excess earnings of the owning spouse and providing a present value for his interest, the method actually excludes most future earnings and avoids the problem of valuing the practice based on post-divorce earnings and profits, the court explained:

Most courts would accept that method especially where, as here, the appraiser makes appropriate modifications for taxation as a Subchapter S corporation and for any "individual" goodwill; excludes annual income representing reasonable compensation for services; and capitalizes actual past earnings instead of estimated future earnings based upon a future growth rate.

Fourth, the trial court did not count the husband's earnings twice by awarding portions of his business in its support awards and then again in its property division. Under the capitalization method, the wife's expert deducted a reasonable salary expense for the husband, and the trial court acknowledged separate bases for its award of alimony and child support. Accordingly, no double-dipping occurred in this case, the court held. "We join those courts which have rejected outright a double-dipping claim with respect to child support, reasoning as between parent and child, the asset subject to property division is being counted twice."

Court prefers term 'personal' goodwill. Fifth and finally, the husband claimed the trial court incorrectly divided his professional goodwill, which is not marital property under the current majority rule. The court found his use of "professional" goodwill to be somewhat ambiguous. "If by that term he includes enterprise goodwill and means that none of a professional practice can be divided,

we resolve this [terminology] by following the vast majority of jurisdictions and including enterprise goodwill in the valuation of a professional practice as part of marital property," the court ruled.


If, as is more likely, the husband was arguing that the trial court divided his individual goodwill, the court resolved this issue by assuming for purposes of this case only that "individual goodwill does not constitute marital property in Georgia." (Presumably, the court is implicitly asking analysts, attorneys, and litigants to use the terms "personal" and "enterprise" goodwill going forward.)


In this case, the trial court in fact excluded individual (or personal) goodwill from its valuation of the husband's medical practice. The wife's expert testified that she did not apply a "key man" discount, because the husband was replaceable. She accounted for any loss of patients, should the husband sell the practice, by using the market approach, which adjusts for a "key man" in the purchase price. She also used a higher capitalization rate in the income approach, which appropriately reflected the risk that some patients might not return. An additional adjustment would have overemphasized personal goodwill by factoring it into the calculation twice, the court said.


Overall, the trial court's valuation of the husband's medical practice, including goodwill, was sufficiently supported by expert evidence, the Supreme Court ruled, and confirmed the same.


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5-Year Average Net Income	4.5%	8.2%	11.5%
Sales	5.4%	8.5%	11.2%
Total Assets	4.5%	8.1%	11.2%

Prime lending rate:¹ 3.25%

Dow Jones 20-bond yield:⁴ 3.69%

Barron's intermediate-grade bonds:⁴ 6.61%

High yield estimate:⁴

Mean 11.1% Median 9.2%

Dow Jones Industrials P/E ratios:⁴

On current earnings:	14.1
On 2010 operating earnings est.:	13.3
On 2011 operating earnings est.:	11.9

Long-term inflation estimate:⁵ 2.5%

Long-term rate of growth GDP:⁵ 2.8%

1 Source: The Federal Reserve Board as reported by the BVR Risk-Free Rate Tool™, located in the Free Downloads section at BVResources.com, December 1, 2010.

2 Source: Risk Premium Report 2010 © Duff & Phelps LLC. All rights reserved. Report includes premiums where size is measured by market value of equity, market value of invested capital, book value of equity, and number of employees. We highly recommend that analysts using Duff & Phelps data for cost of capital have the current year's Report and thoroughly understand the derivation of the numbers used. Complete current and historical Duff & Phelps cost of capital data available at BVResources.com.

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4 Barron's, November 29, 2010.

5 10-year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, December 9, 2010.



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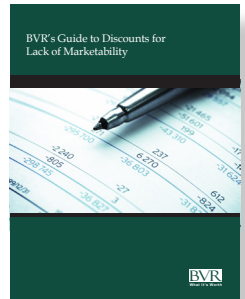
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