



Valuation Case Update - May 2011

In this update we have three unique cases for your review:

1. In *Insignia Systems, Inc. v. News America Marketing In-Store, Inc.*, 2011 WL 167259): *Daubert* challenges are very popular in Federal Courts. In reviewing cases, while a popular litigation tactic, such challenges, including Motion In-limine can often strategically backfire. Her is an example of the Court giving the expert witness an opportunity to clarify his analysis to the detriment of the defendant.
2. *Reis v. Hazeiett Strip-Casting Corp.*, 2011 WL 303207 (Del. Ch. - Jan. 21, 2011): A very interesting Delaware Chancery case about a reverse merger / squeeze out and dueling valuations. The Delaware Chancery Court breaks down both reports and cobbles together their own valuation.
3. *Linton v. United States*, 2011 WL 182314 (C. A.9 (Wash.) - Jan. 21, 2011): Linton case is reversed in 9th Circuit Court of Appeals in favor of taxpayer.

After Passing *Daubert*, Lost Profits Expert May Have Won Settlement for Client

Insignia Systems, Inc. v. News America Marketing In-Store, Inc., 2011 WL 167259
(D. Minn. - Jan. 14, 2011)

This is the second case we've covered against News America Marketing, a subsidiary of News Corp. (owner of the *Wall Street Journal* and Fox television network). In both cases, the plaintiffs competed with News America in the in-store marketing industry and claimed millions of dollars in lost profits due to unlawful disparagement and antitrust violations. After failing to exclude the plaintiff's damages experts under *Daubert* in the first lawsuit, *Floorgraphics, Inc. v. News Am. Mktg. In-Store, Inc.*, 546 F.Supp.2d 155 (D. N.J.2008), the defendant paid \$30 million to settle all claims. (For the digest of the federal court's *Daubert* opinion, see the April 2008 BVU.)

Defendant tries *Daubert* again. In this latest case, the plaintiff's lost profits and economic damages expert estimated that the defendant's anti-competitive behavior caused losses ranging from \$121 million to \$214 million. The expert used two approaches to estimate damages. Under the first, he measured the adverse impact of the defendant's "bad acts" on the plaintiff's going concern value by selecting "a cohort" of publicly traded



firms to serve as a proxy for the plaintiff's market performance and market capitalization. The firms were from various industries, but were similar to the plaintiff's size, performance, and market cap prior to the defendant's alleged harm.

Under his second approach, the expert broke down the damages into categories of harm, such as lost profits on lost sales, lost profits on actual sales due to increased costs, and incremental cost incurred because of the destructive acts. To calculate these losses, the expert asked plaintiff's management to provide its "best estimates" of the company's future performance during the loss period (late 2002 through early 2003). These resulted in conservative damages estimates, the expert said, because they assumed the plaintiff was not adversely impacted prior to the loss period.

Before trial, the defendant challenged the expert's evidence under *Daubert* on numerous grounds, including: 1) his market approach failed to use truly comparable companies and failed to account for alternative causes of loss; and 2) the projections he relied on to calculate lost profits came from "biased" and unverified sources.

To defend against these charges, the plaintiff's expert noted that in a market with so few players, it would make little sense to compare the plaintiff's performance against competitors that were not affected by the defendant's antitrust violations. Nevertheless, he submitted a supplemental report, which recalculated damages by using a different set of comparable companies, including advertising businesses and firms that physically placed ads in stores. The resulting damages estimate ranged from \$195 million to \$207 million, or within the estimated range of his first report. "In short," the expert said, his estimates were not "overly sensitive to the composition of the comparables ... and there is no justifiable reason to prefer [this second set] to my original set."

"The law is clear that comparable companies must be as similar as possible," the court held. However, in this case, the expert's rebuttal report compared the plaintiff to companies in the same market and found similar results to his comparison with firms in various markets, and his analysis met the legal standard, the court held.

Confusing correlation with causation. At the same time, the expert's comparable companies analysis attributed the entire amount of the plaintiff's market losses to the alleged misconduct. A more obvious, alternative explanation would be the company's disappointing fourth quarter earnings in 2002, which were released in February 2003, followed by a 28% drop in stock price. Yet in his report, the expert maintained that this "very pronounced abnormal loss" occurred at the same time as the defendant's disparagement, "and the record does not indicate that there were any other factors that would have been associated with such significant losses."

"This is a strange statement," the court observed, "since it seems clear that it is at least *possible* that a poor earnings report could cause a drop in stock price." The expert's comments and conclusions in his report lent credence to the defendant's claims that he might have confused "correlation with causation." However, the expert's determinations were "within his purview" to make, the court said. Although the expert could have considered a poor quarterly report, he was not *required* to do so. "The wisdom of such decisions is best



challenged on cross-examination," the court held, and admitted his market approach as reliable and likely to be helpful to the jury.

Turning to the expert's reliance on management projections, the court found that they were based on the company's typical budgeting process and the "best estimates" of experienced personnel. Their optimistic forecasts—predicting revenue increases more than five times any prior increase—were supported by an institutional report that predicted "a significant, multiyear revenue and earnings ramp" of 40% to 50% per year. The expert also vetted the projections and their assumptions and rejected the aspects that he could not verify. Given these facts, any alleged bias in the figures could be tested on cross-examination, the court held, and admitted the expert's lost profits conclusions.

Ignoring 'inconvenient evidence.' As a final matter, the defendant claimed the expert's damages estimates were flawed by his failure to account for various "economic realities" and other "inconvenient evidence," such as customer demand, increasing competition, and the presence of exclusive vendors. Essentially, the defendant was arguing with how the expert did his analysis and what factors he should have considered, the court said. These arguments may have been relevant, but they went primarily to the weight and not the admissibility of the expert's evidence and could be explored more thoroughly at trial.

The court also held that the expert did not have to disaggregate damages to fit the various claims of the case. In an antitrust case, so long as some of the alleged acts support damages, an award will be sustained, the court said. Moreover, in this case, the expert's rebuttal report provided a specific way to allocate the plaintiff's losses between its disparagement claims and its antitrust claims. Any objections to his method were better suited for cross-examination than exclusion, the court held, and denied the defendant's *Daubert* challenge in full.

CVS Note: Less than a month later, after the parties made their opening statements at trial but before the presentation of evidence, the defendant settled the lawsuit for \$125 million. (See www.bloomberg.com/news/print/2011-02-09/news-corp-pays-125-million-to-settle-insigniasuit-ending-federal-trial.html.)



DE Chancery Cobbles Capitalization of Earnings Value from Dueling Experts

Reis v. Hazeiett Strip-Casting Corp., 2011 WL 303207 (Del. Ch. - Jan. 21, 2011)

Founded in 1929, the Hazeiett Corporation manufactures large strip-casting machines, selling from zero to four units per year for up to \$16 million apiece. By far, the bulk of revenues for the Vermont-based, family-run company comes from servicing existing machines and selling spare parts.

Older brother wants to keep control. In 1956, the founder turned over the company to his two sons, giving the eldest 800 shares (or nearly 70% of the equity) and the younger 350 shares. When the younger brother died in 2002, he left his 350 shares to 169 individuals, primarily past and present employees. By then, the older brother was CEO, President, and Chairman of the board. According to court records, he "deeply disliked the idea of their family owned company suddenly being opened up to outsiders."

To preserve the company intact, the older brother/CEO authorized it to pay \$1,500 for each of the 350 shares held by the younger brother's estate, for a total of roughly \$560,000. The price was not based on any current valuation; in fact, he later testified that he "pulled the number out of the air." The beneficiaries held out for a higher value, and the CEO used a reverse stock split to force a buyout. An appraisal firm valued the entire company at \$1.83 million, making a fractional interest worth approximately \$1,600 per share at the time (Oct. 2005).

The board amended the company charter to complete the measure, but failed to effectively file the amendment until January 2008. In the meantime, one of the 169 beneficiaries challenged the reverse split in the Delaware Chancery Court, alleging that the company, its CEO, and the board had breached their fiduciary duties to shareholders and violated Sec. 155(2) of the Delaware General Corporation Law (requiring a company to pay "fair value" for repurchasing fractional interests). After initial litigation, the court held that the effective date of the reverse split was January 2008.

Before making a fair value determination, however, the court first clarified the review standard and burden of proof. "When a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections," the court ruled, then the "entire fairness" standard applies and the burden under Sec. 155(2) shifts to the defendant/fiduciary to show it was fair. Applying the standard to this case, the court found that the older brother directly controlled the board of directors, which authorized the reverse split without implementing any shareholder safeguards such as an independent committee or a "majority-of-the-minority" vote. "There was no dealing in this case that could be called 'fair,'" the court concluded.



Proper valuation standard. In fashioning an appropriate remedy, the court noted that Sec. 155(2) uses the term "fair value" without referring to the definition of fair value in Sec. 262, Delaware's appraisal statute. At the same time—after an extensive discussion of the remedies available in an entire fairness case versus an appraisal proceeding—the court found that "the fair value standard is ... economically efficient and should be applied consistently to freeze outs, regardless of form." The same policies that "animate using a fair value standard" to evaluate a squeeze-out merger "calls for its use when the freeze-out is implemented by a reverse split," the court added.

After failing to implement a fair process in this case, the defendants "did not serendipitously" arrive at a fair price when they offered to buy out the plaintiff's shares at the initial \$1,500 offer or the subsequent \$1,600 appraised value, the court held. In an effort to prove fair value for trial purposes, both parties submitted competing appraisals. The defendants offered a second report from the same firm that appraised the company at the time of the reverse split. This time, the firm reached a going concern value as of January 2008 of \$1.745 million, or \$1,500 per fractional interest—nearly \$100 per share less than its prior valuation.

The plaintiff/minority shareholders' expert responded with an appraisal that valued the company's total equity under various approaches at \$6.3 million, or nearly \$5,490 per fractional interest. Under the guideline public company analysis, however, the expert selected comparables that were substantially bigger than the Hazelett Corporation and had more diversified customers, better access to capital, deeper management teams, and different economic drivers. The comparables also generated more stable revenues from new sales rather than parts and servicing. Even with adjustments, the differences were so large that the court found the method was "meaningless" in this case.

The court also rejected the capitalized free cash flow analysis from the plaintiff's expert, because it required too many normalizing adjustments to produce a reliable going concern value. For example, the expert used only an average of two recent periods (fiscal 2007 and annualized 2008) to derive a cash flow projection. This did not adequately account for the company's fluctuating revenues and the court "declined" to modify the expert's work, especially since it was redundant of the many adjustments the court decided to make to the third and final approach.

Appropriate methodology and adjustments. Both party experts applied the capitalized earnings method, which "boasts a considerable Delaware pedigree as one of the methodologies comprising the Delaware Block Method," the court observed. Using forecasted earnings is preferable, but when reliable projections are not available, historical averages are acceptable if calculated across a multiyear period. "Under the Delaware block method ... a five-year period [is] the norm," the court said.

In this case, the record was devoid of company projections; thus both experts looked to historical performance. However, the defendants' expert failed to make any normalizing adjustments to earnings, enabling him to reach a result "conveniently close" to the original \$1,500 buyout price, the court said. At the same time, the plaintiff's expert made several adjustments that were inconsistent with Delaware law. Accordingly, the court used the

valuation by the defendants' expert as a starting point, with the following adjustments, adapted from the plaintiff's expert:

1. *Research and development (R&D) costs.* The industry average for R&D was approximately 5% of revenues, according to the plaintiff's expert, and from 2003 to 2007, the company's R&D hovered around these levels, but when the economy began to decline in 2007, it reallocated the expense of idle employees to R&D, nearly doubling its cost. As result, the plaintiff's expert added back \$1.3 million of R&D in 2007. However, the company had a general policy of retaining rather than laying off employees during down cycles, and this "operative reality" was in line with maximizing shareholder value. Since only a new controller would adjust R&D expense to align with a new operative strategy, the court held, the expert's adjustments would reflect a third-party sale rather than a going-concern value, and it rejected the 2007 add-back to earnings.
2. *Controller self-dealing.* This "raised trickier issues," the court said. The company also had a general policy of giving the CEO several "tax advantaged" returns, such as a high compensation rate (set at a flat 2% of gross revenues) and maintaining a "marine" and "hotel" division, which had nothing to do with the company's main operations but were tax-efficient ways for the CEO to enjoy his "love of sailing." The company also leased five machine tools from a CEO-owned entity. Under Delaware law, the Chancery court was inclined to adjust company earnings for all three expenses—but interestingly, the plaintiff's expert declined to say whether the CEO's compensation and the lease payments were market rate. The expert did adjust for the "marine" division, and the court adopted the same as a reflection of controller self-dealing.
3. *Non-recurring revenues.* The plaintiff's expert deducted revenue resulting from non-recurring sales of fixed assets and from the 2006 sale of company-owned real estate. "These are standard and appropriate normalizing adjustments," the court held, and adopted them as well.
4. *Tax rate.* The court also adjusted the company's earnings by its historic (fiscal years 2003 to 2007) tax rate and a normalized rate of 40% for calendar 2003 and 2008. 5. *Earnings period.* The court adopted the "six year average" earnings trend of \$283,000 per year, as calculated by the plaintiff's expert. But it also believed that some portion of the CEO's compensation and equipment lease expenses should drop to the net income line; thus this earnings estimate "risked undervaluing the minority interest."
5. *Earnings period.* The court adopted the "six year average" earnings trend of \$283,000 per year, as calculated by the plaintiff's expert. But it also believed that some portion of the CEO's compensation and equipment lease expenses should drop to the net income line; thus this earnings estimate "risked undervaluing the minority interest."
5. *Capitalization rate.* Due to the lack of sufficient peer company comparables, both experts used the build-up method (BUM) to derive a cap rate—18% for the plaintiff's expert, compared to 21% for the defendants¹. The defendants' expert also included a "healthy company-specific risk premium" (CSR_P)



of 6%, the court observed, compared to 2% by the plaintiff's expert. Because of "inherent dangers" of overestimating the CSRP and because the court believed the earnings figures underestimated the company's "real economic returns," it replaced the defendants' 6% CSRP with the plaintiff's 2%, resulting in a cost of equity of 17%.

Before using the inverse of the cost of equity as the capitalization rate, the court needed to deduct an appropriate growth factor. After speaking with management, the defendants' expert applied a 4.4% growth rate, compared to 4% by the plaintiff's expert. Since the defendants' expert had better access to operations and more incentive to be conservative, the court subtracted his higher growth rate (4.4%) from its cost of equity (17%) to produce a cap rate of 11.6%. Dividing the company's six-year average earnings base (\$283,000) by the cap rate yielded an equity value of just over \$2.44 million. The court added another \$260,000 for the value of non-operating assets, primarily real estate, and a net operating loss carry-forward.

It did not add another \$244,000 for research and other tax credits, however, because the plaintiff failed to ask for it. It also rejected a \$560,000 adjustment to reflect the amount the company had already paid the plaintiff and other beneficiaries of the younger brother's estate, because the payment did not come from excess cash but from the company's line of credit. The court could not back out the costs of this debt, however, because the plaintiff's expert did not provide this amount. Overall, the court reached an equity value of \$3.65 million for the company under the capitalization of earnings approach, or \$3,175 for a fractional interest.

Book value is troubling. Net asset or book value can be an appropriate appraisal method for a company that derives significant value from its physical assets, the court noted. Although the method may undervalue a business with substantial intangible asset value, it can also serve as a conservative "check" against a going-concern valuation. In this case, the company's books reflected a book value of \$7.7 million, a figure that had remained relatively stable over the base earnings period. Despite recognizing that asset value typically establishes a "floor" against which to check operational value, the defendants' expert rejected the approach without any credible explanation, the court found.

Moreover, the wide disparity between the court's \$3.65 million entity valuation and the company's historic \$7.7 million book value "remains troubling" and reinforced its concern that controller self-dealing depressed earnings. To counter this, the court gave an 80% weight to its capitalization of earnings approach and 20% to book value. It also added the \$560,000 payment to the estate beneficiaries to book value. Using this blended average approach, the court reached a final fair value determination for the company of \$4.57 million, or \$3,980 for a fractional interest.

CVS Comment: It's rare that a Court completely breaks-down both sides appraisal reports as much in this case. Delaware Chancery Court has more exposure to business valuation issues and will often get more involved in the details of the appraisal reports.



Taxpayer Victory in 9th Circuit Family LLC Case

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

The Lintons formed a limited liability company (LLC) in Washington state. On Jan. 22, 2003, they met with their tax attorney to sign and date several documents pertaining to the LLC, including a quit claim deed to transfer certain real property to the LLC and a letter authorizing the transfer of cash and securities. At the same meeting, they signed but did not date agreements creating trusts for each of their four children, and documents purporting to give each of the trusts an equal share of LLC interests.

Attorney error. A couple of months later, the Lintons' tax attorney filled in the missing dates on the trust and gift agreements as January 22, 2003—but later testified that he meant to insert January 31, 2003. The Lintons' accountant and appraiser corroborated this testimony, as did the following:

1. The LLC's federal tax return, prepared by the accountant/appraiser, initially credits the contributions to the Lintons' individual capital accounts and then shows subsequent capital transfers to the children's trust accounts.
2. The Lintons' individual federal gift tax returns, prepared by their tax attorney, listed the gifts as gifts of percentage interests in the LLC dated January 31, 2003.
3. The LLC's membership ledger, also prepared by the attorney in March or April, 2003, showed that the Lintons owned 100% of the transferred assets, and then transferred subsequent percentage interests in the LLC to the children's trusts; however, none of these entries were dated.
4. An LLC valuation, prepared by the accountant/appraiser, states that the LLC interests were transferred on January 31, 2007.

In their gift tax returns and pursuant to the LLC appraisal, the Lintons applied a 47% combined discount for lack of marketability and control. The IRS rejected the discount, claiming that the Lintons made indirect gifts of property to their children's trusts; or, in the alternative, the step transaction doctrine collapsed the transfers into a single gift.



The Lintons paid the assessed deficiencies and applied to the federal district court (Washington) for a refund. On the government's summary judgment motion, the court relied on the express language of the trust and gift documents to find that the Lintons' contributions occurred either simultaneously with or after their gifts of LLC interests to the children's trusts, and thus constituted indirect gifts of the cash and property. In the alternative, even if the LLC contributions occurred prior to the gifts of LLC interests, the step transaction doctrine applied. The Lintons made no affirmative decision to delay the gifts, the district court noted, and no evidence suggested that the trust property was exposed to "real economic risk" during the alleged nine-day interim between the contributions to the LLC and the gifting of LLC interests to the children's trusts.

The taxpayer appealed to the U.S. Court of Appeals for the Ninth Circuit, which reviewed the elements required to complete a gift under applicable (Washington state) law. These elements included the donor's intent to make the gift, a delivery of the gift, and acceptance by the donee. Of these, donative intent "is both the decisive element and the most difficult to determine," the court said. In fact, it was likely that Washington law would collapse the delivery of the gift into an analysis of intent.

In this case, the signing and dating of the relevant documents created a "considerable objective ambiguity" as to when the Lintons intended their gifts to become effective. To resolve this ambiguity, the court looked to when the donor put the gift documents "beyond retrieval." Thus, the execution of the documents on January 22, 2003 was not sufficient, by itself, to effectuate the gifts on that date. In addition, the attorneys retained the documents without specific instructions from the Lintons that the gifts should be made effective on January 31 or any other date.

Based on the current record, either the Lintons left the January 22 meeting with undated copies of gift documents that nevertheless manifested sufficient objective intent to make the gifts immediately effective, the court said (with emphasis); or they empowered their attorney to make the gifts effective at a later date—most likely when he prepared the ledger a few months later and gave his clients copies of the signed gift documents. In the alternative, a gradual "accretion of events" could manifest the required intent prior to the LLC funding. Because the evidence was incomplete on these points, the Ninth Circuit remanded the case to the district court to resolve "when the Lintons objectively manifested the intent to donate the LLC interests" by putting the gift documents "beyond retrieval."

LLC is a 'business activity that makes sense.' To apply the step transaction doctrine, one of the three tests must apply. The "end result" test asks whether a taxpayer intended a series of steps to produce a particular result, and if so, it treats the steps as one. In this case, ample evidence supported the Lintons' intention to convey LLC interests to their children without also conveying ownership or management interests. This result was consistent with the tax treatment they sought. Thus, even if the steps could "somehow be merged," the court held, "the Lintons would still prevail, because the end result would be that their gifts of LLC interests would be taxed as they contend."



The second test asks whether the first step of the transaction triggered a "binding commitment" to fulfill the remaining steps. This test only applies to transactions spanning several years, the court held, and so did not apply here. The final test asks whether the steps were "so interdependent" that the legal relations created by one would have been fruitless without completion of the remainder. This typically requires comparing the transactions at issue with those found in "bona fide" business settings.

In this case, "the placing of assets into a limited liability entity such as an LLC is an ordinary and objectively reasonable business activity that makes sense with or without any subsequent gift," the court held, citing the Tax Court's decision in *Holman v. Commissioner*, 130 T.C. 170 (2008). The Lintons' creation and funding of the LLC enabled them to specify the LLC terms and to contribute a desired type and amount of assets. These "reasonable and ordinary" business activities did not meet the requirements of the interdependence test, the court held, and reversed summary judgment based on the step transaction doctrine.