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Valuation & Litigation BRIEFING

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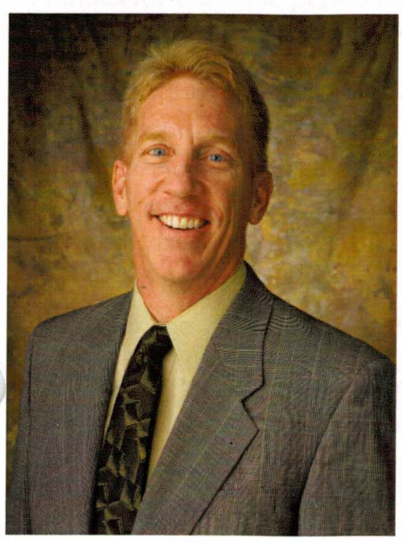

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Impact of growth rate on lost profits

When calculating lost profits, damages experts need to determine the growth rate carefully. Failure to properly analyze the factors that drive a company's expected revenue growth is sure to result in a challenge.

Growth matters

The first step in calculating lost profits is to determine the company's lost revenues. (See "Calculating lost revenues" on page 3.) A key component of this step is to estimate the rate at which revenues would have grown, absent the defendant's alleged wrongful conduct.

By necessity, this growth rate is an estimate, but an expert can take a scientific approach to determining it. As the following cases demonstrate, failure to do so may jeopardize the admissibility of the expert's testimony in a *Daubert* challenge.

Chemipal Ltd. v. Slim-Fast Nutritional Foods International Inc.

The plaintiff, a distributor, sued a manufacturer of weight-loss products for breaching its obligation to provide advertising and promotional support under their distribution agreement. The U.S. District Court for the District of Delaware granted defendant's motion to preclude the testimony of the plaintiff's damages expert as unreliable.

The expert had failed to make any calculations in arriving at a growth rate. Rather, he'd made a "'ballpark' estimate of growth rates based on his own recollection of growth rates of other products he had worked with in the past..."

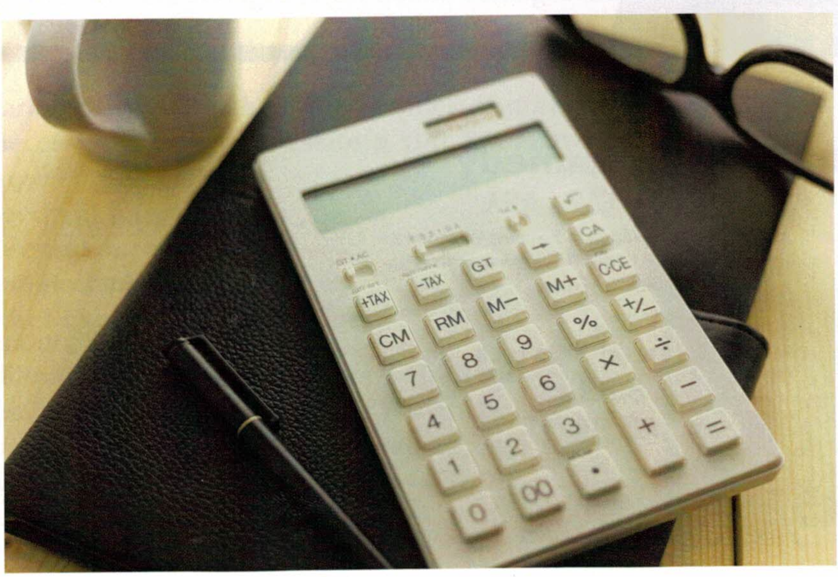
The expert's testimony was inadmissible under *Daubert* because he'd failed to:

- Verify the accuracy of his growth estimates, or
- Demonstrate how those estimates translate into the potential growth rate for the defendant's products.

Because the plaintiff's damages case rested entirely on the expert's opinion, the court granted summary judgment for the defendant.

Celebrity Cruises Inc. v. Essef Corp.

A cruise line sued the manufacturer of the defective spa filter responsible for a Legionnaires' disease outbreak. The plaintiff sought several types of damages, including lost profits from the time of the Legionnaires' outbreak in 1994 until it was acquired by another cruise line in 1997.



The U.S. District Court for the Southern District of New York excluded one of the plaintiff's damages experts in part because she'd used an inappropriate growth rate. To determine the rate, she'd used two other cruise operators as proxies.

The problem was that the proxy companies hadn't achieved projected growth levels. In fact, they'd experienced *negative* growth for most of the relevant time period. The expert claimed she hadn't known actual performance data was available when she conducted her analysis. But even after becoming aware of the proxy companies' poor performance, she declined to incorporate the data into her methodology.

This sort of "forward-looking" approach, the court said, may be appropriate when valuing a company as of a specific point in time. But it's "inadequate to measure damages attributable to an event occurring after the point in time when the projections are made."

Manpower, Inc. v. Insurance Company of the State of Pennsylvania

This case concerned a dispute between a staffing and recruiting firm and its insurance provider over a business interruption claim. The claim involved the collapse of a building containing the offices of one of the plaintiff's subsidiaries. The subsidiary sought to recover its lost profits and additional expenses while it was unable to operate its business at the insured premises. The U.S. District Court for the Eastern District of Wisconsin granted the insurer's motion to exclude testimony by the plaintiff's lost profits expert.

The expert determined that the subsidiary's revenues for the five-month period immediately preceding the collapse were 7.76% higher than revenues for the same period in the previous year. He used that growth rate, without considering growth rates for other periods, under the assumption that the subsidiary's growth spurt just before the collapse was attributable to new management and would continue. But he failed to support that assumption with economic analysis of the factors affecting its revenues.

On appeal, the 7th U.S. Circuit Court of Appeals reversed the district court's ruling, finding that the weaknesses in the expert's testimony went to the expert's conclusions rather than the reliability of his methods, which was a question for the jury.

Importance of growth rates

In cases involving lost profits, be sure that your experts give their growth rates sufficient attention. Failure to support the growth rate with reasonable assumptions and detailed analysis based on objective market evidence can derail your entire damages claim. ◆

CALCULATING LOST REVENUES

Experts typically use the following proven methods — either alone or in combination — to calculate lost revenues:

Before-and-after method. The expert compares the company's sales before and after the alleged wrongdoing.

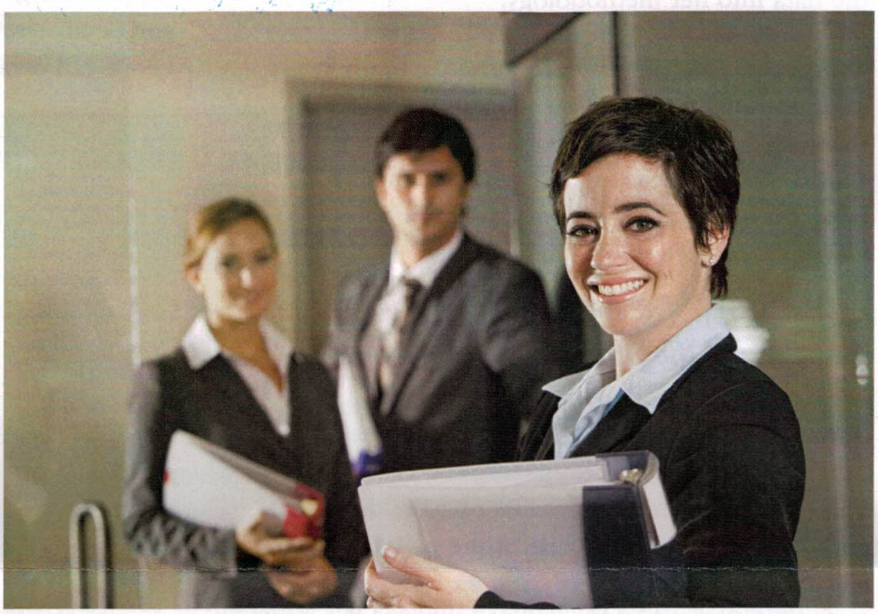
Yardstick method. The expert compares the company's postinjury sales to those of comparable companies, industry averages, unaffected portions of the company's business or some other benchmark.

Sales projection method. The expert compares the company's actual sales after the injury with its preinjury sales projections based on reasonable assumptions.

Market share method. The expert estimates the company's sales under the assumption that it would have achieved or maintained a certain market share but for the defendant's alleged wrongdoing.

Share information and resources with a joint appraisal

A joint appraisal occurs when the parties involved in a lawsuit or a business transaction come together and agree to hire a single expert. It can be useful in some situations, including contentious divorces and shareholder disputes, by facilitating information sharing. Joint appraisal is a specific process that presents numerous benefits — as well as some potential pitfalls.



The benefits

Traditionally, each party to a transaction or lawsuit hires its own expert to value the business. A joint appraisal can streamline the valuation process and minimize divergent opinions that can result from incomplete access to financial data.

Joint experts can facilitate settlements, because both sides are using the same data and may stipulate to key points, potentially eliminating the need to go to court.

Joint appraisal can be especially beneficial in divorce cases, where one (or both) parties lack financial resources or access to financial data. In fact, some jurisdictions mandate the use of a joint appraiser when the marital estate includes a privately held business interest. Joint appraisal also can be key to collaborative divorces, where the parties agree to settle out of court through a series of joint meetings.

Joint experts can facilitate settlements, because both sides are using the same data and may stipulate to key points, potentially eliminating the need to go to court. And using a joint expert can reduce hostility between the parties. This can be particularly beneficial if they need to work together in the future — for instance, co-parenting their children or donating time to economic development projects in their local business community.

Shareholder disputes, buyouts, and mergers and acquisitions are other situations in which joint appraisal can be beneficial.

The pitfalls

But joint appraisers aren't appropriate for every situation. Distrust, dishonesty and personal drama can get in the way of objective analysis, discovery and open communication, which are required for effective joint appraiser use.

If the parties wind up in court, communications between both parties and the joint valuation expert generally won't be granted attorney-client privilege. But these communications would likely be protected under attorney-client privilege if each attorney hired its own valuation expert.

When such negative conditions exist, appraisers get frustrated. Both sides may wind up dissatisfied with the opinion.

Other factors

When considering using a joint appraiser, it's important to consider several factors. For instance, the scope of the valuation can be a point of contention. In addition to a business valuation, parties might request specific due diligence, forensic or forecasting procedures. Generally, the parties agree to split joint expert fees. But one party might agree to pay extra for the ancillary services, if they can't agree on the scope of the joint assignment.

It's also important to ensure that the parties trust that communication will be clear, fair and comprehensive. Typically, a joint appraiser communicates openly with all parties. For example, a joint appraiser would take care to compile and distribute notes following meetings, particularly if one party is absent.

Another factor that affects a joint appraisal is the preferred reporting format. Because both sides usually split the fees in a joint appraisal, it's necessary to decide upfront how the appraiser will communicate his or her opinion. Preliminary settlement talks and purchase negotiations usually are less formal than litigation, so oral presentations or abbreviated letter reports may suffice.

Effective management is key

It can be challenging to overcome the obstacles that compromise the effectiveness of joint appraisers. But clients who can put aside their differences and share resources quickly discover that using a joint appraiser can often save both money and time. ◆

Hugh v. Hugh

Determining value in marital dissolution cases

What type or quantity of evidence is needed to establish the value of a business for marital dissolution purposes? This was one of the key issues in *Hugh v. Hugh*. On appeal, the wife argued that the trial court had erred in declining to value and equitably distribute the couple's interest in a semiconductor brokerage business that the husband controlled.

Vague testimony

Evidence of the company's value came mainly from the husband's testimony and a valuation expert retained by the wife. Unfortunately, the husband's testimony was "vague, indefinite and confusing." The company's website touted "the world's largest inventory of semiconductor and manufacturing equipment parts," although the husband testified that the company had no inventory and no value.

According to the court of appeals, the information provided to the wife's expert was "scant and indefinable." The husband offered little in the way of documentary evidence, which consisted only of the following:

- A 2010 tax return for the company's predecessor, which showed $9.3 million in revenue and just under $400,000 in profit;
- A 2010 financial statement, showing income that was more than double the amount on that year's tax return;

- A 2011 tax return for the eight months before the predecessor company's dissolution, showing $6.8 million in revenue, $50,000 in profit and $240,000 in officers' compensation;
- The company's 2011 tax return for the four months it was in existence that year, showing $155,000 in revenue and almost $13,000 in losses;
- The company's 2012 tax return, showing about $1 million in revenue and $150,000 in losses; and
- A list of 2012 debits from the company's bank account, showing that $335,000 was used to pay personal expenses and most of the husband's attorney's fees.

The husband attributed the company's dramatic downturn in 2012 to the "bad economy" and the poor performance of the semiconductor industry. He testified that, in his view, the company was worthless.

A difficult analysis

The wife's expert, a CPA, valued the company using the market approach, finding that insufficient information existed to support a valuation using the income or asset approaches. Based on an analysis of 31 comparable companies and discounting his valuation by 30% to reflect the husband's personal goodwill, the expert concluded that the company's intrinsic value was approximately $1.4 million.

The expert acknowledged that, given the limited information supplied by the husband, the valuation didn't meet AICPA standards. He expressed doubts about the accuracy of the tax returns, given the amount of personal expenses that were run through the business. In addition, the expert didn't receive general ledgers, QuickBooks files or a complete set of bank statements. Finally, the expert was unable to interview management or conduct a site visit. Nevertheless, he believed the valuation was a useful and reasonable estimate of the company's value.

Given the limited information supplied by the husband, the valuation didn't meet AICPA standards.

Court decisions

A trial court ruled that there was insufficient evidence to value the company, but the Virginia Court of Appeals disagreed. Despite the trial court's doubts about the tax returns and other information relied on by the wife's expert, the court of appeals found a "relative wealth of information" that could have been used to value the business. The appellate court had previously held that tax returns showing a company's gross income could be enough to value a company, observing that "[a]ssuredly, a business that has gross income can be valued."

In this case, the trial court had more than gross income as evidence and "the discretion to place a value within the range provided in witness testimony and documents received into evidence."

Lessons learned

In divorce cases, the financial information typically relied on to value a business may not be available. Nevertheless, an experienced and well-qualified appraiser can extract the information necessary to arrive at a value that's sufficient for equitable distribution purposes. ◆

Discovery and mobile devices: Have a plan

Smartphones, tablets and other mobile devices may contain a broad range of electronically stored information (ESI), including emails, calendar entries, text messages, photos, videos, call logs, notes, documents, Web histories, GPS data and social media posts. In light of this potential wealth of information, attorneys involved in commercial litigation can't afford to ignore these devices when developing a discovery plan.

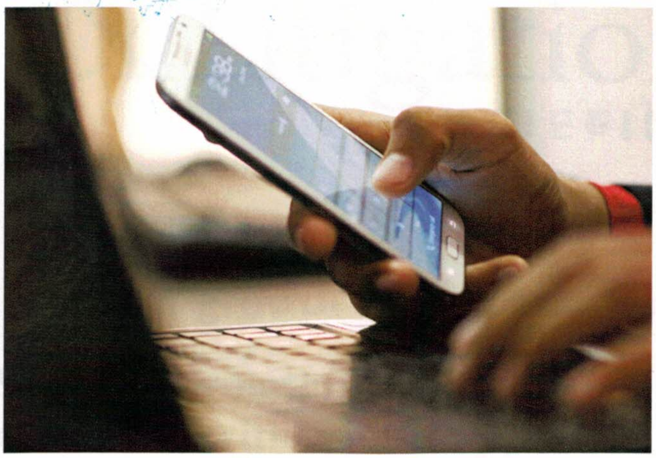
ESI discovery is complex, and mobile devices present unique challenges. In particular, bring-your-own-device (BYOD) policies, which allow employees to use their personal devices for work, raise issues of privacy and control.

To address mobile device ESI early in the litigation process, you should:

1. Take inventory. Determine who in an organization uses mobile devices, how they use them and what types of devices and operating systems are involved. Does data reside in the device only, on a cloud-based server or on a dedicated server the business controls? Different types of data may reside in different places and may be controlled by the business, the user or both.

2. Determine whether you need access. Data stored on mobile devices may be more easily retrieved from other sources, depending on the type of data sought. Business-related emails and calendar entries, for example, are likely synced with the company's servers. And information about the time a call was made or a text was sent is likely available from the wireless provider. In some cases, however, data resides only on the device.

3. Determine who's in control. It's important to ascertain whether a company with a BYOD policy is obligated to produce ESI stored on employees' devices. The law in this area is inconsistent and continues to evolve. Generally, a party is required to produce ESI within its "possession, custody or control."



Some courts deem that an organization or business controls information if it has a legal right to obtain it (pursuant to a BYOD policy, for example). Others require data to be produced if the company has the "right, authority or practical ability" to obtain it. In addition, some courts require parties to notify their opponents about evidence in the hands of third parties.

4. Preserve mobile data. To preserve discoverable information, be sure to include mobile data in any litigation holds.

5. Establish protocols. Have protocols and procedures in place to elicit relevant data while prohibiting discovery or disclosure of personal or privileged information.

An experienced forensic expert can help you design comprehensive ESI collection and preservation strategies. He or she can also assist in interpreting the data you retrieve from mobile devices and other electronic sources. ◆

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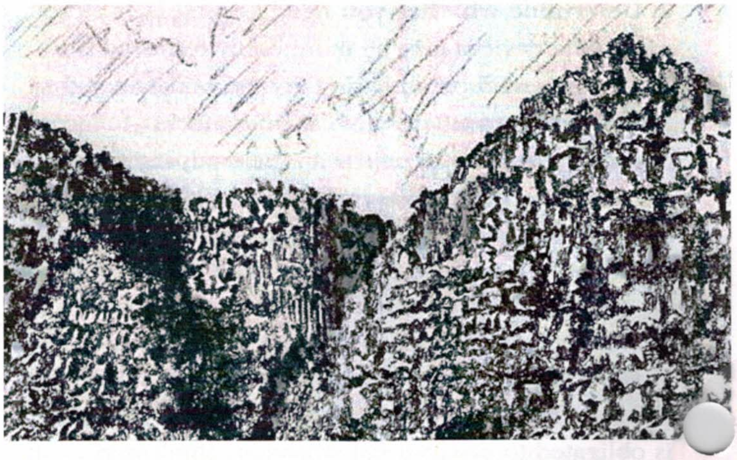
At Canyon Financial Services it is our mission to work closely with our clients, their attorney and/or accountant to provide an objective well-reasoned business valuation or expert report.

Mr. Kennedy has over thirty years of professional experience in the business concentrations of accounting, finance, forecasting and financial analysis and presentation, including the last eighteen years with emphasis in business valuation, litigation support and mergers and acquisitions. Mr. Kennedy's experience includes business valuations for marital dissolutions, estate and gift tax matters, business acquisitions and dispositions, shareholder disputes as well as forensic accounting and economic damages analysis for lost profits, and other litigation matters.

Potential reasons to employ our services:

- Marital dissolutions and Shareholder disputes
- Succession Planning & Estate & Gift Tax Matters
- Buy/Sell Agreements
- Goodwill Impairment
- Forensic Accounting
- Lost Profit Analysis
- Other Expert Witness Services



In addition to his professional work Mr. Kennedy is committed to giving back to the Phoenix Community and is an active member and Past President of the Phoenix Rotary 100 Club. He also serves the community through his work in a variety of other organizations.

For more information visit our website at www.canyonfin.com
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