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- 2Q Delivered second week of March
- 3Q Delivered second week of June
- 4Q Delivered second week of September

For your convenience, the content is organized into four categories:

***BUSINESS VALUATION UPDATE* Q1 2019 CONTENT**
***BVWIRE* Q1 2019 CONTENT**
LEGAL CONTENT Q1 2019
ECONOMIC UPDATE AT A GLANCE

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BUSINESS VALUATION UPDATE Q1 2019 CONTENT

Users Reveal Insights and Tips on *DealStats* and the GCTM

The process of developing the recently launched *DealStats* database involved having a number of business valuation practitioners act as beta testers. Now that *DealStats* has gone live, *BVU* caught up with two of the beta testers to get their insight into the use of the database and some comments on a few aspects of the guideline company transaction method.

DealStats is the result of a major upgrade to *Pratt's Stats*, the leading private-company transaction database, which was long overdue for an overhaul. *DealStats* merges *Pratt's Stats* and *Public Stats* transactions into one powerful platform that is more user-friendly and flexible. The upgrade includes state-of-the-art search capabilities, additional data fields, easy saving and report generation, and much more.

Best new feature. The enhanced search capabilities are the most useful features of *DealStats*, says Paul Heidt, ASA, director of valuation research for Morones Analytics, a BV and forensic accounting firm in Portland, Ore. Heidt was previously at BVR for 10 years as part of the development team for earlier versions of *Pratt's Stats*. "*DealStats* represents a significant upgrade to the search engine in the database," he says. "You can really pinpoint what you're looking for, and you get the results instantaneously, which is a big improvement. For example, you can just click on the SIC code and a dollar range and immediately see the results." Also, instead of having to go back and forth after changing search criteria, *DealStats* instantly displays the new transaction results.

Lance Schmidt, CVA, CBI, CBB, and a former CPA, agrees. "The added conditional 'and/or' capabilities are a boon to those who use *DealStats*," he says. "The slide bar (or the use of beginning and end amounts or values for revenues, EBITDA, etc.) saves major time in refining a search." Schmidt is the president of National Business Appraisers (Mission Viejo, Cal.) and is a valuation expert as well as a business broker who is in the *Pratt's Stats* Hall of Fame for business intermediaries who have contributed the most transactions to the database.

With *Pratt's Stats,* your searches were limited to predetermined fields, he points out. *DealStats* allows you to search on any field in the database, and you can specify terms such as "greater than," "less than," "between," "equals," "does not equal," and so on. Plus, you can now save your search results and return to them at any point in time in the future. Also, there are no longer any caps on transactions or statistics and you can select multiple industries at one time.

Schmidt also likes the new graphic presentation capabilities where you can visually analyze selected data through interquartile ranges, scatter plots, distribution graphs, and stacked bar charts. Other helpful new features include:

- New data points, including the lives of intangible assets and additional profit margins not previously provided;

- Real-time updates as transactions are entered into the database; and

- Easier downloads in that you can choose all the available fields or you can select just the ones you want.

Although he is a regular user, Schmidt says he has only used about 20% of the functionality that's available.

Sample size. In the pages of *BVU*, there has been some debate[1] over how many transactions should be used in the application of the guideline company transaction method (GCTM), so we asked about that. "The size of your sample really depends on the industry. It may be a niche industry where you may only find three or four transactions," says Heidt. He does not use a hard-and-fast rule about a specific number of transactions to use as a minimum. "If you have fewer transactions, you can consider a change to the weighting of the market approach."

"If you have six or seven solid comps, then it's sufficient, in my opinion," says Schmidt. Of course, they have to be relevant, he points out, so you have to consider factors such as the time frame of the transaction. One idea he offers is to talk to the broker who submitted the data to make sure the comp is relevant. If the comps turn out to be not as solid as you thought, can you still use the data? Yes, says Schmidt, but in a different way. The data can be used as a benchmark that can be subjected to certain techniques in order to refine it.

Best advice. Make sure you read the *DealStats Companion Guide* and watch the how-to videos before using the database, Heidt and Schmidt advise. The guide contains useful information, such as how to choose comparable companies, how to select and apply multiples, and how to use the search capabilities. "I still refer back to the tutorials, which I read before using the database, which is important," says Schmidt.

This will help you not only use the data, but also interpret it. "You need to know what's in the data, particularly with regard to the deal price," says Heidt. Different databases do not present all the data the same way. For example, the deal price in *DealStats* includes inventory but BIZCOMPS does not, so you need to adjust accordingly.

As a final point, although *DealStats* went through a major upgrade, there is already a list of planned additions and enhancements to the platform.

For more information. Go to bvresources.com/dealstats for more details and for links to various resources, such as FAQs and the how-to videos. If you have questions, you can contact Adam Manson at adamm@bvresources.com or 503-291-7963, ext.105.

[1] "Valuation Experts Clash Over Analysis of Transactional Data" (with accompanying supplement), *Business Valuation Update*, April 2018.

* * *

New Guidance in Updated Edition of Economic Damages Book

There are a number of books on economic damages, but *The Comprehensive Guide to Economic Damages* is unique in its approach. The book's editors, Nancy J. Fannon, CPA, ASA, MCBA (Marcum LLP), and Jonathan M. Dunitz, Esq. (Verrill Dana), spoke with *BVU* about the new two-volume edition, which has 43 chapters and over 300 court case briefs. The book provides a deep and rich resource, found nowhere else, for financial experts and attorneys seeking guidance on damage calculations.

BVU: *What distinguishes* The Comprehensive Guide to Economic Damages *from other books on damages?*

Nancy Fannon: This book has evolved from earlier editions that focused on lost profits. We saw that there was a lack of meaningful guidance on other types of damages, so we made the book more comprehensive in that it covers many kinds of damages. Also, both financial experts and attorneys wrote many of the chapters whereas either one or the other write most other books of this type.

Jonathan Dunitz: Yes, we always try to give both perspectives. For example, we have a new chapter on franchises that attorneys with a national practice in franchising wrote along with a financial expert their firm works with. Having chapters that financial experts and attorneys co-wrote gives the reader a unique perspective in that it connects the economics of damages to what the courts have to say about the calculations and evidentiary requirements. Damages calculations flow from the case law, so it is critical to have both perspectives.

BVU: *How will this book help the reader?*

NF: The book will help experts understand the appropriate remedy for a particular action, which is often misunderstood. The book contains a great deal of guidance as to when to use one remedy versus another. For example, many experts doing damages will use a lost profits approach that may or may not be the appropriate remedy. Also, there are a lot of nuances in calculating damages that some experts are not aware of, such as jurisdictional differences. The book contains very helpful guidance in this regard.

JD: From a litigation perspective, an important issue this book explains is the difference between preparing an economic analysis that will be used in court and preparing one that will not. Preparing a report for a damages analysis for litigation is not necessarily the same as performing other financial analyses such as a business valuation. Experts who do not understand the difference may find that their valuation report is not admissible in court.

NF: Also, the new edition helps improve the working relationship between the expert and the attorney. If an expert is highly knowledgeable about damage remedies and the context in which they are calculated, he or she can be much more helpful to the attorney in terms of the various options for remedies, given a particular context.

JD: I agree with that. The chapters on procedural matters and jurisdictional differences are a great help to make the expert-attorney relationship more effective. The expert needs to consult with the attorney at the outset concerning jurisdictional issues because, for example, some jurisdictions don't allow depositions, so that's important to know. There are also jurisdictional differences governing what damages are available and how certain damages are calculated.

BVU: *What are the major changes to this new fifth edition?*

NF: Eight chapters are either new or significantly revised or expanded (see sidebar). Some of the new chapters include trade secrets, apportionment in IP, right of publicity, and franchises. Also, a number of chapters have been completely updated, including one on motions to exclude financial experts and the chapters on personal injury and damages relating to wrongful death. The vast majority of the other chapters have been revised and brought up-to-date. In Volume 2, which is on case law, 100 cases have been added, bringing the total cases to about 340.

BVU: *What are you most excited about in this edition?*

NF: For me, the trade secrets chapter and the one on apportionment of damages in intellectual property (IP) are the most exciting. For trade secrets, there is a certain amount of guidance out there, but it is not very helpful, so I'm happy we were able to include a good chapter on that. There's almost no guidance available on the profit apportionment in IP infringement damages calculations, so I'm very excited that we were able to include that as well.

JD: I agree. For trade secrets, there's a significant amount of case law, but, for some reason, there's not much guidance available. The book's chapter on trade secrets is very helpful.

BVU: *Are damages for trade secrets difficult to calculate?*

JD: Yes, they are somewhat difficult to calculate. A trade secret, unlike a trademark, for example, is not registered, so the first step is establishing that a trade secret actually exists. The next step is to establish that the trade secret was used, misappropriated, and used improperly. Then you have to prove damages from the improper use, which can be calculated three different ways: (1) lost profits; (2) the profits generated by the improper usage (unjust enrichment); or (3) a reasonable royalty. The reasonable royalty method may be the appropriate method if you can't establish lost profits or unjust enrichment, but it can be difficult to apply.

NF: For the reasonable royalty method, you can refer to Chapter 26 in the book, which discusses reasonable royalty damages in patent infringement lawsuits. There are not a lot of comparable transactions for trade secrets, which makes this method somewhat challenging.

BVU: *You have a new chapter on the right of publicity. Why did you include that topic?*

NF: The right of publicity has become a significant issue, and it's a very interesting area. This is a form of intellectual property that covers an individual's likeness, including his or her name, image, signature, voice, and so on. It's an issue that often is overlooked because of a lack of awareness. This chapter is an example of our including as many discrete areas of damages as we can because it helps if experts specialize in some specific area of damages.

BVU: *Have you seen any overall trend in economic damages since the last edition?*

NF: The courts and experts have become much more knowledgeable about damages, so the bar has been raised in terms of what the courts are now asking for in terms of evidence. More than likely, the opposing expert will be much savvier than before.

BVU: *You mentioned specialization. Do you advise experts to specialize?*

NF: Yes, absolutely. A damages expert needs to specialize in a particular topic because, if you come up against one in a litigation setting, it could be devastating. For example, in a patent case, it's best to specialize in patent damages as opposed to being a general damages expert. In some cases, it may also be helpful to specialize in an industry or type of business, or at least be knowledgeable about the nuances of that industry.

JD: I agree. While the courts don't require you to be an expert in an industry, you will have a leg up if you are because you will know the specific issues relevant to that industry.

BVU: *If an expert does not have industry experience, should an industry expert be brought in?*

NF: Yes, I've advised attorneys to bring in an industry expert at times.

BVU: *Can we expect any live presentations on some of the topics in the book?*

NF: Yes. BVR will be doing a webinar series presented by some of the chapter authors.[2] That will be a good opportunity for the audience to ask questions of some of the most knowledgeable experts in the field.

[2] For the webinar schedule, go to sub.bvresources.com/conferences.asp.

For more information: *The Comprehensive Guide to Economic Damages*, 5th edition, is available at bvresources.com/products/the-comprehensive-guide-to-economic-damages-fifth-edition.

Sidebar: What's New in the 5th Edition of *The Comprehensive Guide to Economic Damages*

The 5th edition of *The Comprehensive Guide to Economic Damages* is in two volumes: Volume 1 is the main text, and Volume 2 is the case law text. Volume 1 contains seven parts (up from six in the last edition) as follows:

I. "Expert Testimony in the U.S. Courts";

II. "Lost Profits Damages";

III. "Damages in Specific Industry Settings";

IV. "Intellectual Property Damages";

V. "The Unjust Enrichment Remedy";

VI. "Personal Injury and Wrongful Termination"; and

VII. "Other Damages Analyses."

New chapters. The new chapters and authors in Volume 1 of the 5th edition are:

- Chapter 23, "Damages and Right of Publicity Infringements" (Audrey Wessel, Esq., and Mark Roesler, Esq.);
- Chapter 24, "Franchise and Dealership Litigation Damages" (Mark M. Leitner, Esq.; Joseph S. Goode, Esq.; and Ted Stockton);
- Chapter 27, "Trade Secret Damages" (Richard F. Bero, CPA/ABV, CVA, CLP, and Jon Margolies, J.D.);
- Chapter 31, "Profit Apportionment in Intellectual Property Infringement Damages Calculations" (Brian Buss, CFA, and Doug Bania, CLP);
- Chapter 35, "Economic Damages From Personal Injury and Wrongful Death" (James A. (Jim) Koerber, CPA/ABV/CFF); and
- Chapter 36B, "Calculation of Damages in Common-Law Employment Cases" (James A. (Jim) Koerber, CPA/ABV/CFF).

Extensive revisions. Many existing chapters have been updated, but Chapter 7, "Motions to Exclude Financial Experts" (Jonathan M. Dunitz, Esq., and Clifton T. Hutchinson, Esq.), has been extensively revised and expanded.

New cases. In Volume 2 (case law), 100 court cases have been added, bringing the total number of cases to over 300. *Note: Not all of the added cases are new per se—some of them are related to the new chapters.*

* * *

Industry Snapshot: Home Hospice Firms

Valuation experts faced with valuing a home hospice firm may think it is similar to other home health service businesses. While there are similarities, there are some material differences that can affect a valuation. Also, experts who have not done an engagement in this industry may think they are familiar with the term "hospice," but they may not know what it actually means, noted Darcy Devine and William Hamilton, who are both with Buckhead FMV, a firm located in Atlanta that is devoted to the healthcare industry. They conducted a webinar[3] and gave an overview of some main factors to consider when valuing a home hospice firm, which are summarized here.

Hospice is different from the rest of the healthcare industry in that its goal is not to treat or cure individuals, but rather to care for terminally ill individuals, making the process as comfortable as possible and providing support for not just the patient, but the patient's family as well. Hospice care kicks in for anyone certified as having six months or less to live. Some people use the term "palliative care" interchangeably with hospice care, but they are different. Palliative care essentially is pain management and is often part of hospice care, but not all palliative care is hospice care.

Background. The hospice market is fragmented, with many small independent players that are generally small businesses that are not associated with health systems. The majority have patient censuses of fewer than 50 patients. Some hospice firms are nonprofit organizations, but more than half of them are actually for-profit businesses. The number of hospices has grown from about 2,255 in the year 2000 to about 4,200 in 2015. The number of Medicare-certified hospices has almost doubled. There has been a huge growth in the number of people receiving the hospice benefit and in the amount of Medicare expenditures per year.

As for patient demographics, as you can imagine, a hospice business has an older patient base than other healthcare firms. Sixty-five percent are close to 80 years of age, and more than half are female. The average length of stay is around 69.5 days, which is a key statistic for valuation because Medicare reimburses hospice on a per diem basis. Of course, changes in the Medicare reimbursement amounts should be carefully monitored.

[3] Hospice Valuation: Trends, Value Drivers and Physician Compensation, BVR webinar, April 12, 2018 (available at sub.bvresources.com/bvstore/cd3.asp?pid=CD604).

A very small percentage of hospice firms have a brick-and-mortar inpatient facility, so this is not a capital-intensive business. It is very labor-intensive, with staff salaries representing about two-thirds of total operating expenses. When doing a valuation for a hospice business, you will notice that there a number of different employees or contractors: doctors, nurses, nurse practitioners, social workers, clergy, counselors, therapists, and a great many trained volunteers. These are not discretionary workers—hospice services require an interdisciplinary approach, and, in many cases, having these workers available is a requirement. Also, since the services are rendered off-site, there is a considerable amount of travel involved.

A few other overall observations:

- Hospice firms have operating margins of 8% to 9%, which look good compared to most other healthcare entities, so they are attractive M&A targets;

- All hospices must have a medical director, and all hospice patients must have 24/7 access to physician services;

- Management integrity is key because hospices (as all healthcare entities) are subject to a huge amount of federal and state regulations, such as anti-kickback rules, which the appraiser needs to understand;

- Hospices that operate in a Certificate of Need (CON) state would generally have a higher value;

- Fraud can be a major factor at hospice firms that fail to comply with the requirements for recertifying patients who pass the six-month mark—this can trigger stiff penalties; and

- Home hospice firms operate much like other home healthcare businesses, and some firms offer both types of services because the staff composition is similar, but hospice is a different product with different services, and possibly the reimbursements are not the same.[4]

Value drivers. The primary value drivers for a hospice business are:

- *Referral network:* This may be the most important value driver because physicians, nursing homes, hospitals, and others refer patients or the patients' families to the hospice. When valuing a hospice firm, examine the nature of the community's referring entities and the strength of the subject entity's relationships with those entities.

[4] See Chapter 39, "Home Healthcare Services," in the *BVR/AHLA Guide to Healthcare Industry Finance and Valuation*, Mark Dietrich, 2016 (available at bvresources.com/products/the-bvr-ahla-guide-to-healthcare-industry-finance-and-valuation-fourth-edition).

- *Marketing:* This is a very critical element for hospice providers, but this is the area where there is a material risk of fraud. Improper marketing tactics that amount to paying for referrals can be violations of the anti-kickback law. The risk is reduced if the marketers understand the compliance issues.

- *Competition:* Barriers to entry are an issue. There are requirements on the federal level (Medicare participation) and state level (operating restrictions, certificate of need requirements in some states). The existence of too many competitors is a problem unless the population density is such that there are enough people in need of hospice to go around.

- *Management:* A strong management team is a big differentiator for a hospice.

- *Labor market:* Because a hospice needs a variety of workers with different skills, a thin labor market will hurt revenue and cash flow.

- *Level of care:* There are four different levels of hospice care under Medicare: routine hospice care, continuous hospice care, inpatient respite care, and general inpatient care. However, 98% of the payments that Medicare makes for hospice are for the routine hospice care. The other three levels of care are reimbursed at higher levels, but they require far more resources to provide.

- *Demographics:* The cultural makeup of the service area may impact performance. Studies have shown that different ethnicities have different feelings about hospice and will not all embrace the concept to the same degree.

Valuation approaches. For the income approach, a few things to keep in mind:

- Roughly 90% of hospice revenue (reimbursements) comes from Medicare, which has been a steady, increasing income stream. Changes in the Medicare reimbursement amounts will have a direct effect on revenue.

- Expenses are concentrated in staff salaries (nurse-centric); all hospices must have a medical director, and Medicare requires physician coverage 24/7 (doctors are often independent contractors).

- Overall, the margins in the industry average somewhere around 8% and 9%; some of the larger for-profits that achieve a lot of scale can have margins as high as 20%, but some nonprofits and smaller hospices may be operating at a loss.

- For the discount rate, consider the risks embodied in the value drivers and the other factors indigenous to hospice firms; the fairness opinions for the merger of Almost Family and LHC Group, which touch on hospice, had ranges of 10.5% to 12% and 10.5% to 11.5%, respectively.

Here are some observations on the market approach:

- There are no pure-play hospice companies that are publicly traded (Chemed Corp. is close, but 30% of its revenue comes from Roto-Rooter); several have a mix of home health and hospice, such as Almost Family and Amedisys;

- The average transaction multiples for hospice operations are 1.2 (revenue multiple) and 8.0 (EBITDA multiple), based on recent transactions with publicly available pricing data;

- *DealStats* (formerly *Pratt's Stats*) and BIZCOMPS have data on home health firms, but some research will have to be done on your own (digging through press releases and other sources); and

- The size of the agency can have a significant impact on the valuation multiple, as smaller hospices typically sell for implied multiples of 4 to 6 times EBITDA, while regional and national hospice platform companies typically sell for 7 to 11 times EBITDA.

Because of the nature of the hospice-physician relationships, the fair market valuation and commercial reasonableness of the physicians' services are extremely important in light of the Stark and anti-kickback laws.[5]

Final observation. Hospices all operate differently, particularly in the way they use physicians. For example, some hospice physicians do all the face-to-face contact, and some do very few. Some hospices will have fewer physicians, but they will work more hours than is typical. In some markets, hospices will use many part-time physicians to provide the needed services. Because of this and other differences, you can expect that every hospice engagement will be unique.

* * *

Work File Checklist for the Tax Amortization Benefit

A tax amortization benefit (TAB) is the present value of income tax savings (benefit) resulting from the tax deduction allowed for the amortization of an intangible asset. When estimating the fair value of an entity or an intangible asset, the TAB (if any) should be considered.

Under the new requirements for fair value for financial reporting, valuation experts will be expected to have a certain amount of documentation in their work files. For holders of the new CEIV credential, a work file will be reviewed within the first year they receive the credential and then periodically after that. Those without the CEIV credential will be

[5] The webinar has more detail on this. Also, see the *BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements,* 2nd edition, Mark Dietrich, Timothy Smith, 2017 (available at bvresources.com/products/bvr-ahla-guide-to-valuing-physician-compensation-and-healthcare-service-arrangements).

expected to comply with the new requirements, which are designed as overall best practices. In other words, anyone doing fair value for financial reporting should comply with these new rules.

The new requirements are contained in the Mandatory Performance Framework (MPF), which is designed to make sure that the valuation expert adequately documents his or her work and thought processes. The guidance does not explain “how to” perform a valuation but rather “how much” documentation is required.

Practice aid. A work file checklist is a good compliance tool for what the MPF requires regarding all the different aspects involved in fair value measurement. Here, we give you a checklist for the TAB. The MPF explains that a TAB should be included only where appropriate, which is generally when estimating the fair value of an entity using an income approach for a presumed taxable transaction. The MPF gives some further explanation on the TAB.

Sidebar: Work File Checklist: Minimum MPF Requirements for the Tax Amortization Benefit

The valuation professional, at a minimum, must document the following in writing within the work file, if applicable:

- ☑ The valuation professional’s understanding of the market participant tax jurisdiction requirements to determine:
  - The appropriateness of the TAB;
  - The amortization method, whether a straight-line amortization method or an accelerated amortization method, can be used;
  - The tax amortization life of the intangible asset (under current U.S. tax law, a straight-line 15 years is used to calculate the TAB of the intangible asset and goodwill); however, an explanation should be provided when an assumption other than a straight-line 15 years is used (for example, in other tax jurisdictions); and
  - The rationale for the market participant tax rate.
- ☑ The rationale for selecting the discount rate used to estimate the TAB—whether it is the discount rate used to estimate the fair value of the intangible asset, the WACC, or another rate to estimate the TAB;
- ☑ The consideration of the TAB in either a taxable or nontaxable transaction when performing a discounted cash flow or internal rate of return analysis;

- ☑ The interaction with the WARA analyses (for example, pre-TAB versus post-TAB); and

- ☑ The consideration of the TAB in circumstances where foreign transactions are conducted and the TAB may or may not be applicable.

Be aware that these are minimum requirements, so more information may be necessary.

(*Source*: This checklist is derived from the document, "Application of the Mandatory Performance Framework for the CEIV." The information in this checklist has been summarized and adapted. See the actual document for additional explanation and requirements at ceiv-credential.org).

* * *

Work File Checklist for Discount Rates Applicable to Various Assets

Anyone doing fair value for financial reporting should comply with the new requirements that spell out the amount of documentation needed in work files. For holders of the new CEIV credential, a work file will be reviewed within the first year they receive the credential and then periodically after that. For those without the CEIV credential, they will be expected to comply with the new requirements, which are designed as overall best practices.

The new requirements are contained in the Mandatory Performance Framework (MPF), which is designed to make sure that the valuation expert adequately documents his or her work and thought processes. The guidance does not explain "how to" perform a valuation but rather "how much" documentation is required.

Practice aid. A work file checklist is a good compliance tool for what the MPF requires regarding all the different aspects involved in fair value measurement. Here, we give you a checklist for determining the appropriate discount rate or required rate of return to apply to each of the assets. This involves the analysis of an internal rate of return (IRR), weighted average cost of capital (WACC), and the weighted average return on assets (WARA). The MPF gives an explanation of this but is not designed to illustrate how to do the analysis.

We must point out that this checklist represents the minimum requirements, so more information may be necessary depending on the nature of the engagement.

Sidebar: Work File Checklist: Minimum MPF Requirements for Discount Rates Applicable to Various Assets

The valuation professional, at a minimum, must document the following in writing within the work file, if applicable:

- ☑ A rationale for the applicable market participant tax rate used to estimate rates of return for each asset;

- ☑ A rationale for the after-tax rates of return for each asset used in the WARA calculation;

- ☑ An explanation of any discrepancies between the WARA, IRR, and WACC; and

- ☑ All adjustments in the WARA calculation in the event of a nontaxable transaction.

The MPF states: "It is generally understood that the risk profile of an entity's assets tends to increase the further down the balance sheet they are listed." It also points out that the "rates of return are selected based on the risk and return characteristics of the asset being valued. Often, the rate of return estimated for working capital, land and net tangible fixed assets is less than the WACC and the rate of return estimated for intangible assets is greater than the WACC (although there are exceptions to this and the rate of return on the assembled workforce is often equal to the WACC)." Please read the applicable sections in the MPF documents for more information.

Source: This checklist is derived from the document, "Application of the Mandatory Performance Framework for the CEIV." The information in this checklist has been summarized and adapted. See the actual document for additional explanation and requirements at ceiv-credential.org.

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BVR to Launch New Platform for Estimating the Cost of Capital

Cost of equity options for business valuation will increase. BVR is releasing an additional resource for the profession. This new cost of capital platform will initially be available for free to all practitioners and supports BUM and CAPM calculations for any valuation date. BVR's intent is to provide a simple, independent service to augment each appraiser's own judgment and his or her other cost of capital research.

BVR is looking for user feedback during the free launch period (using CRSP market return data up to June 30, 2018). The platform will be available inexpensively with FY2018 data and beyond. New data will be added in March 2019.

BVU sat down with two of the individuals involved in the development of the new platform. Dr. Michael Crain has been a practitioner for over 30 years and is also an academic. He holds several professional certifications (CPA/ABV, CFA, CFE) and received his Doctor of Business Administration (finance) degree from Manchester Business School in England at the University of Manchester. Dr. Crain is a faculty member at Florida Atlantic University and director of FAU's Center for Forensic

Accounting and continues to consult with clients as a senior advisor to Miami-based Kaufman Rossin, a top-100 accounting firm.

Ronald L. Seigneur, ASA, CPA/ABV, CVA, is managing partner of Seigneur Gustafson LLP CPAs, based in Lakewood, Colo., where he is responsible for financial forensics, economic damages assessments, business and intellectual property valuation, exit planning, and related litigation support services. He is a frequent speaker and author on valuation, economic damages, leadership, and other professional firm practice management topics and is in the AICPA Business Valuation Hall of Fame.

BVU: *Why does the profession need a new platform for estimating the cost of capital?*

Michael Crain: We've reached the point where the concept and the inputs to cost of capital have become so complex that the risk of making errors has increased. Finance is not a physical science; it's a social science. Tools of physical science and mathematics are probably being incorrectly applied, and the process has become too much of a black box of applied mathematics. Mathematics should be used as a tool in practice. It should be a means to an end, not the end itself. Focusing too much on math results in an "illusion of precision" that moves us away from using judgment in the process. You can't program professional judgment.

Ronald Seigneur: The new platform is designed to bring back flexibility to the process, i.e., we give you the raw materials, and you use your judgment to shape the final result. You are not steered into a particular way of doing something. The platform will have certain default options, but you have the freedom to decide whether or not to use those options. We're not using enough common sense anymore when it comes to cost of capital, so this platform brings more of that back into the process.

MC: We also feel that the ability to use a solution such as this should be affordable to all and not just bigger firms. Some solutions in the market have become very costly, particularly for smaller firms.

BVU: *Will the new platform address all of the components of the build-up method and CAPM?*

MC: Yes. You will be able to develop the components either from data provided to practitioners or from their own input. In addition to using CRSP data from the University of Chicago, there is access to data Dr. Aswath Damodaran, at New York University Stern School of Business, developed. The cost of equity capital platform provides information on risk-free rates, equity risk premiums, size premiums, and industry considerations.

RS: There is also a place for you to input company-specific risk so that you can develop a complete estimate for the cost of equity. For CAPM, the platform does not provide a beta, but there is a link to Dr. Damodaran's data from which you can develop it.

BVU: *How does the new platform reduce the complexities of estimating a firm's cost of capital?*

MC: We use the "less is more" approach to think about cost of capital and required returns in simpler, rather than more complex, ways. It embodies the idea that cost of capital estimates are just that—estimates—and are not precise calculations to the nth decimal. We cannot actually observe investor expected returns (cost of capital) because investor expectations are unobservable. Even if we could observe them, they change quickly because of news. Instead of observation, practitioners use models to estimate, not calculate, cost of capital. Since ancient times, prominent scientists and philosophers have stressed the importance of simplicity in explaining things. This idea is called the principle of parsimony, or Occam's razor. This principle essentially says that simpler solutions tend to be better than complex ones. This idea also stresses signal over noise. Our platform tries to collect signal, filter out noise, and give a better solution. Complicated mathematics may appear scientific, but it can very easily create noise and give the illusion of precision.

RS: The platform is based on the fundamental approach from the SBBI series that was used for many years. The new platform relies on the Center for Research in Security Prices (CRSP) market return data set, which is the most respected and widely used basis for 10-decile returns in practice and academia. The use of CRSP data has stood the test of time in a litigation setting where testifying experts are required to use reliable methods and principles. Also, because the process is less complex, it is more transparent. As a result, you don't have to spend a lot of time explaining your methodology choices to clients or judges.

BVU: *If you use a simpler approach, will someone spend less time developing a valuation?*

MC: Perhaps, but that's not the goal here. The new platform will help refocus your attention on where it needs to be in the valuation equation, i.e., you will spend less time on the denominator, which includes cost of capital, and perhaps more time on the numerator, the cash flows.

RS: Even though this is a simpler, more fundamental approach, the bottom line is that this new platform is elegant. It gives you everything you need without all of the noise that other tools provide.

BVU: *The profession already has solutions for estimating the cost of capital. Why would anyone consider this new platform?*

MC: For the reasons we just talked about—and more. A major reason is that firms that are offering the other solutions also provide valuation services. This is a clear conflict of interest because, if you try to define the process or create complicated rules for estimating cost of capital—and you are profiting from it—there is no incentive to consider challenges to it based on newer findings. This discourages change and

innovation. The solution other platforms provide also steers you into using the opinions of the provider, which may not have any independent academic basis. The new platform is based on academic research, not someone's spin on the data or opinion of what is "normal."

RS: Also, the solution provider you are currently using may be your competitor, which could make for a very uncomfortable position in a litigation setting.

BVU: *You say a solution a player in the game provides could steer you into its way of thinking. Can you give an example?*

MC: The size premium, for example. Some feel it is alive and well, and that opinion will be embodied into their computer algorithm for estimating cost of capital. Others believe the size premium has diminished or disappeared, but it depends on the time horizon of the data you use. If you look at the last 35 years, since Banz first documented the size premium in 1981, the size effect is very different than if you go all the way back to the 1920s. Our new platform gives you the control over the period of historical return data for your analysis. You can choose which time horizon (e.g., specific historical years) of data is appropriate for your case.

BVU: *What is the next step in the development of this new platform?*

MC: In early November, BVR will make the new platform available for use on a free-trial basis and then available with subscription options shortly thereafter. We encourage feedback, and we will review the comments along with input from an advisory board.

RS: The advisory board will be made up of independent professionals and practitioners who are known for their experience with cost of capital. In the coming months, we will provide more information on the details of the new platform and the thinking behind it. There will be further articles in *BVU*, a user's guide, FAQs, webinars, and other information. In the meantime, BVR has set up a special webpage with more information at bvresources.com/COCplatform.

* * *

Major Changes Enhance the 2018 Edition of *Mergerstat Review* of M&A Activity

The 2018 edition of *Mergerstat Review* has a number of important changes, including updates to historical data, new tables that show premiums paid over the targets' enterprise values, a change to industry categories, better defined foreign seller ownership roles, and the inclusion of "transaction value" instead of base equity price.

Mergerstat Review is an annual publication (with monthly updates) that presents compiled statistics relating to U.S. and cross-border mergers and acquisitions that involve both publicly traded and privately held companies. Data on M&A announcements and purchase prices are presented annually and quarterly, for the

current period and historically, including details on individual deals and trends in prices, methods of payment, multiples, and premiums.

BVU spoke with BVR's Kenny Woo, who oversees the publication of the *Mergerstat Review,* to explain the new changes.

Historical updates. "This is the first year we have been able to update historical data," says Woo. BVR was given full access to the FactSet Mergers M&A data feeds, which allowed BVR to update 20 years of M&A data that capture new and updated transaction data not included in prior editions. Also, FactSet improved its data collection and was able to gather more data than it could for previous editions. "For example, if you look at the year 2000 in the 2017 edition, you'll see 9,566 M&A transactions, but, in the 2018 edition, you'll see 13,098 transactions," says Woo. "The benefit is that users now have more accurate and complete historical data as well as updated trend analyses, multiples, and premiums." The 2018 *Mergerstat Review* is the first edition to feature historical updates, he pointed out. Past editions are relevant because they captured the M&A market from a point in time, but, starting with the 2018 edition and going forward, transaction data will be updated.

Premiums over EV. New to the 2018 edition is additional content that is reflected in several new tables that focus on premiums paid over the enterprise values of the target firms. "This is in response to requests BVR received from users of the guide," says Woo. Transaction premiums still feature the premium paid for the targets' share prices five days prior to the announcement, but now several tables focus on premiums paid over the targets' enterprise values. The data now take into consideration the fact that not all comparable companies have the same capital structure. The new tables added are:

- Table 1-25, which features premiums over enterprise value categorized by deal size;

- Table 1-26, which focuses on the premiums paid comparing public to private buyers, where, for the first time in five years, private buyers paid a higher premium than public buyers; and

- Tables 2-10 and 2-11, which feature the average and median premiums paid over the enterprise value and are analyzed by year and by sector.

Category changes. FactSet has replaced the 40-plus category Mergerstat industry classifications with its 20-category industry sectors, Woo explains. For FactSet Mergers database subscribers, the sectors are now aligned with FactSet's database screening taxonomy when searching for transactions either in the *Mergerstat Review* or the online database. "Mapping is provided to match the selected SIC code with the relevant FactSet sector," says Woo. The mapping is located on page 361 of the guide.

Foreign sellers. There is now a clearer definition to foreign seller ownership roles, Woo points out. In prior editions, seller ownership roles were classified as either public, private, divestiture, or foreign. The 2018 edition breaks down the seller ownership into two groups: (1) domestic transactions: public, private, and divestiture; and (2) foreign transactions: public, private, and divestiture. Foreign ownership roles can be seen in the context of foreign—public, foreign—private, and foreign—divestiture.

Transaction value. The guide now details the purchase price of transactions as the "transaction value" price rather than the base equity price, notes Woo. Transaction value includes the assumption of debt, when applicable. It excludes transactions in the finance sector, where selling companies have debt-heavy balance sheets. The switch was done to better reflect the debt associated with the purchase, he says.

We must point out that recent guidance[6] on control premiums for financial reporting purposes indicates that it cannot be automatically assumed that premiums paid in prior transactions give an indication as to a premium for control that may apply to your subject business. Historical transactions, such as those reported in *Mergerstat Review,* should definitely be considered, but appraisers must be careful when simply relying on historical data regarding premiums paid to determine a control premium. Also, while the new guidance is in the context of financial reporting, it may be relevant for valuations in other contexts.

For more information on the 2018 edition of *Mergerstat Review,* there are FAQs and additional information at bvresources.com/products/factset-mergerstat-review-2018.

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Work File Checklist for the Reconciliation of Intangible Asset Values

Anyone doing fair value for financial reporting should comply with the new requirements for the amount of documentation needed in work files. For holders of the new CEIV credential, a work file will be reviewed within the first year they receive the credential and then periodically after that. For those without the CEIV credential, they will be expected to comply with the new requirements, which are designed as overall best practices. The Mandatory Performance Framework (MPF) contains the new requirements and does not explain "how to" perform the work but rather "how much" documentation is required.

Practice aid. A work file checklist is a good compliance tool for what the MPF requires regarding all the different aspects involved in fair value measurement. Here, we give you a checklist for the reconciliation of intangible asset values. The MPF states: "In the valuation of intangible assets, most often only one approach or method is used. In the event a valuation professional uses multiple approaches as part of the analysis, the

[6] Valuation for Financial Reporting (VFR) Valuation Advisory #3: The Measurement and Application of Market Participant Acquisition Premiums, The Appraisal Foundation.

valuation professional must reconcile the various approaches into a supportable and reasonable conclusion of value." The MPF contains further discussion of this.

Sidebar: Work File Checklist: Minimum MPF Requirements for the Reconciliation of Intangible Asset Values

The valuation professional, at a minimum, must document the following in writing within the work file, if applicable:

- ☑ The aggregate projections and cash flows of the entity with a description of who prepared them (for example, management, subcontractor, third-party specialist, valuation professional);

- ☑ In a business combination, an IRR analysis, comparison to the WACC, and any changes to PFI resulting from this analysis;

- ☑ The WACC, its derivation, and sources of information;

- ☑ The results of the WARA compared to the results of the WACC, including any commentary about significant or relevant observations based on the valuation professional's professional judgment;

- ☑ Reconciliation of the results of the WARA and results of the WACC, if applicable (Important: If these cannot be reconciled, the work file must include documentation of the steps and analysis the valuation professional undertook that illustrate the attempted reconciliation and include an explanation about why the disparity exists);

- ☑ Evaluation of a subject's goodwill value as a percentage of the purchase price to market data (if available). This provides an indication of whether or not the subject company's asset values are in line with broad marketplace expectations. This should include:

  - ☑ A narrative about the results and whether the results are contrary to or supportive of the analysis; and

  - ☑ The name of sources of information for analysis of goodwill relative to the other assets acquired and to total transaction value.

- ☑ Discussions of any apparent underpayments or overpayments for the entity. In the event of an underpayment, valuation professionals should document their discussion with the company and auditor, if relevant, confirming that it is management's responsibility to assess whether a bargain purchase exists.

We must point out that this checklist represents the *minimum* requirements, so more information may be necessary depending on the nature of the engagement.

(*Source*: This checklist is derived from the document, "Application of the Mandatory Performance Framework for the CEIV." The information in this checklist has been summarized and adapted. See the actual document for additional explanation and requirements at ceiv-credential.org).

* * *

Letter to the Editor: Calculation Engagements and USPAP

Editor's note: BVU *published several articles on calculation engagements in the July 2018 and November 2018 issues as well as in BVR's Free Resources section of its website. This letter is in response to those articles.*

You have recently published articles presenting positions on whether calculation engagements (as discussed in the AICPA Statement on Standards for Valuation Services No. 1) are ever appropriate and, if so, under what circumstances. As a part of those articles, statements have been made about whether the Uniform Standards of Professional Appraisal Practice (USPAP) allows calculation engagements. This letter is submitted to briefly comment on USPAP's treatment of this issue. A longer article on the topic will be submitted for inclusion in a future edition.[7]

Calculation engagements can be completed under the Scope of Work Rule of USPAP. However, following are a few brief comments to elaborate on that statement.

USPAP emphasizes that it is the *appraiser's responsibility* to determine whether a reduced scope of work for an assignment (such as a calculation engagement) is appropriate for the intended use of that assignment's results. Whether or not it is appropriate for a given assignment would be dependent on what could be referenced as "best practices" (although that is not the terminology of USPAP). The recently published articles appear to be a debate regarding what our profession considers best practices under certain circumstances.

Also, USPAP requires that:

- The scope of work completed be sufficient to determine assignment results that are "credible"[8] in the context of their intended use;

- The scope of work not be limited in a way that creates biased results; and

[7] This letter does not represent the official position of the Appraisal Standards Board (the board that writes USPAP) or of The Appraisal Foundation. Carla Glass was on the Appraisal Standards Board when the Scope of Work Rule was written. Jay Fishman is the only other living business valuation professional who has served on the Appraisal Standards Board. However, neither of these people is currently on the Appraisal Standards Board.

[8] The word "credible" has a specific meaning within USPAP.

- The report provided not be misleading.

Carla G. Glass, CFA, FASA
Managing Director, Marcum LLP

Jay E. Fishman, FASA
Managing Director, Financial Research Associates

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***BVWIRE* Q1 2019 CONTENT**

Calculation Engagement Value Holds Up in Alabama Divorce Litigation

Many valuators are adamantly opposed to doing calculation engagements. Among other concerns, they fear that nonvaluators, including judges, may not recognize the critical differences between a valuation engagement and a calculation. The critics argue that a valuation engagement, if done right, adheres to standards of independence and reliability. In contrast, a calculation engagement is not only easier to do, it is more profitable. But an Alabama divorce case shows that judges may well be attuned to the differences between the two types of valuation and that a calculation engagement can provide meaningful guidance to the court under the right circumstances.

The parties in this divorce proceeding contested the valuation of the husband's dental lab. The husband served as his own valuation expert. The wife retained a CPA who was a certified valuation and financial forensics analyst. The expert worked pursuant to a calculation engagement. The husband and his counsel attacked the expert at various stages of the trial, arguing, among other things, that he had conducted the "wrong" type of valuation. He had submitted a valuation pursuant to the more lenient requirements of a calculation engagement as opposed to the more "thorough and accurate" valuation engagement. Counsel spent a great deal of time developing evidence as to the difference between the two types of valuation.

The attacks were unsuccessful. The trial court found the expert used "methods recognized and accepted by [the] accounting industry for accountants conducting 'calculation engagements.'" Also, simply because a "more arduous or accurate method (valuation engagement) exists does not preclude the Court's consideration of [the expert's] findings." The court pointed out that the husband did not present evidence that directly contradicted the expert's findings for the relevant years. "And the Husband did not employ his own expert or pay the increased fee to [the expert] to conduct the more rigorous 'valuation engagement.'"

The appeals court affirmed. It said the trial court duly had noted that the expert's value determination conformed to a calculation engagement rather than a valuation engagement. This factor went to the weight of the testimony but did not disqualify the estimate from consideration by the trial court. The appeals court also found the SSVS

approved of the capitalization-of-earnings method, which the expert had used. The husband left the trial court with no credible valuation evidence other than the calculated estimate by the wife's expert, the reviewing court said.

A digest of *Rohling v. Rohling,* 2018 Ala. Civ. App. LEXIS 94 (June 1, 2018), as well as the court's opinion, is available at *BVLaw.*

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Lively Talk Re: ABV Controversy

Several discussion threads on the BVR LinkedIn page take up the decision by the AICPA to open up the ABV credential to non-CPAs. One commenter says that in his 20 years of practice he has found that clients are not very astute about BV credentials and has rarely been asked what credential he has. For those clients who are clued in, they would be able to distinguish a CPA/ABV from an ABV, he feels. Other commenters have had different experiences with clients and their perception of credentials. Some of the points made by commenters:

- Adding non-CPAs to the ABV increases supply while demand stays the same, putting downward pressure on price;

- The BV profession is too fragmented and needs one professional organization to be the voice of the profession;

- It's "naïve" to think that trade groups such as the AICPA don't have a business model that may require them to take steps in the interest of survival that some existing members will disagree with; and

- CPAs may not be the best ones to provide BV services, says one commenter who reminded the group that CPAs as "trusted advisors" were behind big accounting frauds, bank collapses, and myriad other disasters (leading one responder to ask, "Why not blame CPAs for climate change and the collapse of Western civilization?").

Extra: The Virginia State Society of CPAs has sent a letter to the AICPA suggesting an open dialogue on the issue for the next council meeting; other state societies have sent letters. The NYSSCPA's August *CPA Journal* includes the article, "Is the ABV Credential For Sale?"

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Valuation of Private Company Stock for Donations

Chris Mellen (Valuation Research Corp.) reports a marked increase in demand for valuations of shares of privately held companies before an M&A transaction in

connection with a charitable gift. He's written an article on wealthmanagement.com that discusses a strategy for donating stock pending a sale.

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CPA Firms Ramp Up Social Media

Accounting firms of all sizes plan to increase their use of social media, according to the 2018 Marketing and Business Development Strategies at Accounting Firms study. Sole practitioners (47%) and firms with 11-50 persons (59%) ranked social media as the top marketing tool they will be increasing. The study (available for purchase) is by Capstone Marketing and Bay Street Group and is published by CPA Trendlines.

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Marijuana Practice Concern

Some practitioners who want to break into the legal marijuana industry may be concerned that marketing to this audience could negatively influence the more mainstream industries they serve. *Consider this:* Create a different brand name for your new industry vertical, advises an article on marketing to cannabis clients.

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The Effect of Shareholder Lawsuits on Cost of Equity

A firm may see adjustments to its cost of equity capital either at the time a shareholder lawsuit is filed or when the outcome of the lawsuit is determined—or both—says a new paper by **William J. Moser** (Miami University). At the time of filing, if "the probability of a favorable outcome for the firm (dismissal or win) is relatively higher, the effect of the shareholder lawsuit on firm ex ante cost of equity capital is low," the paper says. "In contrast, a high probability of a settlement or a loss for the firm results in a greater increase in firm ex ante cost of equity capital." When the case is resolved, firm ex ante cost of equity capital adjusts only when the final resolution is different from initial probability estimates. The paper is "The Reaction of Firm Ex Ante Cost of Equity Capital to Initiation and Resolution of Shareholder Lawsuits."

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How to Earn the ASA's BV Credential in Just 90 Days

Experienced valuation experts who hold certain designations with other appraisal organizations can earn the BV credential from the American Society of Appraisers within 90 days under the ASA's reciprocity arrangements. This was explained during a free ASA webinar on how experienced valuers can attain the ASA's BV credential. For example, a person holding the CPA/ABV designation with five years of BV experience

would only have to take an ASA ethics exam (one day), pass a 15-hour USPAP course and exam (in-person or online on demand), and submit a valuation report for review. The report review can take 90 days at most but is often much less. For more details on which designations qualify for reciprocity, you can go to the ASA's BV Accreditation Guide or listen to a recording of the free webinar (BV184-WEB - Understanding the ASA BV Application and Accreditation Process) which will soon be available on the ASA website.

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Global BV News: New Research on Global Risk Premiums and Risk-Free Rate

"Market Risk Premium and Risk-Free Rate Used for 59 Countries in 2018: A Survey" is the latest research from **Pablo Fernandez**, **Vitaly Pershin**, and **Isabel Fernández Acín**. The authors found that the change between 2015 and 2018 of the average Km (Rf + MRP) used was higher than 1% for 22 countries. Also, most of the respondents use for European countries a Rf higher than the yield of the 10-year government bonds. To download the entire survey, click here.

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Article Sparks Calculation Report Controversy

Some valuation experts are of the opinion that calculation engagements are not a good thing for the profession. For example, **Michael Paschall** (Banister Financial Inc.) says in an article that the increasing use of calculation engagements "seriously compromises" historical valuation standards of reliability and independence. He feels that the dangers of calculation engagements are that they are being offered in contexts for which they were never intended, are prone to bias, and confuse users who don't know the difference between a calculation and a full valuation.

Opposing view: During a BVR webinar, **Jim Alerding** (Alerding Consulting LLC) made the case for calculation engagements and discussed AICPA guidance on this matter, which he co-wrote. Also, Alerding, along with **Jim Hitchner** (Valuation Products and Services) and **Ed Dupke** (Dupke Consulting LLC), wrote a rebuttal article giving what they say is the "real" story of calculation engagements.

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Biz Brokers Love the Market Approach

People who regularly buy and sell businesses rely on the market approach much more than traditional valuation experts when valuing a company. One broker, who is also a credentialed valuation expert, first looks to transactional data and, if there are enough comps, does his valuation with that approach before using the income approach as a sanity check. **Lance Schmidt,** CVA, CBI, CBB, and a former CPA, is the president of

National Business Appraisers (Mission Viejo, Calif.) and is a valuation expert as well as a business intermediary and business broker with 30 years of experience in both valuation and M&A or sales of businesses including a specialization in auto dealership valuations. He's in the *Pratt's Stats* Hall of Fame for business intermediaries who have contributed the most transactions to the database.

Good data: How many comps are enough? "If you have six or seven solid comps, then it's sufficient, in my opinion," says Schmidt. Of course, they have to be relevant, he points out, so you have to consider factors such as the time frame of the transaction. One idea he offers is to talk to the broker who submitted the data to make sure the comp is relevant. If the comps turn out to be not as solid as you thought, can you still use the data? Yes, says Schmidt, but in a different way. The data can be used as a benchmark that can be refined using certain techniques.

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Working Capital Disputes in M&A Transactions

In 2016 and 2017, over 80% of purchase price adjustments in M&A transactions involved working capital adjustments, according to "SRS Acquiom's 2018 Deal Term Study." The purchase and sale agreement (PSA) commonly includes a purchase price adjustment provision to address differences between the target working capital the buyer expected at the time the PSA is signed and the working capital the buyer received at closing. Disputes often arise between the buyer and the seller as to the proper determination of the working capital based on the closing balance sheet. An article by **Jeff Litvak,** senior managing director, and **Jason Tolmaire,** senior director, both with FTI Consulting, explains how working capital is calculated, how working capital is included in the purchase price, and how disputes arise in the calculation of working capital.

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Royalty Rate Data Sources

In an article by **Robert Reilly** and **Casey Karlsen** of Willamette Management Associates, a number of sources were mentioned for identifying arm's-length intellectual property royalty rate data. The sources mentioned are: ktMINE, RoyaltySource, RoyaltyRange, RoyaltyStat, IntangibleSpring, and Markables. The article, which appeared in *les Nouvelles,* the journal of the Licensing Executives Society, is titled "Intellectual Property Valuations for License and Other Transfer Purposes Part 1."

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Agenda Released for 2019 AAML/BVR National Divorce Conference

The agenda is now available for the National Divorce Conference to be presented by BVR and the American Academy of Matrimonial Lawyers (AAML) in Las Vegas, May 8-10, 2019. Leading matrimonial attorneys and financial experts will give you critical insights in sessions covering financial, valuation, forensic, and legal issues surrounding this growing area of practice.

The conference will be at the Aria Resort and Casino, and there's an early-bird discount if you register before December 31. You can register if you click here. We hope to see you at this unique event.

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Global BV News: Overview of New Rules in India

The Institute of Chartered Accountants of India (ICAI) released a set of valuation standards known as Indian Valuation Standards (confusingly with the same acronym as the International Valuation Standards, "IVS"). **Rajesh C Khairajani,** a valuation partner at Indé Global, wrote an article that provides an overview of the new standards. Indé Global is a member firm of KNAV International Limited, a U.S. firm.

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Readers Comment on Calculation Report Controversy

Are calculation engagements a good thing or bad thing for the valuation profession? In last week's issue, we presented two articles: one urging valuation experts to avoid calculation engagements like the plague and a rebuttal article that disagrees with this view. You can read the two articles if you click here.

Two camps: The comments we've received so far fall on both sides of the table: Some say they don't belong in the valuation expert's toolbox, and others say they have a rightful place.

"With all due respect to the authors of the rebuttal article, a calculation of value can never be used in a USPAP engagement because all USPAP engagements involve an appraisal, which is defined in USPAP as an 'opinion of value.' USPAP scope of work is irrelevant," one commenter says. "The resulting work product from a calculation of value is the issue; it is simply a calculated result and not an opinion of value. Therefore, a calculation of value has no place in situations where an opinion is needed, such as situations where a USPAP engagement is required and trial work in litigation."

"Calculation engagements could be used in much the same analogy as compilation engagements are to audit engagements," says another commenter. "Not everyone has the funds to [spend] up to $25,000 for a small-business valuation. Instead, analysts are called on to provide an experienced third-party assessment of the calculation value of a company."

One commenter had a few choice words about the AICPA guidance on this matter. “It is unfortunate that the authors of the AICPA [guidance on] calculation reports use the term ‘value.’ The Appraisal Foundation and ASA should have objected to the use of that term, which is proprietary to the appraisal industry,” he says, suggesting that the term “calculated amount” should be used instead. “The term ‘calculated value’ is misleading to the users of these reports and it misrepresents the role of the author.”

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Private-Company Performance Up Over Last Year

The value of the private companies in the Carta 100 Index has jumped 60.3%, to 252.36 (as of Sept. 10, 2018), since Carta began tracking firms on June 30, 2017. Carta, a technology firm that helps other companies manage their equity shares held by various owners, is using data it has collected to create what it calls “the most thorough measurement of U.S. private companies’ performance.”

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D&P: Latest Multiples in Healthcare Services

The S&P Healthcare Services Index increased 6.3% over the last month, outperforming the S&P 500, which increased 3.0% over the same period, according to the “August 2018 Healthcare Services Sector Update” from Duff & Phelps. Over the past month, the best performing sectors were: consumer-directed health/wellness (up 17.0%), government managed care (up 15.8%), and HCIT (up 13.0%). The poorest performing sectors were: specialty managed care (down 9.1%), hospital vendors (down 6.5%), and healthcare staffing (down 4.9%). The current average LTM revenue and LTM EBITDA multiples for the healthcare services industry overall are 2.42x and 15.4x, respectively.

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How Valuation Experts Estimate DLOM

Restricted stock studies and pre-IPO studies remain the most cited methodologies for quantifying a discount for lack of marketability (DLOM), according to the results of our DLOM survey. Seventy-five percent of respondents (compared to 76% in our 2016 survey) use restricted stock studies, and 38% (down from 43% in 2016) use pre-IPO studies.

Other DLOM methods and tools cited include: Johnson/Park empirical method (Partnership Profiles) (32%), restricted stock equivalent analysis (19%), Finnerty study (18%), Longstaff study (13%), Chaffee study (12%), Pluris data (11%), and quantitative marketability discount model (QMDM) (11%). Thirty-nine percent of respondents use the Stout Restricted Stock Study (formerly FMV Opinions), and 14% of respondents

cited the VPS DLOM Guide and Toolkit. Respondents were allowed to choose more than one method or tool.

Other results:

- Nearly all (92%) of the respondents quantify separate discounts for a minority interest and lack of marketability when the valuation requires both; and

- Three quarters of the respondents say that they "routinely" consider the 10 *Mandelbaum* factors in determining DLOM. Of all the factors, "restrictions on transferability" and "amount of control in the transferred shares" are the two most cited factors considered. The factor least cited was "costs associated with a public offering."

We received 96 responses to the survey, which was conducted from September 19 to September 28. We'll have more results in next week's *BVWire,* and we will prepare a document with the full results that will be available to everyone. Thank you for your participation!

* * *

Rebuttal to Calculation Report Comments

In last week's issue of *BVWire*, we included some comments from readers about two articles (see "Calculation Report Controversy" link) we posted, one of which urges valuation experts to stay away from calculation engagements and a rebuttal article that disagrees with some of the points made. **Jim Alerding** (Alerding Consulting LLC), who recently conducted a webinar with BVR on the matter and is one of the co-authors of recent AICPA guidance, has responded to some of the comments we received.

Reader comment: "(A) calculation of value can never be used in a USPAP engagement because all USPAP engagements involve an appraisal, which is defined in USPAP as an 'opinion of value.' USPAP scope of work is irrelevant."

Alerding responds: "I would suggest your commenter take this issue up with **Carla Glass** (Marcum LLP) and **Jay Fishman**(Financial Research Associates), both of whom have made clear that the scope of work rule does indeed allow a scope under USPAP that would result in a calculation (the rebuttal article contains citations)."

Reader comment: "Therefore, a calculation of value has no place in situations where an opinion is needed, such as situations where a USPAP engagement is required and trial work in litigation."

Alerding responds: "I am not sure what the commenter is referring to, but the only time that a USPAP engagement is 'required' by law is in real estate transactions. In business valuation engagements (which is what the SSVS calculation engagement applies to),

there is no requirement for a USPAP engagement. The ASA requires that USPAP be followed in all of their business valuation engagements, but that is not a legal requirement. In fact, the ASA has a calculation engagement as part of its business valuation standards. Finally, the assertion that in litigation a calculation engagement is not appropriate is up to the trier of fact and not up to USPAP, the ASA, or the AICPA. There are cases where calculation engagements have been accepted by the courts."

Reader comment: "It is unfortunate that the authors of the AICPA [guidance on] calculation reports use the term 'value.' The Appraisal Foundation and ASA should have objected to the use of that term, which is proprietary to the appraisal industry."

Alerding responds: "The word 'value' is used throughout the appraisal and business valuation 'industry.' To suggest that the word or term 'value' is proprietary simply does not make sense. It is obviously in the public domain. Consider the term fair market *value.* Consider that Revenue Ruling 59-60 discusses the determination of fair market value. Under the commenter's assertion, perhaps the IRS should have the proprietary use of the term. Further, note '[t]he objective of a calculation is to provide an approximate indication of value' from the ASA BVS-I ASA BV standards. The ASA was, by far, the first group to allow a calculation. The quoted language calls the result of a calculation a 'value.'"

"The bottom line is that the calculation engagement is a fact of the SSVS and also a fact of the ASA," says Alerding. "As to the SSVS, I doubt it will be eliminated, although that is my personal opinion."

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Analysis of Appraisal Rights

An analysis that compares appraisal rights in the U.S., France, and Romania is in the *University of Pennsylvania Journal of Business of Law.* Why is Romania included? The country apparently has a robust appraisal regime. "We selected these three countries because they are representative of strong, average, and weak capital markets, respectively, with varying levels of shareholder activism and litigation (high, normal, and low, respectively)," say the authors.

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'Do Private Equity Firms Pay for Synergies?'

That's the title of a paper that analyzed the pricing of 1,155 global PE buyouts and found "strong support" for a valuation effect from buy-and-build strategies. "Our results indicate that PE sponsors pay a premium of up to 47% at entry when the portfolio company acquires add-ons in the same industry within a two-year time window after the buyout," say the authors.

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Global BV News: IVSC Member Developments

A number of member-related developments at the International Valuation Standards Council (IVSC) are worthy of note. The Abu Dhabi government is the first emirate in the UAE to officially adopt International Valuation Standards (IVS) to its new rules and regulations for land and property valuations. Also, several new members have joined:

- Shanghai Orient Appraisal Co. (China)—corporate member (the first in mainland China to join the IVSC);
- Alforsa Real Estate (Bahrain)—corporate member;
- Government of Ajman, Department of Land and Real Estate (UAE)—institutional member;
- Bosnian and Herzegovinian Property Association—associate VPO member;
- The Institute of Company Secretaries of India—institutional member;
- Australian Institute of Business Brokers—associate VPO member; and
- Rwandan Institute of Real Property Valuers—associate VPO member.

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New Jersey Adopts Key *Daubert* Factors for Expert Admissibility Determination

In an important ruling, the New Jersey Supreme Court took a big step toward *Daubert* but failed to embrace it completely. The ruling arose out of a civil mass tort action against the maker of Accutane, a prescription drug for acne. The plaintiffs alleged a causal connection between the drug and Crohn's disease. The first lawsuits began in New Jersey in 2005. Since then, a number of epidemiological studies have found no such connection. However, the plaintiffs' experts rejected the studies and, relying on other facts and data, contended a causal connection can be shown. The trial court found the experts' methodology flawed because the experts did not interpret the relevant data and apply them to the facts of the case as other experts would. The appellate division reversed, and the defendants asked for review by the high court. Among other things, they wanted the court to clarify the expert witness standard, which meant deciding "whether the *Daubert* standard's factors would further elucidate our own standard for the admissibility of expert testimony." The court's short answer was: "We believe that they would."

By way of background, the state Supreme Court pointed out that it was "in the vanguard of courts" that decided to switch from the "general acceptance" standard for testing the

reliability of scientific expert testimony to a methodology-based approach. Two years later, the U.S. Supreme Court, with its *Daubert* decision, did the same. But, even though the state's civil standard and the federal standard "moved in the same direction and toward the same goal," New Jersey "never adopted *Daubert* or incorporated the factors identified in *Daubert"* for the trial court's use when performing its gatekeeper role, the New Jersey high court explained.

The court's ruling reconciled the state standard for the admission of expert testimony with the federal *Daubert* standard. "We are persuaded that the factors identified originally in *Daubert* should be incorporated for use by our courts," the high court said.

At the same time, the New Jersey Supreme Court stopped short of declaring New Jersey a "*Daubert* jurisdiction." The court said it "hesitate[d] to embrace the full body of *Daubert* case law as applied by state and federal courts," noting the "discordant views about the gatekeeping role among *Daubert* jurisdictions." Moreover, the court said it would adhere to the general acceptance test for reliability in criminal matters.

The New Jersey Supreme Court concluded that in the case at bar the trial court engaged in rigorous gatekeeping when it asked whether the scientific community would accept the methodology the plaintiffs' experts employed and would use the underlying facts and data as they did. The trial court's exclusion of the plaintiffs' experts was well supported and well-reasoned, the high court said.

The case is *In re Accutane Litig.*, 2018 N.J. LEXIS 988 (Aug. 1, 2018).

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New York Times Serves Up Scathing Look at Appraisers in Trump Exposé

"Friendly" valuations are the main characters in a brilliantly written and fascinating article in the *New York Times* about President Trump's involvement in "dubious tax schemes" and "outright fraud" to increase the fortune he received from his father. The extensive investigation by the *Times* revealed that manipulated real estate appraisals and sham companies were used to transfer the elder Trump's wealth to Donald and other heirs while slashing estate and gift taxes to the bone.

Big discounts: One of the many techniques the article describes was the splitting up of the elder Trump's real estate empire into two grantor retained annuity trusts (GRATs): 49.8% going to father Fred Trump's GRAT, 49.8% into the mother's GRAT, and the remaining 0.4% split up among their four children (including Donald). The real estate assets were undervalued and then discounted by 45% because each parent was now a minority owner and the assets were subject to a marketability discount. This plus other maneuvers added up to the transfer of $1 billion in wealth to children taxed at a rate of just 5%—not the 55% federal rate that was in effect at the time.

The article makes it a point to say that "appraisers can arrive at sharply different valuations depending on their methods and assumptions" and they have been known to "massage those methods and assumptions in ways that coincide with their clients' interests." Of course, attorneys and CPAs were also involved in these shady dealings, which, for the most part, got past the IRS.

> *Extra:* Last week, BVR conducted a webinar, Agree to Disagree: Perils of Bias in Valuation, that explores the key assumptions that create significant deviations between appraisers and potentially expose bias.

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'Benchmark Average' Approach Dominates for DLOM

The use of restricted stock studies is the most cited methodology for quantifying a discount for lack of marketability (DLOM), according to the results of our DLOM survey. Of those who use this methodology, about two-thirds say they use the "benchmark average approach," while the other third say they use the "restricted stock comparative analysis approach (RSCAA)."

Red flag: Is the benchmark average approach an in-depth analysis? The court in one case said this: "[The valuation expert] simply lists the average discounts observed in several such studies, effectively asking us to accept on faith the premise that the approximate average of those results provides a reliable benchmark for the transferred interests." [*Peracchio v. Commissioner*, T.C. Memo. 2003-80 (Sept. 25, 2003)]

The late Tax Court Judge Laro spoke on this topic and said that more analysis is needed on data that must be current. The analysis should tie the restricted stock study to the characteristics of the subject company. The most widely used restricted stock transaction database is the Stout Restricted Stock Study (formerly FMV Opinions), which is updated quarterly. The database (used by 39% of survey respondents) includes the Stout Calculator, which embodies the RSCAA, and is driven by the financial characteristics of the subject company as well as the volatility of the market.

We received 96 responses to the survey, which was conducted from September 19 to September 28. We'll have more results in next week's *BVWire,* and we will prepare a document with the full results that will be available to everyone. Thank you for your participation!

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S Corp Group Comments on Section 199A Proposed Rules

In August, the IRS issued proposed regulations explaining the new tax law's "qualified business income" (QBI) deduction for pass-through entities (PTE) that will impact all business valuations. IRC Code Section 199a allows a 20% write-off of QBI for sole

proprietors, owners of S corporations, and members of partnerships/LLCs. The S Corporation Association has submitted comments that are positive overall about the proposed rules. “Treasury made a good-faith effort to get the new regime right,” the association says in a statement. “But with any new proposal this big, there are lots of details to work out, and the S-Corp comments include a number of recommendations as to how Treasury can improve the final rules.”

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Global BV News: Global Industry Betas for 3Q2018

BVR offers a free download of *Industry Betas for the Third Quarter 2018*, which contains global levered and unlevered betas for 134 industries and “regional” betas for 10 geographical areas (including North America, the EU, and Western Europe). The data are from Salvidio & Partners, a Rome, Italy-based business valuation firm headed by **Ascanio Salvidio.**

The report is distinctive in that it combines industry and geographical perspectives and also features two separate series of levered and unlevered betas. The first series includes levered and unlevered betas estimated for any selected company, regardless of whether its gross debt is higher or lower than its cash and cash equivalents. The second series excludes “net liquidity” to represent companies where “decisions taken by management, all other circumstances being equal, may be different in case of the company’s gross debt being higher or lower than cash and equivalents,” according to Salvidio.

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Congressional Members Accuse DOL of Undermining ESOPs

As reported by the ESOP Association, in a letter to the White House dated October 1, 27 members of Congress (including one who identified as a CPA) have voiced serious concerns about the DOL’s “investigatory and enforcement policies toward Employee Stock Ownership Plans (ESOPs).” The signors ask the president to intervene in a show of support for American businesses and workers.

The letter notes the important role employee-owned companies have played in the American economy and the role ESOPs have played in enabling employee ownership. Research has shown that employee ownership firms coped with the past two recessions better than conventionally owned companies, the letter says. It claims that, pre- and post-recession, ESOP-owned companies have performed better than private U.S. firms generally. It also maintains that DOL filings show that companies contribute substantially more to ESOPs than non-ESOP companies contribute to 401(k) retirement plans.

The concern is over the DOL's enforcement policies, which the signors say, undermine ESOPs. The congressional members accuse the DOL of not providing substantive guidance on valuation and other important issues and of taking inconsistent positions on legal issues. Although it is the DOL's place to go after bad actors, the department's investigatory approach "is having a destabilizing effect," the signors say. The fear is that no one will want to serve as a plan fiduciary.

The letter relates anecdotes that it claims show the DOL's overstepping its mandate by threatening ESOP companies with extended investigations and lawsuits. According to the letter, these "tactics" began under the former administration but have continued under the present government. They are taking a toll on small businesses, the letter warns.

The signors ask the president to assist in persuading the DOL to work with the ESOP community to develop guidance on valuation and other key issues and to make the DOL halt its current "controversial oversight practices."

Criticism of the DOL position vis-a-vis ESOPs has come from other corners as well. As we reported in connection with the pending appeal of the *Brundle* case, the American Society of Appraisers (ASA) also expressed strong opposition to the DOL's ESOP-focused enforcement projects. In its amicus brief on behalf of the ESOP trustee, the ASA says the DOL policy has given rise to lawsuits "in which a plaintiff submits a blanket accusation, without factual knowledge, that ESOP fiduciaries breached their duties … and violated prohibited transaction rules because they relied upon an appraisal that allegedly resulted in the ESOP's overpayment for the shares it purchased." The ASA expressed unequivocal support for the *Brundle* ESOP trustee and ESOP appraiser.

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Management Pressure on Fair Values

A new research paper documents several tactics management employs to inflate its fair value measurements based on in-depth interviews of Norwegian audit partners and company valuation specialists. The paper also provides evidence on how audit teams interact with company specialists and how company specialists view the work of auditors and auditor specialists. "The findings indicate that auditors' lack of valuation knowledge and auditor specialists' lack of asset-specific expertise lead to deficiencies in their understanding of how assumptions used in FVMs are interrelated and result in auditors focusing on the minutia of the individual assumptions at the expense of a 'big picture' view," the paper states.

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***EOU:* Small Biz Optimism at Record High**

Small-business optimism reported at a record high of 108.8 points, according to the August 2018 *Economic Outlook Update (EOU)*. Consumer confidence is also high—it rose to 133.4 points, its highest level in 18 years. Other highlights from this edition: The Leading Economic Index increased 0.4%, to 111.2 points; housing starts surged 9.2% in August and are 9.4% higher than one year ago; PMI increased 3.2 percentage points, to 61.3 points, recording the highest score since May 2004; and the Producer Price Index declined 0.1%, marking the first decline in a year and a half. The *Economic Outlook Update* is issued monthly and quarterly. You receive permission to use the material and data it reports in your valuation reports (with proper attribution).

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Partner Valuation Issues in MLPs

An article by **Jim Hanson**, managing director in the transaction opinions practice at Duff & Phelps, looks at the relationship between general partner and limited partner interests in master limited partnerships (MLPs). "While there are many ways to look at the relative valuation of an MLP's GP and LP, from simple to complex, it is important to be aware of the dynamics when evaluating MLP transactions," the article states.

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ASA Advanced BV Conference

BVWire attended the Joint ASA 2018 Advanced Business Valuation and International Appraisers Conference in Anaheim, Calif., and the sessions and networking events were excellent. **Ray Rath** (Globalview Advisors) chaired the BV portion of the conference, and ASA international president **Bob Morrison** (Morrison Valuation & Forensic Services LLC) welcomed the crowd. He thanked veteran appraiser **Lee Hackett** for serving as interim CEO while a search is underway for someone to fill the post permanently.

Jeff Tarbell (Houlihan Lokey), the chair of the ASA's BV Committee, gave an update on the committee, which is a group of appraisers who share a common interest in advancing the BV profession. The committee consists of industry leaders who volunteer their time toward several primary efforts. One is the development and delivery of best-in-class business valuation education. Another effort is the advancement of the profession through the establishment and endorsement of professional standards such as the ASA Business Valuation Standards, USPAP, and IVS (the global standards from the International Valuation Standards Council). This reflects the move toward serving the large and growing international marketplace of BV professionals with high-quality and timely education. We noticed that the conference was well-attended by professionals across the globe, including Saudi Arabia, Romania, Japan, China, and other countries.

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Global BV News: Revised Standards for Mineral Valuations

The International Mineral Valuation Committee (IMVAL) has released the third edition of its standards for minerals, including oil and gas. IMVAL's history goes back to discussions in Brisbane in April 2012 to harmonize the mineral valuation codes, such as VALMIN (Oceania), SAMVAL (South Africa), and CIMVal (Canada). It also looked to include, where appropriate, International Valuation Standards (IVS) and the U.S. Uniform Standards of Professional Appraisal Practice (USPAP), as they contain valuation standards of general application to mineral property valuation.

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Florida Supreme Court Negates Legislature's Adoption of *Daubert*

In 2013, the Florida legislature amended the Florida code, section 90.702, dealing with expert testimony, to incorporate the *Daubert* standard in the state's rules of evidence. In a recent ruling, the state's Supreme Court found the legislature had overstepped its authority, declared the amendment unconstitutional, and reinstated the *Frye* standard.

The validity of the *Daubert* standard arose in the context of a personal injury case in which the plaintiff claimed the defendants' products exposed him to asbestos that caused his illness. Following a *Daubert* hearing, the trial court admitted the plaintiff's experts testifying regarding causation. A jury awarded the plaintiff $8 million in damages. The appeals court struck the award, finding the trial court did not properly exercise its gatekeeping role when it allowed the expert testimony into evidence.

The plaintiff petitioned the state Supreme Court for a determination of whether the 2013 legislative change on expert testimony infringed on the high court's rule-making authority. The Supreme Court said it did.

The high court explained that the state constitution prohibited one branch of government from infringing on the authority of the other branches. The court explained that generally the Florida legislature has authority to make substantive law, but the Supreme Court has the power to make procedural law. Section 90.702 as amended in 2013 was not substantive in that it did not create or regulate a right, the state high court explained. Importantly, the high court explained, the recent legislative amendment also conflicted with the existing approach for determining the admissibility of expert testimony.

"*Frye* and *Daubert* are competing methods for a trial judge to determine the reliability of expert testimony before allowing it to be admitted into evidence," the high court said. It explained that *Frye* relied on the scientific community to assess reliability, whereas *Daubert* "relies on the scientific savvy of trial judges to determine the significance of the methodology used."

"With our decision today, we reaffirm that *Frye*, not *Daubert*, is the appropriate test in Florida courts," the court's majority said, sending the instant case back to the appeals court for reinstatement of the final judgment.

In a concurring opinion, one judge noted that *Daubert* limited access to courts. Where *Frye* only applied to testimony based on a new or novel scientific theory, *Daubert* applied to all expert testimony. More litigants risked having their expert testimony excluded under *Daubert*, the concurring judge said. Also, *Daubert* saddled trial judges, "who typically do not possess the requisite training or experience in the expert's field," with the responsibility of assessing admissibility, the concurrent opinion observed.

Three judges dissented on technical grounds.

The case is *DeLisle v. Crane Co.*, 2018 Fla. LEXIS 1883 (Oct. 15, 2018).

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AICPA Council Nixes Request to Suspend ABV Change

At a meeting of the AICPA's governing Council, members voted in favor of continuing to implement an earlier decision to expand eligibility for the Accredited in Business Valuation (ABV) credential to non-CPAs, according to a report in the *Journal of Accountancy*. A number of prominent CPA/ABVs attended the meeting to persuade the Council to take action that addresses their concerns and criticisms (spelled out in an Open Letter to the AICPA). Critics wanted the Council to: (1) suspend the change to the ABV criteria; (2) consider input from stakeholders and have the Council revote; and (3) if the AICPA still wants to issue a valuation credential to non-CPAs, a second credential should be created separate from the ABV. Following a panel discussion that included participants both in favor of and against the change, Council members voted against suspending the decision and re-examining the issue. This clears the way for other qualified professionals who are not CPAs to be allowed to qualify for the ABV credential.

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Takeaways From the ASA Advanced BV Conference

BVWire attended the Joint ASA 2018 Advanced Business Valuation and International Appraisers Conference in Anaheim, Calif., and the sessions and networking events were excellent. Here are a few takeaways from just some of the sessions we attended:

- The Big Four firms are holding off on the new CEIV credential for fair value for financial reporting pending the resolution of quality control issues regarding the inspection process;

- When testifying in court, you face a number of preconceived notions, including the strong perception of being a “hired gun,” so make it absolutely clear you’re being an advocate for your opinion, not an advocate for the client;

- Valuation experts can’t be all things to all people, so specialize either in an industry or area of valuation (e.g., estate and gift, ESOPs, intangibles, etc.);

- At the start of a purchase price allocation engagement, talk with company management about what it sees as the overall value drivers of the firm;

- When doing a valuation of a company that rents space, spend time examining the lease, particularly the lease term, renewal options, and leases with related parties; to get market rent, some states require a broker’s price opinion;

- Pay particular attention to control issues in ESOP valuations—did the ESOP actually get the control it paid for? (DOL doesn’t like the term “control premium”);

- The major concern of the move to “retail health” is the effect on brand value;

- Startups are looking more to Hong Kong for funds—the listing rules have changed there concerning prerevenue companies; and

- Prospective financial information (PFI) deserves much more scrutiny than it has been given.

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Willamette’s *Insights* Looks at Fair Value

The Fall 2018 issue of *Insights* from Willamette Management Associates is titled “Thought Leadership in Valuation for Fair Value Measurement Purposes” and is edited by **Terry G. Whitehead.** Some of the articles are: “The Valuation and Reporting of Contingent Consideration in Business Combinations” (**Charles A. Wilhoite** and **Lisa H. Tran**), “The Market Participant Acquisition Premium for Fair Value Measurement” (**Timothy J. Meinhart**), “Fair Value Valuation of Identifiable Intangible Assets in the Acquisition Accounting of a Business Combination” (**Robert F. Reilly**), and more.

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Access to Capital Improves for Small Firms

According to the Pepperdine Graziadio Business School and Dun & Bradstreet Q3 2018 Private Capital Access Index, small businesses are finding it easier to acquire capital. Just over half (53%) of the small businesses surveyed said they were successful in securing a loan in the past three months. “Small businesses, especially Main Street businesses, have turned a corner and banks have taken notice,” said **Nalanda Matia**,

lead economist at Dun & Bradstreet, in a release. “Funding is flowing to smaller enterprises who are in growth mode.” The report also found that 75% of businesses expect their business to perform better in 2018 compared to 2017 and 84% are confident their business will grow. However, small businesses are now facing a new challenge in attracting and retaining a quality workforce. You can access Pepperdine’s reports if you click here.

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Global BV News: Global Intangible Value Soars; Most Undisclosed

Global intangible value has surpassed $50 trillion for the first time in history, reaching $57.3 trillion at the beginning of the current financial year, according to the latest “Brand Finance Global Intangible Finance Tracker” report. This constitutes 52% of the overall enterprise value of all publicly traded companies worldwide, which now amounts to an equally record-breaking $109.3 trillion, exceeding the US$100 trillion mark also for the first time.

The report reveals that 76% of the world’s intangible value ($43.7 trillion) remains unaccounted for on balance sheets. Undisclosed intangible value has grown by a whopping 25% year on year (it was at $35.0 trillion last year). This rate is five times faster than the value of disclosed intangible assets (up 5%), and it has outpaced by far the overall global enterprise value growth (up 18%).

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BVR Christens New Platform for Estimating the Cost of Capital

The Cost of Capital Professional is the name chosen for BVR’s new, simple, independent service for estimating the cost of equity. The new platform is designed to bring more professional judgment and common sense back into the process, which has become too much of a complex “black box” of applied mathematics. It supports the build-up method and CAPM calculations for any valuation date and will be available in early November on a free-trial basis using CRSP market return data up to Sept. 30, 2018. Later, the platform will be available with a subscription and will contain FY2018 data and beyond. New data will be added in March 2019.

More flexibility: “The new platform is designed to bring back flexibility to the process,” says **Ron Seigneur** (Seigneur Gustafson LLP CPAs), one of the developers of the Cost of Capital Professional. “We give you the raw materials, and you use your professional judgment to shape the final result. You are not steered into a particular way of doing something. The platform will have certain default options, but you have the freedom to decide whether or not to use those options. We’re not using enough common sense anymore when it comes to cost of capital, so this platform brings more of that back into the process.”

Seigneur and **Dr. Michael Crain** (Florida Atlantic University), a co-developer of the platform, gave an interview to *Business Valuation Update,* and you can read it if you click here. You can sign up for the free trial of the Cost of Capital Professional if you click here. BVR is looking for user feedback during the free trial period.

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Hot-Button Issues at BV Firms Large and Small

In the days before the recent Joint ASA 2018 Advanced Business Valuation and International Appraisers Conference in Anaheim, Calif., the ASA held various classes as part of its accreditation process. *BVWire* attended the BV203 class, which focused on the asset approach as well as discounts and premiums. As an interesting aside, the course instructors, **Rob Schlegel** (Houlihan Valuation Advisors) and **Bill Quackenbush** (Advent Valuation Advisors), asked class participants—who were from Big Four firms as well as small firms—to identify some key issues their companies were concerned about. Here are the issues they identified:

- The new fair value credential (CEIV). Smaller firms are waiting to see what the Big Four do in terms of credentialing their people.

- Contingent consideration. The Appraisal Foundation will issue a revised draft (or final version) of the Valuations in Financial Reporting (VFR) exposure draft on Valuation of Contingent Consideration.

- One large firm is seeing more debt-related valuations.

- Private equity and venture capital. A final draft is in the works of the AICPA accounting and valuation guide to PE/VC.

- Audit conflicts—concerns when doing valuation work for a client when the firm is also doing the audit work. Valuation “consulting” may not cause a conflict.

- Troubles with the narrative when writing valuation reports, i.e., linking the numbers to the story of the company.

- Management succession, i.e., disruption if a key person leaves—there’s a shortage of quality people.

- Brexit—a class participant from the London office of a large firm says it’s causing an “evaporating client base.”

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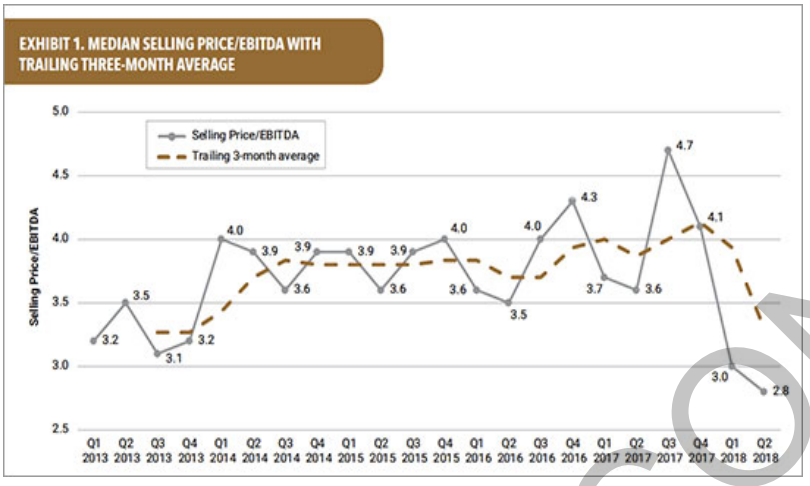
Private-Company EBITDA Multiples Down Sharply in 2Q18

In the second quarter of 2018, EBITDA multiples (median selling price/EBITDA) for private companies plummeted to 2.8x, the largest decline reported in recent years, according to BVR's *DealStats Value Index (DVI).* The relatively steady trailing three-month average trend line from the third quarter of 2014 through the first half of 2017 (see graphic) gave no clear indication that large fluctuations in multiples paid would ensue in the quarters ahead. From the third quarter of 2017 to the present, EBITDA multiples have trended down. EBITDA multiples across all industries were highest over a five-year period in the third quarter of 2017, at 4.7x.



The *DealStats Value Index (DVI)* summarizes valuation multiples and profit margins for private companies that were sold over the past several quarters. The *DVI* is a quarterly newsletter and is complementary with a subscription to *DealStats*. If you are a subscriber to *DealStats*, you can download the current issue to see all the latest transaction trends if you click here.

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More on Florida's Decision Re: *Daubert*

As we reported last week, the Florida Supreme Court recently invalidated a 2013 legislative amendment that required courts to use the *Daubert* standard to assess the admissibility of expert testimony. **Dr. Michael Crain** (Florida Atlantic University) says the high court's ruling "marks a clear break of Florida courts from federal courts." It means that, in state court, testifying experts are subject to the *Frye* standard, whereas, in federal court, expert testimony is subject to the *Daubert* requirements, Crain explains. "For forensic accounting expert witnesses, this likely means their work will be scrutinized less in Florida cases compared to federal cases," Crain says. As he sees it: "Neither evidence standard is perfect. In the end, fairness to the parties concerns the courts. Fairness is about more than evidence quality." Crain's analysis of the high court ruling may be found here.

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Damodaran Eyes Cannabiz

Excited investors are rewarding new companies in the legal marijuana industry with large market capitalizations, according to **Professor Aswath Damodaran** (New York University Stern School of Business) in a blog posting. The cannabis market will be a "big one," he says, with conservative forecasters predicting that global revenues from marijuana sales will increase to $70 billion in 2024, triple the sales today. In terms of investing, he sees potential in indirect players in the market, such as Scott's Miracle-Gro and GW Pharmaceuticals (producing cannabis-based drugs for epilepsy and multiple sclerosis). The professor adds this caveat to his posting: "I have never smoked marijuana, but, on my daily walks on the boardwalks of San Diego, I have been inhaling a lot of second-hand smoke, leaving me a little lightheaded as I write this post. So read on at your own risk!"

> *Extra:* BVR offers several resources for business appraisers who are valuing firms in the cannabis industry, including *The State of Legal Marijuana Markets* and *The Cannabis Industry Appraisal and Accounting Guide.*

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ASA to Give Credit for iiBV Courses

The American Society of Appraisers (ASA) will recognize and give credit as having fulfilled the education requirements toward ASA accreditation to students who successfully complete iiBV courses delivered in all languages. The iiBV (International Institute of Business Valuers) has completed license agreements with the Saudi Authority for Accredited Valuers (TAQEEM) and the National Association of Valuers of Serbia (NAVS) to enable those organizations to deliver iiBV business valuation courses and examinations in Arabic and Serbian, respectively, that the ASA will accept as fulfilling the education requirements for accreditation. The iiBV courses are originally based on the ASA Principles of Valuation courses and have been modified for international valuation, accounting, and economic and legal considerations. The iiBV said in a release that it is continuing to expand its curriculum of courses and to deliver these courses both in-class and online.

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***From the Vault:* Origin of the Market Approach**

When doing research using *BVResearch Pro,* you may stumble on some very interesting things in addition to what you're specifically looking for. For example, we were researching a topic under the market approach, and, in the search results, an article, "The Valuation Profession—A Brief History," written by **James Catty,** popped up that traced the concept of value back to Plato and Aristotle, who believed that the value of an object was created by and existed only in the mind of man. "Res tantum valet quantum vendi potest" is a quote from Roman philosopher Seneca (c. 4 B.C.-65),

paraphrasing Aristotle, which means: “A thing is worth only what someone else will pay for it.” “This can definitely be considered the origin of the market approach,” Catty writes. “To a large degree, Aristotle’s view is still relevant today both for taxes and financial reporting, where, however, at various times, the term ‘value’ can take on different meanings.”

BVResearch Pro has over 10,000 articles, publications, legal digests, webinar transcripts, white papers, and more from the world’s foremost thought leaders in business valuation.

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Global BV News: TEGoVA to Develop European BV Standards

Delegates of The European Group of Valuers’ Associations (TEGoVA) voted in favor of developing European Business Valuation Standards (EBVS), according to a report. These standards will be tailored to the needs of real estate valuers who also undertake business valuations as well as real estate valuers seeking to diversify into the field of business valuation. TEGoVA will develop training programs for real estate valuers who wish to develop business valuation skills. A committee of business valuation experts within the ranks of TEGoVA’s members will draft the EBVS in the coming months. The report did not mention that the new standards would include or be based on International Valuation Standards (IVS) from the IVSC. TEGoVA is a European nonprofit association composed of 72 valuers’ associations from 37 countries representing more than 70,000 valuers in Europe.

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Board of Advisors Shapes Up for BVR’s New Cost of Capital Platform

Experts from the who’s who of the business valuation world have joined the advisory board for BVR’s Cost of Capital Professional (CCP), the new independent service for estimating the cost of equity. The co-chairs of the advisory board are **Ron Seigneur,** managing partner at Seigneur Gustafson LLP CPAs, and **Adam Manson,** director of valuation data at Business Valuation Resources. The current members of the advisory board are:

- **Nancy Fannon** (Marcum LLP);
- **Jim Hitchner** (Financial Valuation Advisors/Financial Consulting Group LLC/ Valuation Products and Services LLC);
- **Harold Martin** (Keiter);
- **Chris Mercer** (Mercer Capital);

- **Dave Miles** (ValueSource);
- **Chris Rosenthal** (Ellin & Tucker);
- **Keith Sellers** (University of Denver);
- **Chris Treharne** (Gibraltar Business Valuations); and
- **Jim Reto** (Kaufman Rossin).

The Cost of Capital Professional is designed to move away from a complex "black box" of applied mathematics and bring more flexibility, professional judgment, and common sense back into the process. It supports the build-up method and CAPM calculations for any valuation date and is available on a free-trial basis using CRSP market return data up to Sept. 30, 2018. Later, the platform will be available with a subscription and will contain FY2018 data and beyond. New data will be added in March 2019. To sign up for the free trial, click here.

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Business Valuations Need to Preserve the Human Element

"If we remove the human element, our valuations will be nothing more than computer-generated nonsense," writes **Robert E. Kleeman Jr.** (OnPointe Financial Valuation Group LLC) in *Business Valuation Update*. Kleeman, who has been in the BV world for over 40 years, says a lot has changed, including more of a reliance on data and a move away from using judgment, common sense, and reasonableness. "The one thing I can state has not changed is the need for practitioners to use their mental capabilities," he writes. "Data are data. They must be converted into something usable to produce a valuation conclusion. The data and conclusion must be reasonable. The valuation professional must use his or her judgment in many areas of the engagement." His article, "A Veteran Valuer Looks at the BV Profession," gives his perspective on some other issues, including the danger of formulas, the state of BV training, and "credential madness." The article is in the August 2018 issue of *Business Valuation Update*.

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Damodaran Criticizes Netflix's Business Model

A *New York Times* article delves into the astonishing growth of Netflix, the video streaming service, and names **Professor Aswath Damodaran** as one of the few analysts who doubt the company's business model is sustainable. When talking to investors and business analysts, the company touts its ability to attract viewers around the world and expresses confidence that, in the foreseeable future, Netflix's willingness to assume more debt to finance its growing original content will pay off.

But Damodaran and a few of other "Netflix skeptics," as the *Times* calls them, remain unpersuaded. Damodaran's discounted cash flow analysis shows a serious disparity between revenue and money spent on new content. As Damodaran sees it, Netflix shares, which have been trading at around $310 per share recently, are worth no more than $177 per share. Other analysts agree, calling Netflix's stock price "baffling" and noting how, until now, the company has been unable to match costs and cash flow. Considering the number of competitors with deep pockets that are ready to develop and market content, Netflix's stock price is poised to fall, these analysts predict. A classic case of price vs. value?

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New *Forbes* List Points Up Right of Publicity Issue

When a celebrity passes away, a large chunk of value in the estate may come from the "right of publicity," which is a form of intellectual property that covers an individual's name and likeness. Typically, public interest in a celebrity increases after death, a phenomenon that gave birth years ago to the remark "good career move," uttered by some callous folks in show biz. Be that as it may, the trend continues, evidenced by the *Forbes* list of "Top-Earning Dead Celebrities for 2018," which puts **Michael Jackson** in the No. 1 spot once again, with earnings of $400 million over the past year.

Pending case: Valuation experts are anxiously awaiting the outcome of the Jackson estate case in Tax Court in which the estate and the IRS came up with widely divergent estimates for the value of the pop star's name and likeness. Hopefully, the case will provide some guidance on this matter. Since Jackson died in 2009, his estate has raked in $2.4 billion in earnings, according to *Forbes.* His estate holds other income-producing assets, so not all of this revenue is from his name and likeness. Estates of other celebrities, such as **Aretha Franklin,** are also grappling with this issue, but not all states recognize a posthumous right of publicity.

A new chapter in the *Comprehensive Guide to Economic Damages,* 5th edition, examines the right of publicity, which is not limited to celebrities. A notable case involved a kindergarten teacher who was awarded $15.6 million over the unauthorized use of his image by Nestle on labels of Taster's Choice coffee.

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Home Health and Hospice M&A Activity Soars

For three quarters in a row, there have been at least 20 publicly announced acquisitions of home health or hospice companies, a much higher quarterly volume than during most of 2017, according to new data from HealthCareMandA.com(Irving Levin Associates). Private equity-backed home health companies were the most prolific buyers in the third quarter. During a BVR webinar, healthcare valuation experts **Darcy Devine** (Buckhead FMV) and **Will Hamilton** (Veralon) explained that hospice firms (that also often include

home health) enjoy operating margins of 8% to 9% compared to the smaller margins of most other healthcare entities, which makes them attractive M&A targets.

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EOU: Solid Growth in U.S. Economy

The Leading Economic Index increased 0.5% in September, coming in at 111.8 points, the 12th consecutive month of gains, according to the September 2018 *Economic Outlook Update*(*EOU*). This upward momentum suggests that "solid growth in the U.S. economy will remain through the rest of the year and into 2019," the report says. Consumer confidence remains high—it rose to 138.4, its highest level since September 2000. The *Economic Outlook Update* is issued monthly and quarterly. You receive permission to use the material and data it reports in your valuation reports (with proper attribution).

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Global BV News: KPMG Germany Releases 2018 Cost of Capital Study

This year's study from KPMG includes 276 companies: 216 from Germany, 30 from Austria, and 30 from Switzerland. Among the findings: the average WACC across industries is 7% (same as the past three years); the average risk-free rate increased from 0.9% to 1.3%; and the market risk premium "remains almost stable," at 6.5% (Germany), 6.7% (Austria), and 5.9% (Switzerland). To download a copy of the study, which has much more information, click here.

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New Tax Law Gets the Spotlight at the AICPA FVS Conference

BVWire attended the AICPA Forensic & Valuation Services Conference November 5-7 in Atlanta where there were a number of good sessions on the Tax Cuts and Jobs Act (TCJA), which impacts "everything" in valuation. Overall, speakers were surprised at the lack of guidance from the IRS as compared with prior tax law changes that were followed up with an abundance of guidance. One speaker called it an "eerie silence" as practitioners grapple with understanding the new law's many provisions.

More due diligence: Speakers all agreed that it is now necessary to have more consultative conversations with management over its plans in light of the new law changes that overall will increase a company's cash flow. But not all of this extra cash will go to the bottom line. The company may increase wages, accelerate capital expenditures, invest in R&D, and the like. Are these plans reflected in the projections you get from management? Will the company change its capital structure? For fair value purposes, do these plans translate into what market participants might do? These are just some of the questions to think about.

Here are a few more takeaways, and we'll have more coverage here in the *BVWire* and in a future issue of *Business Valuation Update:*

- The IRS is expected to follow a strict interpretation of the rule that eliminates the deduction for alimony payments that becomes effective December 31; that is, a marital settlement agreement must be approved by the court—not just agreed to by the parties—before that date for the alimony to be deductible;

- There will likely be many disputes over what was "known or knowable" if you have a valuation date between the dates President Trump was elected and when the new tax law was passed; some will factor in a pre-enactment expectation into their valuations;

- Although the tax effects of certain provisions extend more than five years out, you can still do a standard five-year DCF and use separate analysis modules (bolt-ons) for the cash flow effects of those provisions;

- Consult with a tax attorney over how the new law applies to your subject company; for example, is the company a "service" business with respect to the new QBI deduction for pass-through entities?

- There are a number of industries that get special tax breaks under the new law; and

- Don't lose sight of the notion that, overall, companies are more valuable under the new tax law.

Extra: Attendance at this year's conference was about half of what it has been in recent years, partly due to the boycott by ABVs over their opposition to the AICPA's decision to open up the ABV credential to non-CPAs.

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FAQs Posted for New Cost of Capital Platform

A set of FAQs for BVR's Cost of Capital Professional (CCP) has been added to the webpage that explains the new independent service for estimating the cost of equity. The Cost of Capital Professional is designed to move away from a complex "black box" of applied mathematics and bring more flexibility, professional judgment, and common sense back into the process. It supports the build-up method and CAPM calculations for any valuation date and is available on a free-trial basis using CRSP market return data up to Sept. 30, 2018. Later, the platform will be available with a subscription and will contain FY2018 data and beyond. New data will be added in March 2019. To sign up for the free trial, click here.

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New Paper Finds Scant Evidence of a Size Effect

"The bottom line is that after addressing the facts and fictions of the size effect, we find neither strong empirical evidence nor robust theoretical support for a prominent size premium." That's the conclusion of a new paper by **Ron Alquist** and **Ronen Israel** (both with AQR Capital Management LLC) and **Tobias J. Moskowitz** (Yale University). The size effect is the phenomenon that "small" stocks (i.e., those with lower market capitalizations) on average outperform "large" stocks (i.e., those with higher market caps) over time, on average. Some of the facts and fictions they examine are:

- *Fact:* The size effect has disappeared or weakened since its discovery;
- *Fiction:* The size effect is robust to how you measure size;
- *Fact:* The size effect mostly comes from microcap stocks;
- *Fiction:* The size effect is likely more than just a liquidity effect; and
- *Fact:* The size effect receives disproportionately more attention than other factors with similar or much stronger evidence.

Although this paper backs up other academic research, there is still confusion and debate about the size effect, the authors say. "We examine many claims about the size effect and aim to clarify some of the misunderstanding surrounding it by performing simple tests using publicly available data."

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Alternative Payment Models in Healthcare

A significant impact on the revenue picture for healthcare providers is coming from alternative payment models, such as value-based payments and bundled payments. An article in the ABA's *Health Lawyer*, "Understanding Alternative Payment Models and Related Regulatory Issues," reviews value-based contracting models between payers (government payers and commercial payers) and providers and discusses the relevant legal, regulatory, and valuation issues arising under the value-based contracting arrangements in both Medicare and the commercial market. The authors are **Colin McDermott** (VMG Health) and **Lisa G. Han, Esq.** (Jones Day).

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Latest Study of Private Equity Valuations

Private equity firms paid a median valuation multiple of 11.9x EBITDA for new investments during the first nine months of 2018, according to the "2018 Q3 Private Equity Valuations Report" from Murray Devine Valuation Advisors. The report breaks down private equity activity in 2018 between deal size and sector. While valuations remain near historic highs, multiples have come down slightly in all but the small market, the report says. Still, debt markets and considerable sums of dry powder available to private equity investors have allowed sponsors to pay a considerable premium over strategic acquirers as of the end of the third quarter.

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Global BV News: Serbia to Translate iiBV Courses

The International Institute of Business Valuers (iiBV) and the National Association of Valuers of Serbia (NAVS) signed a new licensing agreement for iiBV courses that will further promote the advancement of the business valuation profession in Eastern Europe. NAVS has begun translations of iiBV courses into Serbian, and **Vesna Stefanovic**, chairman of the NAVS Managerial Board, is being trained as the region's first certified instructor. This is the second regional licensing agreement for the iiBV. The first agreement was made with the Saudi Authority for Accredited Valuers (TAQEEM) covering the Arabic-speaking countries. The iiBV is continuing discussions with other professional organizations in India, Brazil, and around the world to license their education courses and course materials in other languages.

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First Public Demo of BVR's New Cost of Capital Platform

Valuation experts recently got the first walk-through of BVR's Cost of Capital Professional, the newest resource for developing a cost of equity capital estimate. A main takeaway from the demo is that users are not steered toward outputs from a "black box" of complex mathematics. The platform is flexible in that it allows the expert to use his or her professional judgment and common sense in developing one or more COE estimates using the build-up method and CAPM for any valuation date.

Freedom of choice: The platform integrates data from multiple sources, including the University of Chicago's Center for Research in Security Prices (CRSP) data, Professor **Aswath Damodaran's** data resources, and the U.S. Federal Reserve on Treasury bond yields. You have the freedom to choose the period of historical return data for your analysis. For example, during the demo, a start date of 1982 for estimating the size premium was used that showed virtually no size premium in CRSP Decile 10 (companies with the smallest market capitalization). If you go all the way back to the 1920s, the size effect will be very different. The point is that the analyst controls the period of historical return data that he or she feels is most appropriate for the specific subject company. The platform currently has CRSP market return data up to Sept. 30, 2018. Year-end 2018 data will be added by the end of January.

The demo was conducted during a free webinar presented by the author of the platform, **Dr. Michael Crain** (Florida Atlantic University), and advisory board co-chair **Ronald Seigneur**(Seigneur Gustafson LLP). **Adam Manson** (BVR), the other advisory board co-chair, was on hand to field the many questions from the huge audience. In response to a question on methodology, the presenters said that the platform is based on the fundamental approach from the SBBI series that had been widely used for many years. Another listener asked about valuation dates, and the presenters showed that your valuation date can go back to any date in the past.

Try it free: The Cost of Capital Professional is available to all practitioners on a free trial basis until the end of 2018. After that, it will be made available on a subscription basis. To sign up for the free trial, click here. BVR welcomes feedback and comments from all users.

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AICPA Issues Inventory Valuation Guidance

The AICPA's Financial Reporting Executive Committee has issued an early working draft of Inventory Valuation guidanceand would like feedback by Feb. 1, 2019. The draft is part of the upcoming *Business Combinations Accounting and Valuation Guide* on how to estimate the fair value of inventory acquired in a business combination in accordance with FASB ASC 820, Fair Value Measurement. The draft contains a section with general principles for valuing inventory and two examples, one on how to value finished goods and the other on work-in-process inventory. You'll also see Q&As that illustrate some of the inventory valuation considerations discussed in the draft. Please submit comments to yelena.mishkevich@aicpa-cima.com.

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More on the Alimony Deduction

Our coverage of the AICPA Forensic & Valuation Services Conference sparked a few comments from readers concerning the elimination of the tax deduction for alimony that becomes effective December 31. A point made at the conference is that the IRS is expected to follow a strict interpretation of the rule, meaning that a marital settlement agreement must be approved by the court—not just agreed to by the parties—before that date for the alimony to be deductible. One reader mentioned that the court order may have to be stamped and entered before the end of the year for it to qualify. It's not clear that the IRS would go that far, but, given the lack of guidance on this matter, that would be a safe strategy.

Another reader pointed out that, in some states, marital settlement agreements are not approved by courts. The American Academy of Matrimonial Lawyers (AAML) issued an alert about this matter, stating: "The alimony agreement needs to be in a *final settlement*

or court order[emphasis added]—not a temporary agreement—in order to maintain the deduction."

Bottom line: Consult with a tax expert before making any decisions in your particular case.

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New Study of M&A Deals Spotlights Fairness Opinions

A study of about 2,000 M&A deals from 2006 to 2016 suggests that acquirers should pay closer attention to the fairness opinions third-party analysts provide. The study's author, **Matthew Shaffer,** a doctoral candidate at the Harvard Business School, finds that differences between actual deal prices and the valuations estimated by third-party analysts consistently predict whether acquirers will eventually be forced to write down their goodwill over the following five years. The study examines the usefulness and the bias of fairness opinion valuations and finds "tight evidence for both." The study is discussed in the paper, "Truth and Bias in M&A Target Fairness Valuations: Appraising the Appraisals."

> *Extra:* Hundreds of fairness opinions are at your fingertips if you use BVR's Fairness Opinion Research Service (FORS). It gives you full access to actual fairness opinions from around the world, searchable by any data point or field.

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Survey: Small Biz Expects to Do Well in 2019

Small businesses are doing very well, and 70% say they expect to increase profits over the next 12 months, according to *Accounting Today's* inaugural "Small Business Accounting Insights Survey" of over 1,000 owners and leaders from small businesses. The survey also revealed that roughly half of the firms have a "low affinity" for their accountants, meaning they hadn't bought any services from them in the previous year, and were less likely to buy any in the coming year. Those firms were less likely to post better results than firms that work closely with their accountants and CPAs.

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GDP Growth Continues on Strong Pace Per 3Q 2018 *Economic Outlook Update*

The U.S. economy—as indicated by GDP—grew at an annual rate of 3.5% in the third quarter of 2018, putting it on pace to have the largest annual average GDP figure in over a decade, according to the *3Q 2018 Economic Outlook Update (EOU)*. The third-quarter increase is slower than the upwardly revised rate of 4.2% reported for the second quarter of 2018. Still, the 3.5% rate marked the second highest quarterly GDP rate in four years. Other highlights:

- The employment cost index increased 0.8% in the third quarter of 2018;
- The U.S. economy recorded the 113th consecutive month of growth by the end of the third quarter;
- The FOMC raised the target range for the federal funds rate to between 2.00% and 2.25%;
- Pending-home sales were at 104.6% in the third quarter and are down 1.0% from one year ago; and
- Construction spending was at an annual rate of $1,329.5 billion in September, an increase of 7.2% from one year ago.

You get permission to quote any or all of the material in the *EOU* in your valuation reports as long as you give proper attribution. The *EOU* is published monthly and quarterly.

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Global BV News: IVSC '2018 Annual Report' Now Available

The International Valuation Standards Council (IVSC) has issued its "2018 Annual Report" that gives updates on its development of International Valuation Standards (IVS) and its work with standard-setters and regulators around the world to ensure alignment. The report also looks at how and where IVS is being used around the world, drawing on the insights of valuation leaders to understand why common standards are vital to the markets in which they work.

> *Extra:* A recap of the IVSC Annual General Meeting held in Dubai is in the December 2018 issue of *Business Valuation Update*.

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LEGAL CONTENT Q1 2019

Delaware Chancery Says Reasonably Sound Sales Process Delivered Fair Value

***In re Appraisal Solera Holdings, Inc.*, 2018 Del. Ch. LEXIS 256 (July 30, 2018)**

In a post *DFC Global* and *Dell* appraisal case, the Delaware Court of Chancery's chief judge, Chancellor Bouchard, noted that the recent Supreme Court rulings "transformed" the Delaware statutory appraisal landscape. Giving "their full-throated endorsement to market efficiency principles," these key rulings now require the Court of Chancery to assess whether a transaction has been "*Dell* Compliant," such that the trial court may

use the deal consideration as evidence of fair value rather than rely on the discounted cash flow analyses the parties' trial experts present. Chancellor Bouchard found the merger process here supported reliance on the synergy-adjusted transaction price, even where the buyer was a private equity firm.

Global leader starts to struggle. Solera Holdings Inc. was a public company until it was acquired in the merger that gave rise to this lawsuit.

In 2005, Solera set out to transform the insurance industry by consolidating automotive, home ownership, and identity management into a single online site. At the time of the merger, the company was a global leader, with operations in 78 countries. In 2012, the company's founder and CEO pursued a strategy of acquisition and diversification with the goal of increasing revenue and EBITDA. However, over $2 billion in acquisitions later—many at a premium for unique and/or competitive assets—the company saw its leverage balances increase while earnings stayed flat and EBITDA margins shrank. The company's credit rating began to slide, causing lenders to balk at further financing. By early 2015, owing to its aggressive growth strategy, the company was "out of runway." Creditors were unwilling to make loans at acceptable interest rates.

Solera's founder privately began to explore a deal with private equity firms to take the company private. He then asked the board to set up a special committee of independent directors to review any offers and strategic alternatives. The special committee hired independent legal and financial advisors. The financial advisor contacted 11 private equity firms and six potential strategic bidders. The strategic firms declined to pursue a transaction. The remaining parties (private equity bidders) received board-approved, five-year projections, which were based on projections prepared in the normal course of business, but which were modified in connection with the anticipated sale. In the end, the board accepted a private equity proposal at $55.85 per share, for an overall company valuation of approximately $6.5 billion (including net debt). This value represented an unaffected premium of 53% over the then-current market price of $36.39 per share. After a go-shop period during which a final bidder dropped out, the company closed the merger in March 2016. A group of dissenting shareholders (all hedge fund investors) petitioned the Delaware Court of Chancery for a fair value determination under the state's appraisal statute, 8 Del. C. § 262.

Applicable legal principles. Under the applicable statute, in an appraisal action, the court must determine the fair value of the shares "exclusive of any element of value arising from the accomplishment or expectation of the merger." This means the valuation must exclude synergies that may result from the transaction. Further, the court must value the company as a "going concern" at the time of the merger and must consider the company's "operative reality … viewing the company as 'occupying a particular market position in the light of future prospects.'" The statute asks the court to consider "all relevant factors" and gives it discretion to use the valuation approaches the court considers appropriate. Those may include the frameworks the parties proposed or an approach the court devised. Both parties have the burden to establish fair value.

Petitioners rely solely on DCF. At trial, the petitioners claimed the fair value of their shares was $84.85 per share—more than 50% higher than the deal price. The petitioners based this claim on the result their expert achieved by way of a discounted cash flow (DCF) analysis. The expert also provided a multiples-based, comparable company analysis as a "reasonableness check," but he decided to give that calculation no weight.

In contrast, the company's expert maintained that the "best evidence" of fair value was the market-generated merger price ($55.85 per share), adjusted for synergies (-$1.90) to $53.95. This expert also conducted a DCF analysis, resulting in a slightly lower per-share value ($53.15), but found the DCF was "less reliable" in this case. As a "check," he also considered Solera's historic valuation multiples, analysts' stock price targets, and multiples from comparable companies and precedent transactions.

After the trial in the instant case concluded, but before Chancellor Bouchard rendered a decision, the Court of Chancery decided the *Aruba Networks* case. The court in *Aruba* labored to apply the directives the high court had given in *DFC Global* and *Dell* and determined that the unaffected 30-day trading price (which preceded the valuation date by a number of months) offered the best evidence of fair value, despite this amount being 30% below the transaction price. The court reasoned that calculating synergies involved the same potential for "human error" that plagued the determination of the inputs for a DCF model. Further, what complicated the calculation and increased the potential for error was that the fair value should account for the reduced agency costs that the acquirer gains as a result of the merger, the court in *Aruba* said. It's important to note that, in a second intervening case, *In re AOL*, *Inc.*, the Court of Chancery ascribed no weight to the deal price after finding the sales process was not what the court called "*Dell* Compliant." Instead, the court arrived at a price below the deal price based on a DCF analysis.

In the instant case, the company (respondent) tried to use the *Aruba* decision to argue, post-trial, that Solera's unaffected stock price of $36.39 per share was in effect the "best evidence" of fair value. In other words, the indicator of fair value was now more than 35% below the price the company's trial expert had suggested, i.e., the deal price minus synergies.

Belated *Aruba* argument. The Court of Chancery rejected the company's change in position, calling the new value proposition just as "facially incredible" as the petitioners' DCF model. Nothing prevented the company or its "highly credentialed expert" from relying on the unaffected market price prior to the *Aruba* decision, the court noted. The scholarship underpinning the theory that fair value should exclude *both* synergies and reduced agency costs had been in the public domain for years, the court emphasized. Yet the company earlier made no effort to offer this analysis at trial, thus foreclosing the petitioners' opportunity to litigate this issue. The court also said little in the record indicated what the company's true unaffected market price was. The proposed $36.39-per-share price represented the closing price on a *single* day only, the court said with emphasis.

In terms of deducting agency costs, costs that the *Aruba* court concluded were the "flip side of the benefits of control," with both creating value distinct from synergies, Chancellor Bouchard noted the Court of Chancery in a number of decisions had found the value of control to be part of the going-concern value that did not warrant exclusion in a statutory appraisal action. Unlike Vice Chancellor Laster had done in *Aruba*, Chancellor Bouchard said he did not read the high court's *DCF Global* and *Dell* decisions to suggest that agency costs represented a value that was attributable to the merger separate from synergies and that had to be excluded. "Had that been the Supreme Court's intention, I believe it would have said so explicitly."

***Dell* Compliant.** The court found the Solera transaction was "*Dell* Compliant" based on three major aspects. For one, numerous competitive buyers had an opportunity to bid, including financial and strategic firms with access to "robust" public information and in-depth, nonpublic information. Also, the special committee actively negotiated an arm's-length transaction, twice rejecting inadequate bids and extracting the right to a go-shop provision from the eventual buyer. Finally, the market for Solera's widely traded stock was efficient and well-functioning, as the fact that the price remained flat prior to the merger announcement but began to move sharply thereafter suggested.

According to the court, although the process was not "perfect," the merger resulted from a two-month outreach to large private equity firms, a six-week auction by an independent committee, a public notice that put a "for sale" sign on the company, and a 28-day go-shop period that cleared the market, without a single buyer willing to pay more. Given these "objective indicia of reliability," the court said, the only logical conclusion was: "Solera was not worth more than" the merger price of $55.85 per share.

Synergies and financial sponsors. In formulating its offer, the private equity acquirer believed it had significant "touch points" with Solera, from which it created four different synergistic models. The company's trial expert used three of these—portfolio company revenues, private company cost-savings, and tax benefits of incremental leverage—to calculate total expected synergies of $6.12 per share. From there, the expert made a "conservative" estimate that 31% of this value ($1.90) would remain with the seller, based on a Boston Consulting Group study of 365 deals. Although appraisal law requires backing out synergies specific to the deal at issue, the court noted that an expert's derivation of shared synergies is acceptable when reliable, reasonable, and, as here, unrebutted by the opposing expert. "Synergies do not only arise in the strategic-buyer context" but may also exist when a financial sponsor is the acquiring firm, the court said. Accordingly, after subtracting the $1.90-per-share synergistic value from the deal price, the court arrived at a final fair value determination of $53.95 per share.

Compared with this market-generated transaction price, a DCF analysis provides a "second-best" method, the court said. Here, both parties' experts created a "three-stage" DCF model, based on the five-year projections provided during the sales process, plus a five-year transition period and a terminal period beginning thereafter. Nonetheless, the resulting values were hugely different: $84.65, according to the

petitioners' expert, as opposed to $53.15, according to the company's expert. "All of these disagreements predictably result in a higher asserted valuation by petitioners and a lower asserted valuation by respondent," the court noted.

The gap was largely due to the experts' disagreements over the following five inputs:

1. *Plowback rate*. Disagreements over the plowback rate, that is, the percentage of after-tax operating profits the company needs to invest to grow at a specified rate into perpetuity," resulted in a massive $23.90-per-share difference, the court noted. The company's expert, relying on "leading" valuation texts by Professor Damodaran and others, calculated a 37.1% reinvestment rate. Citing more recent publications (by Bradley and Jarrell), petitioners' expert calculated a plowback rate of 16.4%.

2. *Return on invested capital (ROIC)*. Also notable was the disagreement over the ROIC rate. The company's expert relied on the convergence model, which assumed that over time the present value of Solera's growth opportunities would disappear due to increased competition; consequently, the company's ROIC gradually would converge with its weighted average cost of capital (WACC). The petitioners' expert disagreed, contending Solera had built "moats" around its business, such as competitive advantages, market dominance, and other barriers to entry, which would give it *perpetual* advantages over potential threats. (emphasis by the court) The company would earn a 4.5% return *above* its WACC in perpetuity during the terminal period, the petitioners claimed. At the same time, the petitioners' expert admitted that this rate was "a little bit of a finger in the wind."

3. *Stock-based compensation (SBC)*. The company's expert applied the cash-basis method to expense SBC, calculating the cash outlay as a normalized percentage of revenue. The petitioners' expert did not formulate an independent expense but used the company's projections, on a book basis, benchmarked to Solera's actual stock price and assuming 5% annual growth.

4. *Contingent tax liability*. Had there been no merger, the company's expert assumed that the company would have repatriated over $350 million in foreign profits, for which it would still owe residual U.S. taxes, and that it would continue to repatriate foreign earnings on a rolling basis following a five-year deferral period, incurring additional U.S. tax liability and lowering its overall value. The petitioners' expert assumed the company would *never* pay such taxes (court's emphasis) because the timing and amounts were too speculative.

5. *Excess cash.* Solera posted $480 million in cash at closing, from which it needed $165 million for operations, according to its CFO. Therefore, the company's expert added back the difference ($315 million) as excess cash. In contrast, the petitioners' expert added back *all* of the $418 million, saying modern technology should keep a "good" CFO from wasting such a "big chunk of cash."

'Unavoidably speculative' conclusions. There were other points of divergence. All things considered, the court said it found "comfort" knowing that the company's DCF analysis was "in the same ballpark" as the court's deal-minus-synergies estimate. Considering the court's trust in the quality of the sales process, the court found it was not credible that potential bidders would have left $2 billion on the table, as the petitioners' DCF model suggested. Further, the petitioners' expert attributed over 88% of enterprise valuation to periods *after* the company-produced five-year projections: "In other words, petitioners' DCF… is largely a prediction about the company's operations many years into the future," the court said, finding those value conclusions "unavoidably speculative."

But the court also rejected the company's DCF conclusions, to a large degree because the company's expert had admitted his DCF-based valuation was less reliable than the merger price minus synergies. The latter price was dispositive in this case, the court said. The court's ruling thwarted another appraisal arbitrage strategy, at least for now.

* * *

Flawed Sales Process Has Chancery Revert to DCF to Determine Fair Value

***Blueblade Capital Opportunities LLC v. Co.*, 2018 Del. Ch. LEXIS 255 (July 27, 2018)**

This Delaware statutory appraisal case fell in between two of the most important rulings in recent years. Specifically, this case went to trial after the state Supreme Court had handed down its decision in *DFC Global* but before it issued the *Dell* opinion. Aware of the high court's preference for the "sale value resulting from a robust market check," the Court of Chancery (Vice Chancellor Slights) nevertheless found the merger price here was unreliable because of "significant flaws" in the sales process. The court also concluded there was no evidence that justified relying on the unaffected trading price. Accordingly, the court looked to a "traditional valuation methodology," that is, a discounted cash flow analysis. Because neither of the parties' experts "walked the high road from start to finish during their respective DCF journeys," the court did its own analysis, drawing on the most plausible aspects of either expert's work.

'Fixated on Fortune.' For at least a decade, Norcraft, a leading manufacturer of kitchen and bathroom cabinetry, operated as a privately held company. Ownership was split among the CEO, his family members, and two private equity firms. The company operated in a cyclical industry; its own success was tied to the fortunes of the home improvement industry and housing starts. For years, Norcraft experienced steady growth, but, in 2007, growth began to stall, for about six years.

In 2013, the company offered 39% of its shares to the public at $16 per share. The private equity firms retained a 61% equity interest, of which the CEO and his family held a solid prospective share. As part of the initial public offering, the company entered into

tax receivable agreements (TRAs) in which it agreed: (1) to pay private equity 85% of certain tax savings; and (2) to accelerate these payments in the event of a "Change of Control." The TRAs became an important point of discussion during the merger negotiations.

In fall 2014, a leading competitor—Fortune Brands Home & Security Inc. (Fortune)—offered to buy Norcraft for $22 per share and to assume the latter's obligations under the TRAs. Norcraft's CEO let it be known to the potential buyer that he wanted to play a role in the post-merger entity. He kept coming back to this point numerous times during the negotiations, while Fortune remained noncommittal. Norcraft's board of directors retained legal and financial advisors to assess the offer and asked the CEO and CFO, both of whom had experience preparing long-term projections, to prepare five-year forecasts. The company did not prepare those projections in the ordinary course of business but only in the context of "extraordinary event[s]." Following the board's meeting, the CEO and CFO developed a "base case" set of projections as well as an aggressive "upside" case based on a top-down approach. This methodology contrasted with the bottoms-up approach the company used to develop its annual budget. Also important, the board did not form a special committee or task its advisors with canvassing the market for additional buyers. Instead, the board left the negotiations mostly up to the CEO, who had conflicting interests.

Initially, the board rejected Fortune's bid as too low, prompting the latter to offer $25 per share and finally $25.50 per share. Even though the board still believed these bids undervalued the company (and the tax savings under the TRAs), it did not pursue any alternative prospects. The court later noted the board remained "fixated on Fortune," such that it bid against itself and finally "capitulated" to Fortune's $25.50 bid as well as to a 35-day, go-shop provision that heavily favored the buyer. No other bidders could effectively compete during such a limited time frame, and the merger with Fortune closed on May 11, 2015.

The petitioners acquired over half a million shares after the merger was announced. Shortly after the transaction closed, they filed a petition for a fair value determination by the Delaware Court of Chancery under the state's appraisal statute, 8 Del. C. § 262.

Applicable legal principles. Under the applicable statute, in an appraisal action, the court must determine the fair value of the shares "exclusive of any element of value arising from the accomplishment or expectation of the merger." This means the valuation must exclude synergies that may result from the transaction. The court must value the company as a "going concern" at the time of the merger and must consider the company's "operative reality … viewing the company as 'occupying a particular market position in the light of future prospects.'" Further, the court must consider "all relevant factors," but the court has discretion to use the valuation approaches it considers appropriate. Those may include the frameworks the parties proposed or an approach the court devised. Both parties have the burden to establish fair value.

Expert values again 'miles apart.' "[A]s we have come to expect in appraisal litigation," the parties offered expert valuations that were "miles apart," the Court of Chancery said. It noted that both experts, at times, selected inputs based more on the desire to achieve a certain outcome than on generally accepted market and financial principles. This practice among experts continues, the court said, despite "repeated expressions of frustration by our courts." Voicing more frustration, the court said: "When a rushing river flows against a resisting rock, eventually the river wins out. Perhaps that is the hope among appraisal advocates and the valuation experts they engage to sponsor their positions."

The petitioners' expert argued the merger price did not reflect the company's value. He noted in particular the lack of a competitive bidding process. To achieve fair value, he developed a DCF analysis that was based on the base-case projections, extended by an additional five years, to arrive at a per-share value of $34.78. He also conducted a comparable companies analysis, which yielded a $33.92 value, but did not assign it any weight because of difficulties in finding truly comparable companies.

To bolster their argument that the deal price was not a reliable indicator of fair value, the petitioners also offered the testimony of a deal-process expert, who pointed to the "informational asymmetries" between Fortune and any third-party bidders as well as the deal-protection mechanisms that rendered the go-shop period ineffective.

In contrast, the company's expert contended the deal process was "robust." Accordingly, she proposed to use the deal price minus synergies. She estimated the value of synergies from the company's premerger analyses at $3.60 per share, which resulted in a final value of $21.90 per share. To support her conclusion, she also performed a DCF analysis, based on the base-case projections, which yielded a value of $23.74 per share. Finally, this expert used two market methods to generate additional corroborating values of $23.46 per share (comparable companies) and $17.48 per share (precedent transactions).

Market value indicators not reliable. The court dismissed the proposition that the sales process was "robust," noting the company's expert presented "only a cursory, mostly conclusory, analysis of that process." The court added that other company witnesses "struggled to recall basic aspects of the deal process." On the other hand, the petitioners made a credible argument that the merger lacked a meaningful market check. The sales value here was not the product of "the collective views of many sophisticated parties with a real stake in the matter," sufficient to support the deal price as a reliable indicator of fair value, the court concluded.

It also found there was little evidence in the record that justified giving any weight to the company's unaffected trading price. The company had a limited trading history (its IPO occurred only 18 months before the merger), and it operated in a specialized, niche market. Accordingly, the court found "no evidence-based rationale that would justify looking to the unaffected trading price … either as a standalone indicator of fair value or a data point underwriting the use of a deal-price-less-synergies metric."

Moreover, the court found market-based valuation methods did not provide meaningful guidance regarding the company's fair value since there were no genuinely comparable companies or precedent transactions.

Divergence on two basic inputs. For its fair value determination, the court performed its own DCF analysis, borrowing the "most credible components of each expert's analysis." The court noted the experts' disagreements in their DCF analyses boiled down to two critical areas: projections and beta calculation.

Extending the base-case projections. The petitioners' expert extended the base-case projections for an additional five years (through 2024), before applying a perpetuity growth rate (PGR) of 3.5% at the end. Extending the projections was necessary to account for the company's potential growth, which the projections did not fully capture, this expert claimed.

The company's expert said the extension was "patently unreasonable," as it amounted to a projection of steady growth over a total of 12 years for a business that depended heavily on the housing and consumer sectors. Instead, she applied the same 3.5% PGR at the end of the five-year projection period.

The court found the company expert's approach more credible given the cyclical nature of the business. Considering the management of the company was not inclined to project financial results beyond FY 2019, "I see no basis to do so post hoc for the sake of reaching a litigation result," Vice Chancellor Slights said.

Estimating WACC. Both experts calculated the company's cost of equity pursuant to CAPM. They both used the same risk-free rate of return (2.75%), equity risk premium (6.21%), and size premium (2.69%).

But they differed on the company's pretax cost of debt. Although they looked to different sources (15-year averages of B and BB rated bonds versus average of high-yield bonds plus total return on the company's outstanding debt), the court found the experts' respective estimates both were "reasonable." The court therefore used the average of their rates (6.95% vs. 5.85%) to arrive at 6.40% for the court's pretax cost of debt rate.

In terms of determining beta, given the company's limited trading history, both experts looked to a proxy beta but disagreed over the selection of guideline public companies (GPCs). Further, they disagreed on whether to use net or gross debt to unlever and relever the proxy betas. Finally, they disagreed on whether to use the company's actual capital structure or a target capital structure to relever the concluded beta when calculating the company's cost of equity.

The petitioners' expert used the same four GPCs as in his market analysis and then measured beta over a two-year lookback period (measured weekly) and a one-year lookback period (measured daily)—both relative to the merger date—before unlevering

each GPC beta using the gross debt of the corresponding GPC. The result was a proxy beta for the company of 0.80.

By comparison, the company's expert used a total of 16 GPCs and then used the median of the unlevered GPCs, measured weekly over a two-year lookback period relative to the merger date. This expert came up with a proxy beta for Norcraft of 1.02, using each GPC's net debt. Both experts said the other expert's GPC selection was flawed.

The court found both experts made valid arguments. To achieve its own proxy beta, the court used the four agreed-upon GPCs plus Fortune (the buyer) and a major competitor of Norcraft and then took the median of the GPCs' unlevered betas. The court said it had consulted finance literature and concluded the use of gross debt was more appropriate when applying the *Hamada* unlevering/relevering formulas. While net debt might eliminate some of the drawbacks of the *Hamada* formula, it added significant risk of error due to its subjective derivation from public companies' historical cash balances, the court said.

The court also found the petitioners' expert, using the company's actual capital structure as of the merger date, had the better argument. This component represented the company's "operational reality." Accordingly, the court used the observed structure (75% equity, 25% debt) in its beta calculations. The court estimated a levered beta of 1.187.

Providing an exhaustive summary of all its DCF inputs, adjustments, and computations, the court concluded that the total equity value for the company was $546.3 million on the merger date, for a per-share value of $26.16.

In concluding, the court emphasized that, although the merger price was unreliable for purposes of a fair value determination, this did not mean this data point was *irrelevant*. Rather, the merger price served as a "reality check" for the court's DCF analysis. The court also noted that the $0.66-per-share difference between the two values, as well as the infirmities of the sale process, indicated that the board had left money on the table and that the court's DCF value was grounded in reality.

* * *

Expert's Detailed Risk Analysis Bolsters Use of Deep Discount in Law Firm Valuation

***Fredericks Peebles & Morgan LLP v. Assam*, 2018 Neb. LEXIS 142 (Aug. 3, 2018)**

At the root of this buyout dispute is a lawyer's premature resignation from his law firm. Because he misunderstood a compensation issue, the lawyer voluntarily resigned, only discover later he had made a mistake. When he tried to walk back the resignation, the remaining partners instead offered to buy back his minority interest pursuant to a

partnership agreement. Eventually, the firm sued for a declaration of the value of the withdrawing partner's ownership stake. The trial court heard valuation testimony from a phalanx of experts, including the lawyer himself. The opinions diverged in terms of what the standard of value required, what factors determined the applicable discount rate, and how to treat old accounts receivable worth about $10 million. The court credited the expert with the most experience valuing law firms, noting he was able to communicate to the court how law firm valuations were special and why the risks facing the subject firm were particularly great. On review, the state Supreme Court agreed, calling the expert's testimony "persuasive and controlling."

Fair market value requirement. The defendant (departing lawyer) was one of five equity partners in a nationwide law firm that specialized in issues affecting various Native American tribes. It was organized as a limited liability partnership and had offices in many parts of the country; the principle place of business was in Omaha, Neb. One of the issues that concerned the partners was the firm's significant amount of outstanding accounts receivable, a good number of which were "years old." The partners reviewed the accounts for which they were responsible and ultimately decided that about $10 million was over four months old and not collectible. Collectively, they decided to write this amount off.

The defendant, a financial attorney whose practice included business valuation matters, had a 23.25% ownership interest in the firm. Typically, he worked on accounts the other partners brought into the firm. He was not a rainmaker. In 2014, over a period of several months, the firm's partners decided to revise the firm's compensation structure. Various proposals floated around, including one that would have based compensation on client generation alone. Ultimately, the partners settled on a hybrid of two compensation structures, based on bringing in clients and on equity ownership.

The defendant failed to keep up with the various proposals and began to feel the change might have a negative effect on his compensation. In 2014, he hired a major accounting firm (Eide Bailly) to value his interest in the firm by way of a calculation engagement. In October 2014, the defendant, registering protest, notified the remaining partners via email that he was voluntarily resigning from the firm. Shortly thereafter, he realized that the new compensation structure was not as dire as he had thought and asked to rescind his resignation. The remaining partners rejected the request and offered to buy him out under the existing partnership agreement. When the two sides could not agree on the value, the firm filed a declaratory judgment action. The defendant countersued, asking for an accounting, fair valuation, and a money judgment.

The firm's partnership agreement provided that the "withdrawing Equity Partner will receive an amount equal to 100% of the fair market value of the Equity Partner's interest in the Partnership as of the date of such notice of voluntary withdrawal." In court, the parties agreed that this agreement controlled the buyback of the defendant's interest.

The fair market value standard assumes a willing hypothetical buyer and a willing hypothetical seller, with both parties having reasonable knowledge of the facts and neither side being compelled to buy or sell. The goal of either party is to maximize its economic advantage. Put differently, fair market value assumes an objective hypothetical buyer, not a specific (subjective) buyer.

Abundant expert testimony. The plaintiff law firm offered testimony from one highly qualified expert, who, for over a decade, was a principal in a law firm management consulting group, developing a specialty in law firm mergers and acquisitions. He consulted extensively with law firms of all types and sizes and, throughout his career, performed some 25 law firm valuations. He had testified as an expert seven times and published on valuation topics and served as a speaker on the issue of law firm financial management. Earlier, he had worked as an accountant and auditor.

In testimony, the plaintiff's expert explained the different valuation methods and said he decided the income approach, focusing on the firm's future cash flows, was the most appropriate method here. He relied on five years of historical income statements, with the income normalized to remove nonrecurring expenses and to add liabilities that did not appear on the firm's income tax forms.

To determine the applicable discount rate, he used the "Ibbotson Build-Up Model." He analyzed risks specific to the legal environment, government regulatory risks, and risks specific to the firm. Regarding the risks to the firm, he noted that it was the aging partners who generated most of client revenue, that the firm had lower-than-average collection rates, and that it was largely unable to collect outstanding bills because many of the firm's Native American clients were not subject to federal law and therefore could not be sued. He further pointed out that characteristics specific to law firms in general—the fact that only lawyers are allowed to own law firms, that lawyers must not be subject to noncompetes, and that most law firms have in place partnership agreements that control compensation and admission to the firm—limit the control and marketability of a law firm interest. For all these reasons, the plaintiff's expert applied a 60% discount to the defendant's ownership interest. The expert valued the defendant's interest at $590,000.

Switch to fair value. The defendant offered testimony from three experts: two worked for Eide Bailly, the firm that had prepared a calculation of value for the defendant in 2014, and a third expert served only as a rebuttal expert and did not provide an independent value determination. In the end, the defendant renounced all of these opinions and became his own valuation expert.

Based on Eide Bailly's 2014 calculation engagement, the defendant's interest was over $3.4 million. In 2016, after the defendant had resigned, he engaged Eide Bailly to perform a detailed valuation. The valuation engagement produced a $3.1 million value.

Both Eide Bailly appraisers were senior persons in the firm's business valuation department. One of them was a CPA and credentialed business valuator, who

performed a substantial number of valuations per year for businesses in a variety of industries. However, he had performed only one law firm valuation. The other appraiser had a J.D., an MBA, and a background in economics. He also had performed hundreds of valuations but had never done a law firm valuation.

Both of these appraisers' reports used an income approach, based on only four years of income, instead of five years. The appraisers decided that one year, 2010, showed an income that was lower than the other years and therefore was not representative of the firm's regular income. They conceded, however, that they typically used a five-year sample. The appraisers also adjusted the valuation upwards to account for the firm's status as a pass-through entity (PTE). In testimony, one appraiser allowed that, to date, the U.S. Tax Court had yet to accept this approach.

The Eide Bailly appraisers gave great significance to the partnership agreement—specifically, the fact that it provided for a buyback of a withdrawing member's shares. Even though the agreement specified the use of fair market value, which assumes an arm's-length transaction, the appraisers assumed a specific hypothetical buyer, the firm. Prior to working on the valuation engagement, the defendant's counsel had sent a letter to the appraisal firm that said: "[T]he Agreement provides for a market within [the firm] and its Equity Partners. This means the transaction occurs at a fair price and on fair terms, not as if the sale were to a stranger." The letter talks about an "internal market" and says fair market value in this context should "be understood as the fair value of the partner interest." This directive guided the Eide Bailly appraisers' discount analysis and value conclusions.

The defendant's rebuttal expert was hired to review, compare, and critique the various valuations. This expert was also a CPA, with a J.D. and a master's degree in professional accountancy. He also was an accredited business valuator, but he had never worked in a law firm and had valued only one other law firm.

The rebuttal expert decided each expert report was flawed. In essence, the Eide Bailly opinions overstated the value of the defendant's interest by nearly $1.3 million, whereas the opinion by the plaintiff's expert understated the value by about $1.2 million. The rebuttal expert fundamentally disagreed with the defendant's own valuation, saying it was not credible "in any respect" and was 'ridiculous."

Defendant's valuation 'unreliable and not credible.' The defendant valued his interest at nearly $4.9 million. The valuation was based on the asset approach, the income approach, and the market approach. As for his qualifications as an expert, the defendant said he routinely performed business valuations to assist clients and he had read "some articles" from the American Bar Association and *Inc. Magazine* in preparation for his valuation. His calculation included the firm's $10 million in uncollectible accounts receivable, which the defendant claimed the remaining partners had written off in bad faith. Under the asset approach, the defendant also included the value of real estate, automobiles, equipment, etc. Under the income approach, he added 2013 income figures with estimated 2014 income figures and divided the result

by two. For the market approach, he determined average annual gross revenue, using the amount from the income approach, and multiplied it by two.

The defendant urged the court to disregard his experts' valuations and instead adopt his valuation. The trial court declined to do so.

The court found the $10 million write-off was not done to harm the defendant. Rather, the write-off affected all of the partners, and it was a point of discussion among the partners before the defendant resigned.

The court called the defendant's valuation "unreliable and not credible." It also rejected the Eide Bailly opinions, noting the defendant improperly had tried to "influence in an upward manner" the firm's value conclusions. The appraisers worked under the incorrect assumption that, for purposes of this valuation, the defendant's firm had to be considered the hypothetical buyer of the defendant's specific interest, even though the partnership agreement required the use of the fair market value standard. The court also noted the appraisers' lack of law firm valuation experience.

The court rejected the rebuttal expert's opinion for the same reason.

In the end, the trial court adopted the opinion the plaintiff's expert offered. The court found the appraiser's high discount rate was justified as part of a fair market value analysis. The expert correctly assumed a public marketplace and considered a hypothetical buyer's ability to convert the ownership interest to cash and to control the investment. This expert, the court found, was the only expert who identified and weighed the various risk factors that would influence a hypothetical willing buyer who sought to maximize his economic interest. Accordingly, the trial court determined that, under the partnership agreement, the defendant's interest was worth $590,000.

Improper PTE adjustment. The defendant appealed this and other trial court findings with the state Supreme Court. He argued the trial court erred when it adopted the value conclusion of the plaintiff's expert, in part because the expert did not assign any value to the $10 million in accounts receivable and failed to account for the firm's nonoperating assets and real estate investments.

The high court noted that its review not only was de novo, but also was based on the principle that the trier of fact was uniquely qualified to decide how much weight to give the testimony of experts. Assessing the credibility of a witness is the province of the trier of fact, the reviewing court noted.

The state Supreme Court observed that this case featured many experts whose different value conclusions stemmed from the different considerations the experts gave to facts. The reviewing court found nothing in the record supported the valuation approach the defendant proposed. It noted that the defendant's own expert had called the defendant's valuation "ridiculous."

The high court agreed with the trial court that the Eide Bailly valuations were seriously flawed. They did not accord with the required fair market value standard and improperly used a four-year-income period; they also made an adjustment for "passthrough [sic] entity tax status" that was not supported by the U.S. Tax Court. The high court noted the appraisers' lack of "significant experience in valuating law firms." And it pointed out that the appraisers' decisions all had the effect of increasing the valuation.

The high court observed the rebuttal expert also lacked relevant valuation experience and found he used an industry risk premium for companies that had much larger revenues than the subject company. He used a lower company-specific risk premium but had not reviewed the partnership agreement or other financial statements specific to the company. He, too, used an unjustifiable pass-through entity adjustment, and he included $2.5 million of goodwill in the value of the defendant's interest based on the unjustified assumption that the goodwill was attributable to the partners, as opposed to the enterprise. The goodwill inclusion resulted in an overstatement of $573,000, the high court said. This expert's value determination was "not accurate," the Supreme Court concluded.

The high court agreed with the trial court that the plaintiff expert's valuation was reliable. This expert had extensive relevant experience, which made his version of the facts the most credible. He also used an approach that valued the defendant's interest "in the context of a market," the Supreme Court said. He articulated why the income approach was best suited to value this firm, and his discount analysis properly considered the risks to the industry and the firm. He "was able to articulate why law firms should be valued differently from other professional services industries," the high court said.

In concluding, the Supreme Court also found it was appropriate to write off the $10 million in accounts receivable. The plaintiff's expert explained why, in all likelihood, they were not collectible. He found the write-off was a correct reflection of the "net realizable value" of the assets. Finally, the defendant's argument that the trial court failed to apply value to the firm's other assets was misguided because all the experts, excepting the defendant, had decided the asset approach was not the best way to value the firm, the high court noted.

The state Supreme Court upheld the trial court's value determination, confirming the defendant's equity interest in the law firm was worth $590,000.

* * *

'Lady Liberty' Stamp Costs USPS Millions in Copyright Infringement

***Davidson v. United States*, 2018 U.S. Claims LEXIS 801 (June 29, 2018)**

The sculptor of a well-known Las Vegas Lady Liberty statue alleged the United States Postal Services (USPS) infringed his copyright by featuring a photo of his work on a "forever" stamp without permission, not to mention attribution. The court found the

Postal Service liable and considered expert testimony, including testimony on the value of a hypothetical license between the parties, to fashion a remedy. This case illustrates how experts and the courts employ patent law tools, including the *Georgia-Pacific* framework, to value licenses in the copyright context. As in many other valuation contexts, the high-caliber experts here arrived at hugely different value conclusions, leaving the court to perform its own analysis.

A different Lady Liberty. In 1996, the plaintiff created his version of the Statue of Liberty by making a sculpture for the New York-New York Hotel & Casino in Las Vegas. He made a profit of about $233,000 on this work. Because he did not apply for a copyright until 2013, his copyright fell outside the five-year time frame that would have entitled the holder to a statutory presumption of validity. Consequently, the plaintiff had to prove the copyright was valid, which meant showing the work was original. The plaintiff was able to do so.

Around 2008, the defendant, USPS, was looking to replace its first "forever" stamp. The idea was to present a "new, fresh, and attractive" image. A "forever" stamp is one that customers buy for the price of first-class postage and that keeps its validity no matter the current price of one-ounce fist-class postage. The Postal Service considers this type of stamp a "workhorse" stamp because it sells at a high volume and customers, most of the time, use it to send first-class mail (as opposed to collecting it).

A photo that showed a close-up of the Statue of Liberty's face captivated USPS, and, in mid-2010, it paid Getty Images $1,500 for a three-year, nonexclusive license. The agreement allowed the Postal Service to use the picture and make it appropriate for a stamp. In late 2010, the Postal Service decided to issue the Lady Liberty stamp together with a newly designed American flag stamp. Both items were workhorse stamps. The press release for the Lady Liberty stamp gave attribution to the Getty Images photographer but not to the plaintiff sculptor.

After printing nearly 3 billion copies of the paired stamps, at an investment of $8 million, the Postal Service learned that the Lady Liberty image was not a photo of *the* Statue of Liberty but of the Las Vegas replica. It seems USPS's legal department was asked to determine "what licenses must be executed" and that USPS was examining the contractual relationship between the sculptor and the Las Vegas hotel. Not much seems to have happened, however. The Postal Service retired the Lady Liberty and flag stamps in January 2014. By then, 4.9 billion of the Lady Liberty stamps had sold, achieving over $2.1 billion in sales. USPS collected an equal amount for the paired ("convoyed") flag stamp.

The Postal Service also tracks stamps that are sold to collectors and that won't ever be used or redeemed. The rate of those stamps is known as retention or breakage; this rate is important because it indicates almost pure profit for USPS in that USPS does not have to perform any service in connection with the sale of the stamp. The Postal Service's financial statements showed that profitability from retention or breakage from

the Lady Liberty stamp was nearly $71 million. The amount was about the same for the flag stamp.

In the meantime, back in Las Vegas, one day in 2012, the sculptor's wife excitedly told her husband "our statue is on the stamp." When the copyright was issued, the plaintiff sued USPS for infringement and economic damages. Until then, he had never licensed or otherwise monetized his copyright of his Lady Liberty statue or sued anyone else over copyright infringement.

In defending against the suit, USPS argued that the work was not legally protected, as it was not original; alternatively, this was an architectural work whose pictorial representations are exempted from copyright protection. Moreover, USPS's use of the image was "fair use" and thus excluded from the definition of infringement. The court rejected all of the defendant's arguments, finding the face of the sculpture was original and protected. USPS was liable for infringement.

Legal principles at work. Under the applicable statute, a court should award "reasonable and entire compensation as damages for such infringement." The Federal Circuit has found that the applicable measure of damages is the fair market value of a license to use the plaintiff's work, which assumes a hypothetical willing buyer and a hypothetical willing seller negotiating at arm's length. The Federal Circuit has approved the use of the framework that guides the determination of a reasonable royalty in the patent law context, including the use of the *Georgia-Pacific* factors and the concept of a hypothetical negotiation between the parties prior to infringement. A court asked to calculate a remedy in the copyright context may also look to objective signs of the value of similar work in the market.

USPS's unique licensing approach. Here, the parties offered testimony from experienced business valuation experts who specialized in valuing intellectual property. The aim was to determine the value of a nonexclusive license for the plaintiff's work. USPS also presented fact witnesses who provided background on what USPS typically paid for the use of art and what the Postal Service demanded to license its own art.

Regarding USPS's unique approach to licensing, witnesses agreed that USPS never paid more than $5,000 for images the service used on stamps. The defendant, therefore, asked the court to cap damages at that amount. Witnesses for USPS said some companies or organizations, including Walt Disney and the Andy Warhol estate, in fact allowed the Postal Service to use their art for free because they appreciated the visibility and publicity resulting from the exposure. The plaintiff countered that, in those instances, the use was with attribution, which meant free publicity for the copyright holders. In the instant case, USPS did not offer the plaintiff this option.

A licensing specialist for USPS also testified that USPS had a practice of copyrighting its stamps and stamp booklet covers. When USPS receives a request from an entity that wants to use the image of the stamp commercially, USPS insists on executing a licensing agreement based either on a flat fee or a running royalty. During the relevant

period, USPS licensed its intellectual property out at a rate of 8% of the other party's total gross sales. The current rate was 10%, this witness said. If a third party wanted to use a single image, the license likely would be based on a flat fee agreement. Generally, the Postal Service would try to "negotiate the best that we can get," the witness said, noting she was responsible for making money for the Postal Service.

The parties' experts focused on different factors and reached startlingly different conclusions as to the value of a hypothetical license. In a nutshell, the plaintiff's expert considered the market for artwork broadly speaking, whereas the defendant's expert emphasized USPS's particular licensing approach.

Specifically, the plaintiff's expert considered the factors the two sides would consider when bargaining for a license: timing, duration, exclusivity, and territory. He believed that, in 2010, the Postal Service was under pressure to release a new "forever" workhorse stamp and that the service then had few viable options. In looking at comparable licenses for artwork in the marketplace, he concluded a running royalty would range from 2.5% to 10%, the average being 6.5%.

He found that a running royalty for the Lady Liberty stamps that customers used to send mail should be 1.5%; the rate for stamps that went to collectors and were never redeemed as postage should be 5%. Further, the rate for convoyed stamps should be 0.75% for the flag stamps that were used to send mail and 2.5% for those that were not redeemed. Moreover, philatelic products that were sold only to collectors commanded a 10% rate, this expert said. He used USPS's own sales numbers and estimated retention figures and arrived at a license worth over $53 million.

The plaintiff's expert rejected the idea that USPS's own licensing policy, with its $5,000 cap, was relevant to determining a hypothetical license here. However, he considered the plaintiff's lack of a licensing history, noting this factor weakened the plaintiff's bargaining position. Further, he assumed any license agreement would not include attribution to the plaintiff, where attribution would be of value to the plaintiff.

USPS's expert contended a hypothetical license in this case was worth no more than $10,000 because the plaintiff had no history of selling rights to his artwork and because all of the Postal Service's licenses were below $5,000. This expert said he had examined hundreds of such licenses.

He also contended USPS had options if the parties did not agree on the $10,000-or-less rate. Moreover, the plaintiff had suffered little harm, this expert maintained, because the plaintiff had not attempted to earn a profit or commercialize his work.

Court favors a mixed license. The court emphasized that the measure of damages, fair market value, required it to assume a *willing* buyer as well as a willing seller. "This means that the government cannot avoid accountability by arbitrarily imposing limits on what it would have been willing to pay." And, the court said, "The rule is rationality in view of the evidence presented."

The court said a mixed license was “the most appropriate measure of damages.” It included a flat fee applicable to the Lady Liberty stamps that were used to send mail and a running royalty for retained stamps and philatelic products. The court explained it would make no economic sense for the Postal Service to pay a running royalty for stamps that were used in the mail because the Postal Service does not make money on those sales. The cost of carrying mail and retaining a workforce to do so is greater than the money made from selling those stamps as well as other revenue earned. “In essence, each stamp redeemed for service is a small contract on which USPS will lose money,” the court observed. It added that the plaintiff would not be in a position to demand a running royalty for those stamps. Accordingly, $5,000, the amount the service historically paid, was an appropriate flat fee in this instance.

In contrast, testimony showed the Postal Service makes money on stamps that are retained and other philatelic products, the court noted. In choosing the Las Vegas Lady Liberty image, the Postal Service specifically opted for an image that was likely to attract buyer interest and maximize USPS’s profit. It was reasonable to assume the plaintiff would ask for some percentage of the profit USPS would make of these stamps and related philatelic products and that USPS would have been willing to pay such a percentage as it reflected no additional risk. The court decided it was appropriate to apply a 5% running royalty to unredeemed stamps and philatelic products. (The court explained that philatelic products were collectible items that were produced for sale but not for use as stamps. Items associated with the two contested stamps and worth over $29,500 had been sold.)

As the royalty base, the court used USPS’s profitability estimate of $71 million for breakage and retention. Applying the 5% royalty rate to the $71 million estimate, the court arrived at a damages figure of slightly over $3.5 million. Revenue from the sale of philatelic products resulted in a royalty of about $1,500, the court found. It added this amount and the $5,000 flat fee to the running royalty amount.

At the same time, the court rejected various arguments by the plaintiff that the government would have paid at least $10 million for this license given various exigencies. “The economic incentives and realities cited above would have driven both parties toward a running royalty in the range that we have found,” the court concluded.

* * *

Courts Are Alert to Valuations Unmoored From the Facts

***Cristofano v. Chahal,* CL17-1291 Circuit Court of Fairfax County (Honorable Jan L. Brodie), Judge’s Ruling (March 26, 2018)**

Perhaps experts feel pressure from the hiring attorney or the client, perhaps they are unable to access key documents or information, or perhaps they simply lack valuation and litigation experience. Whatever the reason, case law provides too many examples

in which valuation and damages experts have proffered opinions that were plainly counterfactual and in which the court called them out on it. The lesson for experts is simple. Don't be an ostrich. Deal with the facts of the case (especially so-called "bad facts") and keep your calculations real.

Two recent decisions illustrate the point. *Cristofano v. Chahal* is a buyout dispute in which the plaintiff's expert augmented income by developing projections based on the plaintiff's forecast, resulting in an estimate double that of the actual profit for that particular year. The expert's projections also assumed ongoing income from a lucrative contract, even though it was known that the contract likely would end in 2018. The court found there were other ways in which the expert inflated income and by extension the value of the company. In contrast, the defense expert analysis relied on historical data and properly accounted for the facts of the case, the court said, adopting his value conclusion.

Zaffarkhan v. Domesek concerned a shareholder dispute involving a short-lived software startup whose one product, a medical software application, never got beyond the beta stage of development. The plaintiff, a founding member, rejected a buyout and sued the other founders, alleging various breaches. The plaintiff's expert claimed the company's "most likely" value was $6 million. A defendant shareholder described the company as "a very Mickey Mouse operation," with "poor documentation, poor record keeping, poor legal counsel, and naïve team members." The trial court awarded zero damages, noting the plaintiff's expert had no experience valuing software companies, misapprehended basic facts, and developed multimillion-dollar valuations for a company with no product, no revenue, and no investors. The appeals court affirmed.

* * *

Court Rejects Appreciation in Value Calculation, Citing SSVS Violations

***Hebert v. Cote*, Case No. 312017DR000305, Circuit Court of the Nineteenth Judicial Circuit in and for Indian River County Florida (Order 5/29/2018 and Order 8/29/2018)**

This appreciation in value case collapsed when the court decided in two orders to exclude valuation testimony the nonowner spouse offered to make a claim to a portion of the increase in value of the owner spouse's separate business. The expert's calculation did not meet the statutory requirements for valuing the asset and failed the expert admissibility requirements, the court found. Moreover, testimony from an SSVS expert showed the appreciation analysis breached the professional standards in several regards. The nonowner spouse's subsequent attempt to introduce a revised calculation failed for essentially the same reasons, leaving her unable to meet her legal burden.

Background. In April 2003, the husband set up a Canadian company (Canix Colo Inc.) that provided "business technical collocation services." This meant offering server space in a multivendor-enabled environment, direct connection to optic networks, domain

name hosting, etc. The company was very successful, and, in February 2011, the husband sold it for about $37 million. Net sales proceeds were about $22 million.

The husband and wife married in October 2009, years after the creation of the company. The company, by all accounts, was the husband's separate property.

The issue during the divorce proceedings was whether the marital unit had a right to a portion of the appreciation in value the company experienced during the marriage. The analysis has two parts. For one, the court has to make a determination that there was an appreciation (or "enhancement") in value. Assuming the court finds there was an increase in value, it must determine the reasons for the appreciation in order to determine whether all or a portion of the enhanced value is marital property. Under the applicable law, if a nonmarital asset increases in value during the marriage, only the part of the appreciation that is the result of either party's efforts qualifies as marital property. Basically, once the owner spouse shows the asset was separate property, the nonowner spouse must show there was an enhancement in value and it is marital property. If he or she succeeds, the other party has to show that some or all of the enhanced value is not part of the marital property.

Here, the applicable valuation dates were the value of the company on the date of marriage (October 2009) and on the date of the sale of the company (February 2011).

To quantify the increase in value, the wife retained a valuation expert who calculated what he called a "minimum marital component" from the proceeds of the sale of the company. The marital portion was $8.9 million from the gross sale and nearly $6.5 million from the net sale, the expert determined.

Broadly speaking, the approach he used considered revenue and earnings between July 2009 and July 2010 (not valuation dates!) to determine a percentage change. He applied this percentage change to the valuation dates (October 2009 and February 2011) to calculate a value for retained earnings as of the date of marriage. He calculated a goodwill value by subtracting the retained earnings as of the sales date from the gross sales price. He then applied the percentage change to the goodwill value to determine the goodwill value as of the date of marriage. Finally, he added the extrapolated value of the increase in goodwill between the valuation dates to the extrapolated value of the increase in retained earnings between those dates to arrive at the $8.9 million figure related to the gross sale.

Inadmissible testimony. The husband argued the expert testimony was inadmissible under Florida's version of *Daubert*. (Readers of *BVWire* may remember that the statute that governs the admission of expert testimony was revised in 2013 to reflect Florida's adoption of the *Daubert* standard.)

In its May 2018 ruling, the trial court agreed with the husband and excluded the wife's expert. The court's order noted the expert admitted he had not calculated the fair market

value of the husband's company and had not determined an increase in value based on the relevant dates. Under the applicable law, he was required to do so, the court noted.

Further, he did not use any of the valuation methodologies (asset, market, income approaches) that were required under the professional standards that apply to business valuators. "Professional standards" refers to the Statement of Standards for Valuation Services (SSVS) of the American Institute of Certified Public Accountants.

The court noted that, instead, the wife's expert developed "a completely different technique" to calculate the amount allegedly owed to the marital unit. In a footnote, the court made a fact-finding that the expert's "minimum marital component" calculation "does not meet the only recognized standard for 'fair market value.'" Further, the court's order noted the expert had not requested or received documents from the opposing party that might have been helpful in developing his valuation. The expert maintained his valuation met the SSVS because he was retained under a calculation engagement, as opposed to a valuation engagement.

The court also rejected this argument, finding a calculation engagement "has no precedent in any statutory or case law in the state of Florida to render an opinion of fair market value." The court further pointed out the expert used "subsequent acts," specifically the sale of the company, "as one of the anchor points in reaching his conclusion of valuation." Under the law, "only known facts may be used in making the evaluation," the court said. For all of these reasons, the expert opinion was inadmissible, the court concluded.

Exclusion affirmed. The wife filed a motion for rehearing, reargument, and clarification in which she asked the court to reconsider its earlier order not to allow the expert to testify. However, the husband offered testimony from an expert on the SSVS that confirmed the valuation the wife's expert had proposed failed to comply with the professional standards.

The SSVS expert had done over a thousand business valuations and was one of the three "primary writers" of the SSVS, which became effective on Jan. 1, 2008. In deposition testimony, this expert explained that all 50 states have adopted the SSVS and any CPA providing valuation services had to follow the standards. He further explained that he was only retained to provide an opinion on whether the work of the wife's expert was in compliance with the SSVS. He did not give an opinion on the methodology the wife's expert used or on the figures the wife's expert proposed.

The SSVS expert determined the new valuation by the wife's expert reflected four SSVS violations. One, the wife's expert did not seem to have a work paper file. Two, the wife's expert had not done enough work to offer a valuation opinion. Three, the opinion the wife's expert offered relied, at least to some extent, on subsequent events, i.e., documents related to the sale of the company as opposed to the date of marriage. And four, the wife's expert did not provide an engagement letter or any memorandum identifying the client and the type of valuation the expert was asked to perform.

The court rejected the wife's request to allow her expert to offer a "new" opinion. Instead, it found the work of the wife's expert "does not conform to the SSVS standards in many respects." It cited the expert's failure to keep a work file, the failure to use one or any of the accepted valuation methods for his value determination, as well as the failure to provide a valuation based on the date of the marriage. The court also said there was no evidence the expert was "now prepared to testify to the fair market value" of the company, as the wife claimed in her motion. The court's refusal to allow the wife to recall the valuation expert meant the wife had no evidence to support her claim that there was an appreciation in value during the marriage and that the enhanced value was marital property.

* * *

Lack of Facts and Data Render Expert's Fair Value Balance Sheet Not Helpful

***Weinman v. Crowley (In re Blair)*, 2018 Bank. LEXIS 2281 (Aug. 2, 2018)**

This bankruptcy-cum-*Daubert* case presents a study of what not do as an expert. A trustee retained a solvency expert to prove claims of actual and constructive fraud. The defendants challenged the expert's opinion, alleging it was unreliable and irrelevant. In excluding the testimony, the court explained at great length how unequipped the expert was to follow the methodology (fair value balance sheet method) he had selected. Faced with insufficient information and lacking the resources to do the required background work, the expert assigned zero value to certain assets. He made similarly unjustified assumptions regarding the debtor's liabilities, the court noted. It found the testimony was of no help to the court and called some of the work product "the worst sort of made up 'expert' analysis."

Background. In 2015, the debtor filed for Chapter 11 bankruptcy. A short time later, he died. The Bankruptcy Court then converted the case into a Chapter 7 proceeding. In 2017, the trustee for the debtor's estate sued the debtor's widow and an entity associated with her with the goal of returning money to the estate. The crux of the trustee's case was that the debtor had made a series of transfers with an actual intent to defraud and that a number of transfers also represented constructive fraud under the Colorado Uniform Fraudulent Transfer Act (CUFTA). The trustee had the burden of showing that the debtor was insolvent at the time of the contested transfers. The valuation date was May 2011.

The trustee hired a financial expert to perform a solvency analysis, which the defendants attacked in a *Daubert* motion under the reliability and relevance prongs. The defendants did not question the expert's qualification, but the court, on its own accord, found the expert "just barely" passed the qualification requirement.

Rule 702 of the Federal Rules of Evidence and *Daubert* and its progeny provide that expert testimony is admissible if the witness qualifies as an expert by "knowledge, skill,

experience, training or education." Moreover, the testimony must be based on sufficient facts or data and must be the product of reliable principles and methods, which the expert must have reliably applied to the facts of the case. In short, the expert's opinion must help the trier of fact understand the evidence or determine a fact in issue.

The court plays a "gatekeeping role" to ensure that the proposed expert testimony is reliable and relevant. The party seeking to introduce the expert testimony has the burden of establishing that the expert meets the qualifications, reliability, and relevance requirements.

Lack of solvency experience. In terms of qualifications, the trustee's expert had had a long career in the derivatives industry before he left that sector and became a CPA. He also obtained certification in financial forensics. For about six years, the expert was a "tax and accounting practitioner" and, in this capacity, worked on over 500 bankruptcy estates. Recently, he had presented three papers at CLEs that dealt with taxation in bankruptcy.

The court, however, pointed out that none of this experience indicated that the trustee's expert had ever testified in any court as an expert on solvency. Further, there was no showing that "solvency analysis (as distinct from general 'valuation') was part of [the expert's] education, training, or work," the court said. It added that none of the expert's high-profile international career in the derivatives industry "bears on determining solvency." The court observed the expert only recently had obtained certifications as a CPA and CFF; consequently, the expert's qualifications to provide a solvency opinion were "rather weak." But since the defendants did not contest the expert's qualifications, the court found he met this requirement based on some "knowledge, skill, experience, training, or education," in finance, economics, and accounting.

Unacceptable assumptions. The court's reliability inquiry focused on the expert's methodology and application of the selected methodology to the facts, the court explained.

The trustee's expert said he used a fair value balance sheet test, which the court found was a method that both the Bankruptcy Code and the applicable Colorado statute considered mandatory for assessing solvency. The court further noted that the authors of the key authority on which the expert relied (*A Practical Guide to Bankruptcy Valuation* 239 ABI, 2nd ed., 2017) also endorsed the fair value balance sheet method, calling it the "asset-accumulation method." The approach required preparing a balance sheet of the debtor's assets and liabilities, excepting exempt assets, and adjusting the balance sheet to reflect fair market value as of the date of the contested transfers.

At the same time, the court pointed out that the expert and the trustee had used slightly different definitions of the term "insolvent." Specifically, the expert used the Bankruptcy Code's definition, whereas the trustee based his fraudulent transfer claims on Colorado law. The court said that, fortunately for the expert, the definition of insolvency under the Bankruptcy Code was very similar to that under Colorado law. Essentially, the trustee

and his expert had to show the sum of the debtor's debts was greater than the total value of the debtor's assets at a fair valuation.

The problem with the expert's opinion was not the methodology but the lack of sufficient facts and data for the methodology to work, the court decided. It noted that the fair value balance sheet approach here required the expert to go back in time to determine the fair market value of assets from about seven years ago. According to the court, "the historical exercise can be difficult under optimal circumstances and virtually impossible without sufficient facts and data," which the expert acknowledged, repeatedly, he had lacked.

The trustee's expert determined there were essentially four categories of assets, the most critical being "cash on hand" and "investments." As for "cash on hand," the expert identified 13 financial accounts and admitted he lacked data for five of them. The court credited the expert for asking the trustee's counsel for data. However, it disapproved of the expert's way of resolving the dilemma when learning that no such information was available. Specifically, the expert decided to value the five financial accounts at "$0." According to the court, "[t]his was rank speculation."

Similarly, in the "investment" category, the expert listed two equity interests. Regarding one such interest, he acknowledged that the balance sheet approach required him to determine the fair market value of the investment's assets and then subtract the respective entity's liabilities. In a footnote, the court observed that this value determination would have required substantial work from the expert, including assessing oil and gas assets, making site visits, and potentially hiring industry experts to assist with the valuation. The solvency expert, the court said, did not have the resources to do a "real fair market valuation" and apparently decided this task "was not included in his assignment." According to the court, "he did not perform the hard work that the methodology required."

Instead, the expert created a balance sheet based on book values, while, at the same time, acknowledging that book value "sometimes" bore little relationship to fair market value. Altering the methodology was a "step that renders the analysis unreliable [and] renders the expert's testimony inadmissible," the court noted.

At the *Daubert* hearing, the expert also allowed that he might have used other methods to analyze the value of the investment, including performing a sales comparison analysis or a discounted cash flow analysis. However, in his deposition testimony, he said using the other methods was "not worthwhile." This statement again did not go over well with the court.

The valuation of the debtor's second investment proved equally difficult and the expert's value conclusion was equally unreliable, the court noted. To do the work, the expert had only "two scraps of data" related to the debtor's equity interest, the court said. One piece of information indicated that, in 2015, the debtor had valued his interest at about $156,000. However, the 2011 tax return showed no income or loss for the entity. The

trustee's expert decided to rely on the 2015 value statement even though this valuation occurred four years after the May 2011 valuation date, the court said with disapproval.

'Suspect' liabilities assessment. The expert's liability determination also did not hold up to scrutiny, the court found. The only important liability the expert was able to identify was a $2.3 million judgment entered against the debtor in 2015. The lawsuit resulting in the judgment was filed at least one year after the valuation date, in 2012. In deposition testimony, the expert conceded that this liability qualified as a contingent liability and, following standard procedure, required a probability analysis. He admitted that he did not have sufficient information to come up with a reasonable loss estimate as of the valuation date. The court said the expert "engaged in some hindsight time travel" when he decided to designate the full amount of the 2015 judgment for the 2011 liability determination. In doing so, he also ignored the teachings in the *Valuation Practical Guide*, his primary solvency source, the court observed.

Throughout the *Daubert* hearing, the expert acknowledged that he did not have as much information as he required or would have liked to have to. He also suggested that the asset approach he had chosen "seemed best" under the limited circumstances. Given the persistent lack of information problem, the court considered the entire expert report and balance sheet unreliable.

Moreover, the court found the expert not only lacked the information he needed to execute his chosen methodology, but he also failed "in numerous ways to reliably apply the facts and data in accordance with his own selected methodology."

Finally, the court observed that, even though the applicable statutory provision requires the fair value balance sheet approach, the expert, possibly misapprehending the state statute, proposed an alternate and ill-advised "cash flow insolvency" analysis that sought to show that the debtor generally was not "paying his debts as they become due." After conceding the record indicated the debtor, on the valuation date, actually paid his bills on time, the expert subtracted "really whatever income he chose to delete," the court said. "Obviously, such an approach is inadmissible and unreliable," it added.

The defendants also argued the expert's report contained mathematical and similar errors, but the court declined to consider those for purposes of its admissibility analysis. The focus, according to the court, was on "principles and methodology, not the conclusions that they generate." Errors and value conclusions may be challenged on cross-examination, assuming the testimony is admissible, the court pointed out. However, here the proposed expert testimony was entirely inadmissible under Rule 702 and *Daubert*.

* * *

In Transfer Pricing Case, Tax Court Fails to Perform Adequate CUT Analysis

***Medtronic, Inc. v. Commissioner,* 2018 U.S. App. LEXIS 22835 (Aug. 16, 2018); *Medtronic, Inc. v. Commissioner*, Tax Ct. Memo LEXIS 111 (June 9, 2016)**

This transfer-pricing dispute was about how to calculate royalty rates applicable to the taxpayer's intercompany licenses. According to the Internal Revenue Service, the taxpayer underpaid income tax by shifting profits and intangibles from its U.S. entities to its Puerto Rican subsidiary. The taxpayer used the comparable uncontrolled transactions (CUT) approach to determine arm's-length royalty rates, whereas the IRS advocated for the comparable profits method (CPM). The Tax Court used the CUT approach but made certain adjustments. On appeal, the 8th Circuit found the Tax Court did not make the in-depth comparability assessment between the CUT and the intercompany licensing agreements the regulations mandated. The concurring judge wrote an insightful analysis of the similarities between this case and patent damages cases that use prior licenses in lieu of a hypothetical negotiation.

Backstory. The taxpayer was Medtronic, a medical device company that manufacturers and markets medical device pulse generators (devices) and physical therapy delivery devices (leads). Medtronic's parent company and its distributor (together, "Medtronic US") were located in the U.S. Its manufacturer, Medtronic Puerto Rico Operations Co. (MPROC), was in Puerto Rico. The U.S. entities were responsible for research related to core products as well as new therapies. The research involved feasibility work to determine whether an idea could be developed into a commercial product. Most of the MPROC employees worked in manufacturing. However, throughout its dispute with the IRS, Medtronic emphasized that the Puerto Rican entity was not simply the manufacturer of devices and leads but played an important role in quality control to ensure that the developed products could be manufactured on a commercial scale.

Medtronic allocated profit earned from its devices and leads between the U.S. entities and the Puerto Rican subsidiary through intercompany licensing agreements. Specifically, Medtronic US and MPROC entered into license agreements, effective as of Sept. 30, 2001, for the intangible property used to manufacture devices and leads. Initially, MPROC paid Medtronic US what the parties considered to be an arm's-length royalty of 29% for devices and 15% for the leads on intercompany sales. Later, to resolve a dispute with the IRS, the entities amended the agreements and MPROC paid 44% royalty to Medtronic US for devices and a 26% royalty for leads.

However, going forward, the IRS and Medtronic continued to disagree over the royalty income. For the tax years 2005 and 2006, the IRS argued that Medtronic's Puerto Rican entity was paying too low a royalty rate to Medtronic US, resulting in a tax deficiency. Medtronic contended that the Puerto Rican subsidiary bore a large part of the risk related to manufacturing defects and deserved a commensurate rate of return on its operations.

Methodology was a focal point of the dispute. The IRS applied the CPM and initially determined that there was an $84 million deficiency. Medtronic rejected the finding and argued in favor of using the CUT method. Medtronic also claimed that, based on the

original royalty rates, it had overpaid taxes. Subsequently, the IRS increased the royalty payments from MPROC to Medtronic US by an additional $455 million. A further re-examination of the case, using the CPM, prompted the IRS to issue a notice of deficiency of over $198 million for year 2005 and over $759 million for year 2006. Seven months later, the IRS amended that notice to claim the deficiencies were about $548 million for 2005 and $810 million for 2006.

Tax Court opts for CUT. Medtronic petitioned the U.S. Tax Court for review, doubling down on its argument that the CUT method was the most appropriate method under the circumstances. It relied on expert testimony to support its position. (The Tax Court dealt with four intercompany agreements but ultimately only the agreement related to device and leads licenses became a point of contention on appeal.) The IRS, also relying on expert testimony, adhered to its argument that the proper approach was the CPM. The IRS contended that the only significant function MPROC had within the Medtronic structure was to assemble the finished products; Medtronic US provided important oversight and assistance.

In a nutshell, the CPM method determines whether the amount charged in a controlled transaction is arm's length by considering objective measures of profitability (profit level indicators) that are derived from transactions of uncontrolled taxpayers that perform similar activities under similar circumstances. The method seeks to calculate "the amount of operating profit that the tested party would have earned on related party transactions if its profit indicator were equal to that of an uncontrolled comparable (comparable operating profit)."

The CUT method looks to the amount charged for the transfer of intangible property in a comparable uncontrolled transaction. The controlled and uncontrolled transactions must involve the same intangible property or comparable intangible property as defined in the regulations.

In applying the CUT method, Medtronic argued the Pacesetter agreement was the best comparable transaction. This 1992 agreement arose out of patent litigation between Medtronic US and Siemens Pacesetter Inc. (Pacesetter). At issue were Medtronic US's patents for many of its cardiac rhythm stimulation devices. Following a court ruling that found Medtronic's patents valid and infringed by Pacesetter, the parties developed a settlement. It was intended to "buy peace" and included cross-licenses for the parties' pacemaker and patent portfolios. Pacesetter also agreed to pay Medtronic US a lump sum of $75 million and would pay Medtronic US a 7% royalty on the sale in the United States of all cardiac stimulation devices or components covered under Medtronic's patents in the U.S. as well as a 3.5% royalty on all sales outside the United States.

The taxpayer's expert used the Pacesetter royalty rate as a starting point and then adjusted for exclusivity and know-how but apparently did not explain the rationale for the know-how increase.

The Tax Court found the IRS had taken an all-or-nothing approach, relying entirely on the CPM and refusing to suggest adjustments to Medtronic's CUT method. However, the CPM analysis was flawed in that it did not give enough emphasis to the quality control role MPROC played and generally underestimated MPROC's role within Medtronic's enterprise, the Tax Court decided. To determine the arm's-length returns for the Puerto Rican entity versus the U.S. entities, the IRS's expert improperly assumed that MPROC's only function was to manufacture a finished product and that all the intangibles necessary to accomplish this task were essentially licensed from Medtronic US. If MPROC did not have the intercompany licenses, the IRS expert assumed, MPROC would have to make deals with a third party to pay for similar intangibles and for a sales force that would market its products. Given its limited role, MPROC was easily replaceable, the IRS maintained. The Tax Court disagreed. MPROC not only made the finished product, but it also had to make a safe product that could hold up over time. Also, the IRS's expert used an incorrect return on assets approach, improperly aggregated transactions, and ignored the value of licensed intangibles.

At the same time, the Tax Court found Medtronic's CUT analysis did not result in an accurate arm's-length adjustment. For one, it did not distinguish between devices and leads and consequently generated an unreliable and overly broad result.

Notwithstanding, the Tax Court found the CUT method to be the best way to determine an arm's-length royalty rate for the intercompany agreements. The court performed its own valuation analysis and made several adjustments to the Pacesetter agreement. Ultimately, the court decided an appropriate rate would be 44% for devices and 22% for leads, which is half of the 44% rate for devices. While Medtronic's expert had failed to differentiate between the two products and did not have a separate rate, Medtronic argued to the court that 15%—about half of the 29% royalty rate for devices—was the appropriate rate for leads since, during the contested years, device operations always were considerably more profitable than leads operations. The Tax Court found that argument convincing for its own rate determination. The court concluded that Medtronic's income tax deficiency for tax year 2005 was about $26.7 million and for tax year 2006 was almost $12.5 million.

Deficient Tax Court analysis. The IRS appealed the Tax Court findings with the U.S. Court of Appeals for the 8th Circuit. The government asked for a reversal and remand for a reevaluation of the best transfer pricing method and a recalculation of the arm's-length royalty rate.

The 8th Circuit began its analysis by noting that the applicable Treasury regulations, specifically section 1.482, state that "there is no strict priority of methods" for determining an arm's-length result of a controlled transaction. When several methods are available, the key factors to consider are "the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis."

Further, if an uncontrolled transaction involves the transfer of the same intangible under the same or substantially the same circumstances as the controlled transaction, the results derived generally will be the most direct and reliable measure of the arm's-length result for the controlled transfer of an intangible. (Treas. Reg. § 1.482-4(c)(2)(ii)) To be comparable, both intangibles must be used in connection with similar products or processes within the same general industry or market and must have similar profit potential. Ibid. subdiv.(iii)(B).

The 8th Circuit noted that a comparability analysis also considered other factors, including relevant functions, contract terms, risks, economic conditions, and property or services.

The 8th Circuit found that the Tax Court's fact-finding did not allow the 8th Circuit to assess whether the Pacesetter agreement was the best CUT here. Specifically, in its comparability analysis, the Tax Court did not sufficiently analyze the circumstances surrounding the Pacesetter agreement as opposed to the Medtronic intercompany licensing agreements. The Pacesetter agreement was the product of litigation. However, the applicable regulations state that transactions not made in the ordinary course of business are not generally considered reliable for arm's-length purposes. The Tax Court did not properly address this factor, the 8th Circuit found.

Moreover, the Tax Court did not analyze the difference when it came to the contractual terms. The Pacesetter agreement included a lump-sum payment and cross-licensing agreements; the Medtronic agreements did not include these terms. The regulations state that, in evaluating the comparability of controlled and uncontrolled transactions, certain factors, including the existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor, may be particularly relevant.

Moreover, the Pacesetter agreement was limited to patents and expressly excluded other intangibles such as technical know-how, design information, manufacturing, marketing, and/or processing information or know-how, designs, drawings, specifications, software source code, and other documentation related to the use of the licensed patents. On the other hand, the Medtronic intercompany licensing agreements did not exclude such intangibles. Even though the Tax Court made a know-how adjustment to account for the value MPROC received from Medtronic US and a small adjustment for the differences between the Pacesetter agreement and the Medtronic intercompany agreements, the 8th Circuit found the adjustment alone did not allow it to assess whether it was appropriate for the Tax Court to use the Pacesetter agreement as a CUT.

Also, the Tax Court did not perform an adequate analysis of how the risk and product liability expense should be allocated between the Medtronic entities. The Tax Court rejected the IRS's claim that MPROC only incurred 11% of the costs of manufacturing devices and leads and therefore the allocation of profits should be similar. The Tax Court, finding the IRS did not appreciate the role MPROC played and the risks it took

related to quality control, allocated almost 50% of the device profits to MPROC, without making specific fact-findings as to the proper risk allocation, the 8th Circuit observed.

The appeals court found that an analysis of these factors was essential to enable it to review the Tax Court's decision to use the Pacesetter agreement as a CUT and to decide whether the Tax Court used the best transfer pricing method and/or made appropriate adjustments under the method it had selected. The appeals court remanded, asking the Tax Court to review the prior opinion in light of the 8th Circuit's decision.

Analogy to patent damages actions. One of the deciding judges wrote a concurring opinion in which he noted that the Tax Court here failed to sufficiently address four factors in its comparability analysis: (1) the litigation context giving rise to the CUT; (2) the lump-sum payment; (3) cross-licensing; and (4) exclusion of certain intangibles.

The concurring opinion noted that an analysis of these factors is not just important for appellate review, but also consideration of these factors is mandatory under the applicable Treasury Guidelines.

Moreover, courts determining damages in patent infringement cases also find these factors decisive, the concurring opinion observed. The goal in patent cases is to achieve a royalty that the parties would have arrived at in a hypothetical negotiation between the patent holder and the infringer prior to the infringement. Often the parties look to earlier licensing agreements as proxies for the hypothetical negotiation, the concurring opinion said. However, in patent cases, "courts often shy away from comparisons that differ on even one of the four planes the tax court failed to analyze here." Any search for a comparable uncontrolled transaction is "quixotic," the concurring judge noted. "But, I harbor serious doubts that the Medtronic-Pacesetter agreement can serve as an appropriate CUT."

* * *

Court Looks to Owner's 'Proportionate' Share in Business to Quantify Appreciation in Value

***Herbert v. Joubert,* 2018 Va. App. LEXIS 222 (Aug. 14, 2018)**

This divorce case provides insight into how a valuator can quantify the increase in the value of the owner spouse's separate property that was achieved during the marriage. Here, the owner spouse retained a veteran appraiser to defeat the statutory presumption that all of the enhanced value was marital property. The expert's multipart analysis included separating the passive and active factors that contributed to the appreciation and teasing out the value of the contributions of third parties to arrive at a residual value representing the marital share. The trial court, in a somewhat muddled ruling, adopted part of the valuator's analysis of active factors, and the appeals court affirmed.

Background. The husband was the co-founder of a company that created trial technology for litigation. The husband and wife agreed that the company was separate property. On the agreed-upon valuation date, December 2015 (the year the couple separated), the husband held a 30% interest in the company. Three other principals together owned the remaining 70%. The parties did not dispute that the value of the company increased significantly during the marriage and that the personal efforts of the husband contributed to producing the increase.

The major sticking point during the divorce proceedings was how much of the increase qualified as marital property. The wife claimed all of it did, whereas the husband, through expert testimony, argued that 14% of all the activity contributing to the company's growth was attributable to the husband's personal efforts. This was the marital portion.

The underlying legal issue was whether the owner spouse, the husband, met the applicable burden of proof.

Applicable legal principles. Pursuant to Virginia law, if separate property increases in value during the marriage, the appreciation is considered marital property if the personal efforts of either spouse generated it and if certain other conditions that were not at issue in this case are met. The personal efforts must be "significant" and must lead to a "substantial" appreciation of the separate property.

Initially, the nonowner spouse has to prove that: (1) one or both spouses expended personal effort on the separate property during the marriage; and (2) there was an increase in value. If this burden is met, a statutory presumption in favor of the nonowner spouse kicks in, which says that the personal efforts caused all of the increase in value. In other words, the entire enhanced value is marital property. To counter the presumption, the owner spouse has to show that other, passive and active, factors contributed to or produced the increase. Assuming the owner spouse satisfies the burden of proof, the trial court may make the appropriate downward adjustment to the percentage of the increase classified as marital property. *See* Code of Virginia § 20-107.3(A)(a).

Expert uses residual approach. To distill the value of the husband's personal efforts for the company, the husband engaged a CPA who had extensive valuation experience. The husband's expert said he used a "residual approach" under which he "start[ed] with 100% appreciation" and whittled that percentage down by looking at two factors: market forces and the active efforts of third parties. According to the expert, after accounting for those factors, the percentage left over is attributable to the spouses' personal efforts. (Here, the wife did not dispute that the personal efforts at issue were those of the husband.)

The expert detailed the market forces (i.e., passive factors) he considered, including the volume of patent litigation, which was a primary litigation area using the company's

services. Market forces, the expert concluded, accounted for 48% of the total appreciation in value between the relevant dates. The wife objected that the calculations were speculative, and the trial court agreed.

In terms of third-party efforts, the expert looked at the contributions of the company's other principals. As for the control factor, he noted that the remaining partners owned 70% of the company, whereas the husband owned 30%. As for management contributions, the expert considered the various partners' supervisory roles and their recruitment of new employees. Further, he considered the partners' direct revenue generation.

The expert noted that the husband and two other partners had a similar amount of supervisory duties. All of the partners contributed to the growth of the company by "recruiting key professional staff." Initially, all the partners also contributed to growing the company through direct marketing efforts. In later years, the husband's role shifted from serving as the "primary rainmaker" to managing the company's finance department and overseeing operations.

The expert's analysis of direct generation of revenue showed that the partners owned 70% of the company and produced 77% of the revenue. When the figures were averaged, the partners' efforts produced 73.5% of the increase in value, whereas the husband's personal efforts produced the remaining 26.5% in company revenue, the expert concluded.

Moreover, the expert undertook a third analysis that considered everything—the market forces, third-party efforts, and the husband's personal efforts—and arrived at a rate of 14% representing the marital portion of the increase in value of the husband's ownership interest.

Passive factor analysis not persuasive. The trial court, in a letter opinion, first determined that the total amount representing the increase in value was $2.2 million. The court noted and rejected the expert's analysis and conclusion as to the effect of passive factors. The court said there was insufficient evidence as to the degree to which market forces, patent litigation, and other passive factors were responsible for the increase in company value. The passive-factor analysis alone did not defeat the presumption that 100% of the increase was marital, the trial court found.

The court also found the expert's determination that only 14% of the husband's personal efforts helped to generate the increase "materially understated" the husband's contribution.

However, the trial court considered the expert testimony on active factors, including the efforts of the husband's partners and the husband's efforts. According to the court, the expert relied mostly on figures related to the direct generation of revenue, as the husband provided. The court rejected the expert's proposition that once the husband's duties switched from bringing in clients to managing key aspects of the company, the

amount of the increase in value attributable to the husband's effort declined. As the court saw it, the change in the husband's duties meant the other partners believed the company would benefit from the husband's taking on a more managerial role. Also, the husband did so while the company's workforce doubled and while it became "the largest company in its industry."

The trial court said it found the husband's testimony on his contribution to the company "generally credible." But it noted the husband failed to differentiate between his contribution and the contribution of others.

The trial court emphasized that the husband's "proportionate" share in the business was 30% and decided this rate represented the share attributable to the husband's effort in generating the increase in value. Therefore, 30% was marital property. The court referenced the expert testimony, which calculated a 26.5% share, noting the expert's conclusion was only slightly lower and supported the court's finding.

However, in its letter opinion, the court listed the full amount of the increase in value in the slot asking for the dollar amount to be included in the equitable distribution. The court later acknowledged its mistake and issued an amended opinion that stated that approximately $664,000 represented the marital portion of the increase in value.

Not a 'formulaic approach.' The wife claimed the trial court committed several errors related to the valuation of the husband's interest in the company. The gist of her argument was that the trial court erroneously found the husband met the burden to show less than 100% of the increase was marital property.

The Court of Appeals rejected the wife's assertion that the trial court's original letter opinion, listing 100% of the increase as marital property, was correct. It also rejected the claim that the trial court's subsequent decision to attribute 30% of the husband's personal efforts to the increase based on his ownership share was arbitrary.

The appeals court noted the trial was critical of some of the evidence the husband offered to meet the burden of proof, particularly regarding the contribution of passive factors to the increase in value. However, the trial court did not reject the evidence the husband's expert offered regarding the impact of the *personal efforts* of the company's other principals, the appeals court emphasized. In fact, in finding that 30% of the company's growth was attributable to the husband's efforts, the trial court expressly noted the expert's calculation (26.5%) was only slightly lower.

The appeals court also said that the husband's expert also had taken into account the husband's ownership interest but decided the percentage should be reduced based on the husband's average revenue generation. The trial court, in turn, found that, even though the husband's direct generation of revenue declined in later years, he indirectly contributed to the increase in value through his managerial role in the company.

The Court of Appeals also observed that, in the amended opinion, the trial court said it considered “all of the evidence” for its valuation, including portions of the expert report and expert testimony. And the trial court expressly stated it did not take a “formulaic approach,” the appeals court noted.

The trial court correctly applied the controlling case law and supported its factual findings as to the valuation with evidence, the Court of Appeals concluded. It upheld the decision to designate 30% of the increase in the value of the husband’s share as a marital asset.

* * *

Federal Circuit Sharpens EMVR Test Applicable to Multicomponent Products

***Power Integrations, Inc. v. Fairchild Semiconductor Int’l, Inc.,* 2018 U.S. App. LEXIS 26842 (July 3, 2018)**

In a patent infringement case involving power supply controller chips, the jury awarded the plaintiff almost $140 million in damages based on expert testimony relying on the entire market value rule (EMVR). The Federal Circuit recently struck down the award and, in doing so, elaborated on the showing a patentee must make to justify damages for the entire value of a multicomponent, infringing product that has numerous other valuable features. The test essentially requires the patent holder to prove a negative—a formidable hurdle—which the plaintiff here could not clear.

Litigation history. Both the plaintiff, Power Integrations, and the defendant, Fairchild Semiconductor Corp., produce power supply controller chips that are used in power supplies. The parties have a history of suing each other. In this litigation, Power Integrations alleged Fairchild violated two patents that covered switching regulators and a “power supply controller.” The jury based damages solely on the patent covering switching regulators.

The controller chips are integrated circuits used in power supplies. Switching regulators direct the transistor in the circuit when to turn on and off to send the desired amount of power to the electronic device. The plaintiff’s switching regulator technology addressed problems occurring during low-power periods.

The case first went to trial in early 2014. The jury found infringement of both patents and awarded the plaintiff $105 million in reasonable royalty. The defendant filed a post-trial motion for judgment as a matter of law (JMOL) or a new trial, which the district court denied. However, while the case was still pending, the Federal Circuit (the federal appeals court that hears appeals on patent and certain civil cases) issued a key decision related to the general rule that a patent holder seeking damages for infringement of a multicomponent product must apportion only to the patented feature. Specifically, in its *VirnetX* decision, the Federal Circuit said that apportioning to the smallest salable unit was not enough to meet the apportionment requirement when the

smallest salable unit itself contained noninfringing features. *See VirnetX, Inc. v. Cisco Systems, Inc.*, 767 F.3d 1308 (Fed. Cir. 2014).

Since, in the instant case, Power Integrations had not apportioned to a unit smaller than the smallest salable unit in its royalty calculation, the district court granted a new trial on damages. During the second trial, the court excluded the plaintiff's expert testimony on apportionment under *Daubert*. However, the court allowed the expert to show damages under the entire market value rule. The jury then awarded a reasonable royalty of nearly $140 million. The defendant again challenged the verdict in post-trial motions, which the district court again denied.

The defendant appealed the infringement and damages findings with the Federal Circuit. The defendant's damages argument was that it was improper to use EMVR in this case. The Federal Circuit upheld the infringement finding but agreed with the defendants as to EMVR and damages.

Applicable legal principles. The cornerstone of patent damages is that the patent holder is only entitled to a reasonable royalty capturing the value of the infringing features. The patent holder is reimbursed for the "value of what was taken," no more. Consequently, a royalty calculation must apportion between the infringing and noninfringing features of the product. *See Ericsson, Inc. v. D-Link Sys., Inc.* 773 F.3d 1201 (Fed. Cir. 2014). The Federal Circuit has cautioned that, where infringement of a multicomponent product is alleged, the royalty base should not exceed the smallest salable unit that embeds the patented invention. The court also has cautioned against using the value of the entire product, noting that doing so tends to "skew the damages horizon for the jury, regardless of the contribution of the patented component to this revenue." *See Uniloc USA, Inc. v. Microsoft Corp.,* 632 F.3d 1292 (Fed. Cir. 2011), and *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51 (Fed. Cir. 2012).

The entire market value rule represents an exception to the general rule of apportionment. The overarching goal is to ensure that a reasonable royalty does not compensate for components that the patent does not cover.

EMVR allows the patent holder to obtain damages based on the value of the entire multifeature apparatus if the patent holder can show the patented feature forms the basis for consumer demand. *See Lucent Techs., Inc. v. Gateway, Inc.,* 580 F.3d 1301 (Fed. Cir. 2009). Put differently, the patent holder must "establish that its patented technology drove demand for the entire product." *See VirnetX.* In reviewing case law, the Federal Circuit noted that EMVR may be appropriate in circumstances where the other, nonpatented features are "simply generic and/or conventional and hence of little distinguishing character."

Other valuable features in play. The Federal Circuit noted that, in the instant case, Power Integrations based its royalty rate on one patent's frequency reduction feature. The plaintiff argued this feature drove consumer demand for the defendant's controller chips as many consumers considered this particular feature essential because it

allowed the products that contained the feature to meet the federal government's Energy Star program. The plaintiff also showed that some customers asked for this feature, that products that had the feature sold better than other products, and that marketing material promoted the feature.

At the same time, the parties agreed that the infringing products contained other valuable features. The plaintiff did not offer evidence as to the impact of those other features on the value of the products, the Federal Circuit observed. In its post-trial motion, the defendant claimed the plaintiff did not present enough evidence to support the use of EMVR. The district court, citing a string of cases that preceded the Federal Circuit's *LaserDynamics* decision, said the plaintiff here offered sufficient evidence based on the earlier cases.

In its review, the Federal Circuit pointed out that none of the pre-*LaserDynamics* cases "discussed other valuable features that made the application of the entire market value rule inappropriate." Instead, the earlier cases "merely considered whether a patented feature formed the basis for consumer demand." However, *LaserDynamics* and subsequent cases only allow EMVR if the patented feature is "the sole driver of customer demand or substantially creates the value of the component parts," the Federal Circuit explained.

The test, according to the Federal Circuit, is: "Where the accused infringer presents evidence that its accused product has other valuable features beyond the patented feature, the patent holder must establish that these features do not cause consumers to purchase the product." It is not enough to show the patented feature is essential, that the product would not be commercially successful without the patented feature, or that consumers would not buy the product without the patented feature, the Federal Circuit explained.

The plaintiff here was not able to pass the test because the evidence showed other features in the power supply controllers were important. In fact, the plaintiff sought damages related to one such other feature (a jittering element) in a separate litigation, the Federal Circuit noted. The court observed that the defendant's marketing materials highlighted the jittering feature, as well as several other features. "There is no proof that these features … did not affect consumer demand," the court said. Failing to offer this evidence, the plaintiff did not prove that the patented feature was the sole driver of consumer demand, "i.e., that it alone motivated consumers to buy the accused products," the Federal Circuit concluded.

The court set aside the jury award and sent the case back to the district court for a new trial on damages.

Editor's note: Digests of all of the referenced cases, as well as the court's opinions, are available at BVLaw.

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Fairness Opinion Triggers Viable Aiding and Abetting Claim Against Financial Advisor

***Mesirov v. Enbridge Energy Co.,* 2018 Del. Ch. LEXIS 294 (Aug. 29, 2018)**

In a noteworthy ruling related to a dissenting shareholder action, the Delaware Court of Chancery recently allowed a claim against the financial advisor to a controversial transaction to go forward. The plaintiff accused the financial advisor of aiding and abetting the defendant entities' breach of fiduciary duty by providing a compromised fairness opinion, which ignored a key comparable transaction and other value indicators pointing to overpayment. The court noted that the plaintiff had to meet one of the most difficult pleading requirements there is to survive the defendants' motion to dismiss. The plaintiff's most recent version of the complaint met the standard, the court concluded.

Brief case history. This convoluted dissenting shareholder suit (a class action) began about three years ago in reaction to a third-party related deal, and it has moved between the Delaware Court of Chancery and the state Supreme Court.

In brief, the Court of Chancery dismissed the plaintiffs' first complaint for failure to state viable claims of breaches by the defendants. However, the Delaware Supreme Court, providing guidance on how to construct the controlling limited partnership agreement (LPA), reversed and remanded for further proceedings. The Court of Chancery then allowed the plaintiffs to amend the earlier version of their complaint and substitute a new lead class representative. The revised complaint prompted the defendants to file another motion to dismiss.

Citing baseball's Yogi Berra's "It's déjà vu all over again," Vice Chancellor Slights, who is presiding over the case, noted that he had seen many of the defendants' arguments before and would not entertain those on which he or the high court had ruled earlier. However, the most recent version of the plaintiffs' complaint included a new claim against the financial advisor that required detailed analysis by the court.

The impetus for this lawsuit was a 2015 transaction in which the nominal defendant, a master limited partnership, Enbridge Energy Partners LP (EEP), bought back a significant asset from its general partner, Enbridge Energy Co. Inc. (EEP GP) for roughly $1 billion after having sold the same asset to the controlling parent of EEP GP in 2009 for about $800 million.

EEP GP, and a related management entity, owned a 52.8% limited partnership interest in EEP. The controlling parent, Enbridge Inc. (Enbridge), was a Canadian company that indirectly owned and controlled 100% of EEP GP and, as such, also indirectly controlled a 52.8% limited partnership interest in EEP. The court noted it was not entirely clear from the amended complaint which Enbridge entity (entities) were on the other side of the transaction from EEP. However, the plaintiffs claimed EEP bought the contested asset from EEP GP.

The plaintiffs owned EEP Class A common units. The defendants were various Enbridge entities and directors and officers of EEP GP, as well as the successor company to the financial advisor that had delivered the controversial fairness opinion supporting the transaction.

Ignoring valuation metrics. The asset in dispute was the U.S. portion of the Alberta Clipper pipeline (the AC interest), representing about two-thirds of the pipeline. The gist of the plaintiffs' claim was that EEP overpaid and that several valuation metrics indicated to the special committee and its financial advisor that the agreed-upon purchase price meant EEP was overpaying.

For one, in 2009, EEP GP bought the AC interest for $800 million, which reflected a multiple of 7x projected EBITDA. The deal included a right to expand the pipeline and rights to projects that would substantially increase the pipeline's throughput capacity. However, the 2015 transaction price of $1 billion represented a multiple of 10.7x projected EBITDA. At the same time, between 2009 and 2015, projected EBITDA declined by almost 20% because of a serious drop in the price of Canadian crude oil. Also, the 2015 transaction did not include expansion rights. Further, the interest itself had become much riskier for a number of reasons. One increased risk was that tariffs on the pipeline would be rebased, which could have a long-term negative impact on revenue.

The pipeline operated under a cost-of-service model that enabled it to recover costs over the expected life of the pipeline. The current "rate base," which represented the remaining capital investment not yet recovered, served as proxy for the pipeline's current market and fair value, the plaintiffs alleged. In 2014, the average rate base was about $1.06 billion, and, in 2015, it was $1.01 billion. In 2015, the implied market and fair value of the AC interest was between $674 million and $707 million, the plaintiffs claimed.

In a September 2014 memo, management for EEP GP, the alleged seller, reported to the board that the discounted cash flow value of the AC interest resulted in a value of $478 million. The transaction price, therefore, meant the buyer paid approximately 45% above the DCF value EEP GP had determined, the plaintiffs contended.

Further, the plaintiffs claimed that, as part of the deal, EEP GP obtained shares in a new class of units (Class E units) that had unique tax benefits resulting from the transaction. Holders of Class A common shares did not get this benefit. Also, the Class E units benefitted from a "Liquidation Preference" that public unit holders of EEP did not enjoy. Neither the special committee nor the financial advisor determined the value of the Class E preferred units, plaintiffs argued. Rather, the financial advisor "inexplicably" assigned the Class E preferred units the same value as the Class A common units, the plaintiffs said.

Importantly, a provision of the controlling LPA stated that "[w]henever a particular transaction … is required under this Agreement to be 'fair and reasonable' to any Person, the fair and reasonable nature of such transaction … *shall be considered in the context of all similar and related transactions*." (emphasis added) According to the plaintiffs, the financial advisor "reviewed and analyzed" the LPA. However, it ignored this provision, which required consideration of the 2009 transaction. The latter was "by far the most relevant comparable transaction."

The plaintiffs noted that the financial advisor, which was very familiar with the energy industry, was hired to provide "an opinion as to whether or not the Transaction [was] fair to Partners and the unitholders [sic] of Partners." The fee was $600,000—$100,000 was the initial advisory fee, and $500,000 was payable upon delivery of the fairness opinion, not including expenses. According to the plaintiffs, this was the fourth fairness opinion the financial advisor had provided to the defendants within 19 months. The plaintiffs claimed that, on three earlier occasions, the financial advisor had "rubberstamped" conflicted transactions.

In December 2014, the financial advisor issued a fairness opinion that declared the transaction at $1.025 billion fair from a financial point of view. The plaintiffs alleged that the financial advisor specialized in "issuing fairness opinions on conflicted transactions between master limited partnerships and their controlling sponsor entities." The plaintiffs noted that the financial advisor here knew well that the defendant entities would use the fairness opinion to escape liability for breach of fiduciary duty but was willing to provide a "perfunctory valuation" to maintain its relationship with Enbridge.

'Knowing participation' requirement. At this juncture, the Court of Chancery found the controlling LPA included "contractual fiduciary duties" and that the plaintiffs' current version of the complaint stated a claim that EEP GP and the related management entity breached those duties. One key unresolved question was whether the financial advisor had aided and abetted the breaches.

Under the applicable law, a plaintiff alleging aiding and abetting a breach of fiduciary duty must show several elements: (1) there was a fiduciary relationship; (2) there was a breach of that relationship; (3) the defendant nonfiduciary (here, the financial advisor) "knowingly participated" in the breach; and (4) the breach proximately caused damages.

The survival of the plaintiffs' claim depended on whether the plaintiffs could satisfy the "knowingly participated" requirement, the Court of Chancery explained. The complaint had to present facts "that allow a reasonable inference that the aider and abettor acted knowingly, intentionally or with reckless indifference." This requirement "is among the most difficult in our law to satisfy," the court added.

The Court of Chancery explained that, generally, courts dismiss claims for aiding and abetting against financial advisors when the plaintiffs fail to provide facts "from which it may reasonably be inferred that directors were relying upon the financial advisor to provide information that the board did not already know or that the advisor knew the

board was breaching its fiduciary duties." The court acknowledged that it was difficult to produce those facts at the initial stage of the litigation but said this high pleading burden was appropriate before requiring the financial advisor to defend its advice. The burden was "not insurmountable," the court added. It found that in the instant case the plaintiff had pled enough facts to sustain a claim of aiding and abetting a breach of fiduciary duty against the financial advisor. As to that claim, the court denied the defendants' motion to dismiss.

In terms of remedies, the court also clarified that the state Supreme Court earlier had found the plaintiffs convincingly alleged that the defendants had acted in bad faith. At this point, based on the plaintiffs' allegation, the defendants were not entitled to a presumption of good faith by arguing they relied on the financial advisor's fairness opinion, the Court of Chancery said. It allowed the case to move to discovery on the surviving claims.

* * *

Expert's Inability to Defend Income Analysis 'Is Decidedly Troubling,' Court Says

Judges are alert to incongruities in valuations, as is clear from a recent condemnation case in which landowners hired three experts to calculate the compensation owed to them. The court excluded all experts under *Daubert,* and it had particularly harsh words for the valuation expert who was unable to support critical elements of the valuation. The income analysis lacked "any indicia of reliability" and the capitalization rate determination was "entirely suspect," the court said.

A pipeline reached agreements with most landowners whose property was affected by the construction. However, the company litigated the compensation issue with a couple of property owners who operated a Christmas tree farm on some of the condemned land. They argued the construction altered the soil composition and growing conditions, making it impossible, going forward, to grow the "highly coveted Fraser fir tree." Also, the construction forced the owners to prematurely harvest their Christmas trees, which resulted in a substantial loss.

The correct measure of damages was the difference between the property's fair market value immediately before and after the taking, plus any incidental damages to the remaining property. Further, the court declined to exclude, as a matter of law, evidence of lost profits.

However, the court found the loss analysis the landowners' BV expert offered was fatally flawed. Assuming no trees would ever grow on the property again, she valued the business under the asset, market, and income approaches. The first two analyses resulted in a loss to the landowners of $167,000 and $157,000, respectively. The income approach, which the expert said best captured the loss, increased the amount to $888,000.

Using the build-up method to determine the capitalization rate, the expert relied on Duff & Phelps (D&P) figures for her risk-free rate of return and equity risk premium. But she rejected D&P's 5.9% small stock risk premium, using a 1% rate instead. The court noted the effect on the loss calculation was dramatic, where using a 5.9% rate would have reduced the expert's proposed $888,000 loss to about $339,000, leaving all the other inputs the same. The expert failed to explain "why she used the 'generally accepted' Duff & Phelps numbers when they raised her valuation but ignored the guide's suggested number when it lowered her valuation," the court said. It also questioned other inputs. Even though experts in disciplines requiring the use of professional judgment are generally less likely to be excluded, they are not immune, the court cautioned. Professional judgment alone, without a demonstrated basis in facts or data, is insufficient to support opinion testimony," the court said. It deemed the expert's opinion inadmissible.

* * *

Can ESOP Appraisal Satisfy Charitable Contribution Reporting Requirement?

***Chrem v. Commissioner*, 2018 Tax Ct. Memo LEXIS 164 (Sept. 26, 2018)**

This charitable contribution case, which was in front of the Tax Court on motions for partial summary judgment, includes a noteworthy discussion about what it means to provide a "qualified appraisal" in the tax context. Here, the petitioners-sellers donated stock to a nonprofit as part of a two-step stock acquisition by a related entity. The petitioners later argued a related ESOP appraisal sufficiently satisfied the income tax verification requirements. Although the court explained in great detail why, on the face of it, the ESOP report did not seem to be the kind of appraisal the regulations contemplated, the court ultimately found a reason to send this issue to trial, barring settlement by the parties.

Two-step acquisition. A number of petitioners owned all of the stock of a closely held Hong Kong company, Comtrad Trading Ltd. As of October 2012, Comtrad had 7,000 shares of outstanding common stock, of which the petitioners owned 5,425 shares. A few other individuals or couples related to the petitioners held the remainder shares.

Comtrad's primary customer was a U.S. corporation (SDI Technologies) that manufactured and sold a broad spectrum of consumer electronic goods. SDI was organized as an S corporation and was owned by an employee stock ownership plan (ESOP). The petitioners and other shareholders of Comtrad appeared to be beneficiaries of the ESOP. Comtrad and SDI were related in other ways as well. The companies had shared management, and there was an overlap of the board of directors.

In late 2012, SDI developed a plan to buy all of Comtrad's stock in a two-step process. SDI said the acquisition, among other things, was intended to "take advantage of the favorable tax treatment that would be afforded Comtrad's net earnings due to SDI's

status as an S corporation." The first step was for SDI to buy 6,100 of the 7,000 shares for a price of $4,500 per share, with $450,000 paid in cash and $27 million paid in promissory notes. The second step required the petitioners to donate the remaining 900 shares to a Jewish nonprofit and "use all reasonable efforts" to cause the nonprofit to tender the shares to SDI. SDI would pay $4,500 per share in cash for the 900 shares and secure 100% ownership of Comtrad. If that effort failed, SDI would use a squeeze-out merger or other technique to secure the remaining shares; however, if those efforts failed within 60 days of acquiring the majority of shares, SDI would return the acquired shares to Comtrad's shareholders.

'Sole use' appraisal. The ESOP trustee hired a valuation firm to determine the fair market value of "100% of the ordinary shares of Comtrad" to ensure that the ESOP paid no more than adequate consideration for the stock, as required under the Employment Retirement Income Security Act (ERISA). The ESOP valuator noted that the acquisition would occur "in two stages" and that, in each stage, the contemplated price per share was $4,500. The appraiser valued Comtrad as a going concern, using the market approach and income approach (discounted cash flow analysis) and applying a 5% marketability discount. The relatively low DLOM was appropriate because the discount rate was significantly less for a control block than a minority interest block, the appraiser explained.

Based on its analysis, the ESOP appraiser concluded that the FMV of Comtrad's shares was between approximately $4,200 per share and $4,600 per share. The valuator submitted to the ESOP trustee a "restricted use appraisal report" and two days later a fairness opinion that concluded the contemplated transaction was fair to the plan. The valuator also said that its combined report was for "the sole use" of the ESOP trustee and that the appraisal "does not take into consideration any tax consequences related to Comtrad's selling shareholders" (i.e., the petitioners and remaining shareholders).

Two days after submission of the ESOP fairness opinion, SDI purchased the 6,100 shares. At the time of the Tax Court proceedings, the parties were in dispute over when the petitioners donated the remaining 900 shares to the nonprofit. The timing mattered for purposes of deciding whether the petitioners were liable for taxes related to the donation. The parties agreed, however, that the nonprofit tendered the gifted shares on the same day the Comtrad shareholders tendered their shares. All shareholders received $4,500 per share, but the nonprofit was paid in cash.

On their income tax forms for the applicable tax year 2012, the petitioners claimed a noncash charitable contribution deduction. The petitioners submitted an appraisal summary on Form 8283, Noncash Charitable Contributions. The individual petitioners indicated the number of shares each of them donated. A representative of the ESOP appraiser signed a "Declaration of Appraiser" on each Form 8283. The forms listed Dec. 5, 2012, as the date on which the nonprofit received the donated stock.

Under the verification requirements applicable in charitable contribution situations, where a taxpayer makes a charitable contribution of property worth more than $5,000,

the taxpayer must secure a “qualified appraisal.” See 26 U.S. Code § 170(f)(11)(C). If the taxpayer claims the contribution is worth more than $500,000, he or she must provide a copy of the appraisal with the tax return. 26 U.S. Code § 170(f)(11)(D).

Here, none of the petitioners secured an individualized appraisal or attached an appraisal to their individual returns. But the Internal Revenue Service (IRS) examined the petitioners’ tax returns and asked that, for qualified appraisals, each petitioner provide a copy of the ESOP appraiser’s report. The IRS then issued notices of deficiency, stating that the petitioners were liable for taxes in connection with the transfer of shares to the nonprofit under the assignment of income doctrine. Further, the petitioners were liable for failing to satisfy the charitable contribution substantiation requirements. The IRS also claimed that accuracy-related penalties applied. In response, the petitioners, in 11 separate actions, asked the U.S. Tax Court for a review. The court consolidated the cases. Both sides filed motions for partial summary judgment, on which the court ruled in this decision.

Assignment of income issue. The court first dealt with the IRS’s claim that the petitioners faced a tax liability related to the donated stock under the assignment of income doctrine, which says that income is taxable to the person who earns it and that a person who anticipates receipt of income “cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person.”

Numerous cases have dealt with the assignment of income doctrine involving the use of charitable contributions, the court observed. Typically, the taxpayer donates to a charity stock that is about to be acquired by the donor through stock redemption or by another corporation in a merger or acquisition. Before the doctrine applies, courts must decide whether there is a mere expectation of acquisition or whether the future acquisition, and realization of gain, is virtually guaranteed. Another important consideration regarding this issue is the donee’s control. The question is whether the parties involved in the transaction can compel the donee (charity) to surrender the donated shares. The court noted that the existence of an “understanding” among the participants to the transactions might be a relevant piece of information, as might the timing of the transactions.

The court decided it was not able to resolve this issue summarily because a genuine dispute over material facts existed and required development at trial. For example, the buyer and seller in this transaction were related and both aimed to complete the stock acquisition, the court observed. Further, email and a document exchange involving the chosen charity suggested that the charity in advance agreed to tender the donated shares and that the steps to the transaction were prearranged.

The parties disagreed over the dates on which the transactions occurred. The petitioners claimed the donation took place about a week before SDI acquired the remaining shares from the nonprofit. Some documents appeared to support this claim, the court found. However, the IRS contended the nonprofit became owner of the remaining shares only two days before it tendered them to SDI and only until it had

unconditionally agreed to sell them to SDI. There was support for this contention as well, the court found, including a note from the ESOP appraiser that said the remaining 900 shares would be transferred "[s]imultaneously with SDI's acquisition of the 6,100 shares."

Another important factor might be whether the nonprofit, as the custodian of charitable assets, sold the shares because it had certain fiduciary duties to the organization, the court noted. It pointed out that, if the nonprofit tendered the shares, it would immediately receive $4,500 per share in cash. If it failed to do so, it might be left with a 13% minority interest in a closely held Hong Kong company whose market value "might be questionable."

"A trial will be necessary to determine whose version of the facts is correct," the court concluded as to this issue.

Qualified appraisal issue. The court explained that income tax regulations applicable to charitable contributions other than money require that a "qualified appraisal" include (among other things): (1) a sufficiently detailed description of the donated property; (2) a "statement that the appraisal was prepared for income tax purposes"; (3) the date of (or expected date of) contribution to the donee; (4) the appraisal date; (5) the appraised fair market value of the donated property. See Sec. 1.170A-13(c)(3)(ii).

Case law shows that in certain circumstances the taxpayer claiming a deduction may satisfy the appraisal verification requirement by proving substantial, as opposed to literal, compliance. Also, as a defense, the taxpayer may show the failure to comply with the reporting requirements "is due to reasonable cause and not to willful neglect." The taxpayer may show "reasonable cause" by proving that he or she relied on the advice of a tax professional.

The IRS did not challenge the ESOP appraiser's status as a "qualified appraiser." Instead, the government claimed the appraiser's report did not represent a "qualified appraisal and that, even if the report were a qualified appraisal, the petitioners who donated stock worth more than $500,000 did not qualify for a deduction because they failed to attach copies of the appraisal to their tax return, as required by the regulations.

The petitioners countered that they substantially complied with the legal requirements. In the alternative, they maintained the failure to comply was excusable under the "reasonable cause" defense.

The court agreed with the IRS that the ESOP appraisal "fits awkwardly with the appraisal reporting requirements." The court noted the offered appraisal did not examine any charitable contributions of property, it did not state the date or expected date of the contribution, and it did not include a statement that it was prepared for income tax purposes. Just the opposite, the court noted. The ESOP appraisal expressly said it was for ERISA compliance purposes and it did not consider any tax consequences for the selling shareholders. Also, the appraiser did not value the specific

property each petitioner actually donated. The donations ranged from 35 to 125 shares of Comtrad's stock.

The petitioners together donated fewer than 13% of the company's outstanding shares, but the ESOP appraisal, valuing the company as a going concern, determined the value of 100% of the company's shares, the court noted. The ESOP appraiser was focused on ensuring the offering price met ERISA's "adequate consideration" requirement, the court noted. Further, since the ESOP appraisers valued the entire company, it was appropriate to apply no minority discount and a small DLOM. If the appraiser had been asked to value the minority interest block that each petitioner donated to the nonprofit, it "would obviously have written a very different sort of report," the court said.

The court noted that the petitioners took the position of "no harm, no foul." They argued that the nonprofit in effect might have received a better deal because SDI paid cash for the shares the nonprofit sold, whereas the other Comtrad shareholders mostly were paid in promissory notes. Rather than a discount, an appraiser might have applied a premium, the petitioners contended. Although the petitioners admitted that the relied-upon appraisal did not meet the requirements the regulations specified, the petitioners considered these lapses nothing more than technical shortcomings.

An appraisal that values property different from the property donated can be fatal to the taxpayer's claim for a charitable contribution deduction, the court said. Moreover, it pointed out that the petitioners who claimed donations of $500,000 faced another hurdle in their substantial compliance argument in that they failed to attach the qualified appraisal. It is not obvious that providing a fully completed Form 8283 satisfies this extra requirement, the court noted.

At the same time, the court allowed that the petitioners' failures as concerns the appraisal might be excused under the "reasonable cause" provision. The petitioners claimed an experienced CPA had prepared the relevant tax returns based on the ESOP appraisal report and based on all relevant information about the stock acquisition. According to the petitioners, the tax preparer did not instruct them to include a copy of the appraisal with their returns. The court found, at this time, the record was silent on what, if anything, the CPA advised regarding the appraisal report and whether the petitioners relied in good faith on any advice the CPA gave.

The court said the "reasonable cause" issue was another issue that would need to go to trial, barring settlement. The court further noted that, if the petitioners were able to prevail on the "reasonable cause" defense, it would be unnecessary for the court to determine whether they substantially complied with the appraisal reporting requirements. Moreover, the court said, there could be an overlap between the assignment of income issue and the appraisal requirements issue. The court envisioned a scenario in which the petitioners might argue they did not need to obtain an appraisal at all because the value of Comtrad stock was set at $4,500 per share based on an offer from SDI that was certain to close.

Stay tuned.

* * *

Court Adopts Appreciation Analysis That Places 'Specific Dollar Value' on Goodwill

***Mann v. Mann*, Case No. 14-DR-1064 N, Circuit Court of the Twentieth Circuit in and for Lee County, Fla. (July 7, 2016)**

In recent years, appreciation in the value of separate property has become one of the most contested issues in divorce cases. Valuation expert testimony has been critical for the parties both to show (or refute) an increase in value and to quantify the marital portion of that increase, assuming it exists. The valuation discussion in a recent Florida divorce case is noteworthy because it shows how a goodwill analysis may fit into an appreciation determination and how a noncompete analysis may fit into the personal goodwill determination.

Key role in thrift-shop business. The parties married in September 2003. At that time, the husband was a family lawyer and the wife was a 50% shareholder of a family thrift store business (Cosas Buenas Baratas Inc. (CBB)), which had stores in various states, including Florida. The business, which the wife's father started in 1987, was organized as an S corporation. The wife worked there while she was in college and later full time, starting at the bottom and eventually ending up as CBB's president and CEO. Along the way, the wife cultivated a critical relationship with the business's main supplier of inventory, the Vietnam Veterans Association (VVA). Typically, VVA solicited donations and, in a bid process, used an operator, including CBB, to pick up the donated goods. CBB paid VVA for the inventory and then sold the donated goods in its stores. After the wife's father, who initiated the relationship with VVA, pulled back from the business, the wife assumed full responsibility for maintaining the connection.

The VVA connection was vital for CBB's success, even more so when VVA moved away from a strict open bid process and used more VVA operators with whom it had proven personal relationships. This new arrangement, which developed during the divorce proceedings, meant CBB no longer had to participate in a bidding war to ensure renewal of its one-year contract with VVA.

During the wife's 17-year involvement with the family business, she acquired 65 shares (of 100 shares) in three transactions. A flashpoint throughout the litigation was how the shares should be legally classified. Were any them separate property or were all 65 shares (a controlling interest in the company) marital property?

The first transaction took place in 1998, when the wife and her father agreed that he would transfer 38 nonvoting shares of CBB to the wife at $27 per share. In exchange, the wife signed a nonrecourse promissory note for over $1 million. In 2001, the wife and her father agreed that he would transfer an additional 12 shares of nonvoting stock for

the same per-share price. The wife signed another nonrecourse promissory note for $324,000, and the second transfer was memorialized in a stock certificate. The transaction resulted in the wife owning 50% of the total number of CBB shares. The agreement between the wife and her father was that she would pay her father for the shares out of distributions received from the company. Because of the company's S corp status, the wife was liable for income tax on the distributions. At the date of marriage (September 2003), the wife's payments on the shares totaled nearly $198,000.

A third stock transfer took place in July 2004, after the wife and husband were married. The husband, convinced that the wife's father did not act in the wife's best interest and that the prior transfers were not real, enlisted the help of an attorney he knew to pursue a modification of the prior notes. The amended agreement also provided that the wife's father would transfer an additional 15 shares to the wife. The new agreement stated the other agreements were still in effect to the extent the 2004 agreement had not modified them. The 2004 transfer increased the wife's shares in the company to 65, which resulted in her owning a controlling interest in CBB. Also, the 2004 amendment gave the wife voting rights to all shares.

The wife had been running the company since 2001. At the time of the divorce proceedings, the company had 200 employees in four stores across the country. Throughout the marriage, the wife kept working at the company and financially provided for the family. Meanwhile, after the marriage, the husband closed down his law practice, declared that he would become a mediator, and, later, with backing from the wife, became a county judge. However, during the divorce proceedings, and before his term as judge was up, he resigned his judgeship and stopped working or searching for work. He never contributed to the business.

Separate vs. marital assets. The parties separated in June 2013, and the husband filed for divorce in March 2014. The parties did not have any joint bank accounts or real estate. The divorce proceedings centered on CBB: how to classify the 65 shares the wife held in the company and how to determine the value of the marital interest in the company.

The husband's main argument, to which he returned again and again, was that all of the 65 shares were marital property because the wife only "actually" acquired them by way of the 2004 stock modification agreement that the husband had negotiated with the wife's father. The husband maintained that the 1998 and 2001 stock purchase agreements were illusory or void for lack of consideration.

The trial court rejected this argument, finding the wife had had legal ownership of the initial 50 shares before the marriage. As such, those shares were not a marital asset and not subject to equitable distribution at divorce.

At the same time, the court found that the additional 15 shares the wife acquired after the marriage, in the 2004 transfer, represented a marital asset.

Although the wife's 50 shares in the company were not a marital asset, under the applicable state statute, the appreciation (enhancement) in value of a nonmarital asset is a marital asset if the appreciation results either from the efforts of either party during the marriage or from the contribution to or expenditure of marital funds. Passive appreciation in value (an increase generated by market forces) does not render the appreciation a marital asset.

The court found here there was not enough evidence that the husband contributed marital labor to enhance the value of the wife's 50 shares. However, the wife's efforts—leading and managing the company—resulted in an increase in the value of those shares, making the enhancement in value a marital asset for purposes of an equitable distribution analysis, the court said.

The parties offered testimony from three valuation experts to determine the value of the marital portion in the wife's 65 shares in CBB. Two experts testified on behalf of the husband, one expert testified on behalf of the wife. They used different valuation dates.

Three discrete valuations. The court clarified that the total marital value of the wife's shares required the three experts to subtract the value of the wife's 50 shares as of the date of marriage from the total marital value of the wife's 65 shares as of the date of valuation.

Value of 50 shares (nonmarital property). The husband's first expert calculated the value of the 50 shares as of the date of marriage was $376,000 in total. The husband's second expert determined the value was $500,000 in total.

The wife's expert found the value was $400,000 in total.

Value of 65 shares. The husband's first expert determined that the value of the wife's 65 shares was $3.1 million. The husband's second expert found the value was $2.6 million or $2.8 million, depending on the valuation date.

In contrast, the wife's expert found the value of all shares was $1.56 million.

Marital value of 50 shares (nonmarital) and 15 shares (marital). The husband's first expert, using as valuation date Dec. 31, 2013, the last year-end closest to the date of divorce filing, calculated a marital value of $2.7 million. The husband's second expert, using as valuation date Dec. 31, 2012, the last year-end closest to the date of separation, found the marital value was $2.1 million; alternatively, using as a valuation date Dec. 31, 2013, the last year-end closest to date of divorce filing, this expert achieved a marital value of $2.3 million.

In contrast, the wife's expert, using as a valuation date the date of separation, June 2013, determined the marital value was just short of $1.2 million.

Goodwill attributable to wife. Significantly, the calculations the wife's expert provided included a goodwill analysis that separated the goodwill attributable to the wife (personal goodwill) from the value of the wife's ownership interest in the company. He was the only expert to quantify any goodwill, the court noted.

The analysis pivoted around the wife's strong ties and relationship with the company's key inventory supplier, VVA. This relationship, the expert explained, was the "secret sauce" to keeping the company a going concern. Without the wife's relationship with VVA, the company would not have access to inventory and would stop existing, considering 90% of the company's inventory came from VVA. Moreover, the wife's strong connection to VVA assumed particular importance when VVA changed the open bid process to a process that relied on personal relationships with known VVA operators, including CBB.

At trial, the experts agreed that the measure of the wife's personal goodwill was the amount a willing buyer for the company would pay for a noncompete agreement from the wife. If a willing buyer does not think it necessary to require the wife to execute a noncompete, the logical conclusion is that there is no significant goodwill attributable to the wife, the court noted. There is no value to the personal goodwill. But if, in an arm's-length transaction, a willing buyer would be expected to make the wife's noncompete a condition of the purchase, then personal goodwill exists and its value would be the amount the buyer was willing to pay for the noncompete agreement, the court noted. The wife's expert maintained that, here, a willing buyer would definitely require the wife to sign a noncompete as a condition of purchasing her interest in CBB.

On the other hand, the husband's first expert claimed there was no goodwill attributable to the wife. In the alternative, even if there was personal goodwill, it was not worth much, this expert contended. The husband's second expert admitted in court that he was not familiar with the process of valuing a noncompete agreement.

The court agreed with the wife's expert that the proper valuation date was the date of separation. This was the date when the parties "ceased acting as marital partners, and there was no evidence of reconciliation" between the separation and filing for divorce, the court noted.

The court said the valuation date issue was but one reason why the court adopted the value determinations the wife's expert proffered. This expert had "far superior credentials with regard to the nature and type of valuations required here," the court said. It also pointed out that he was the only expert "who placed a specific dollar value on the Wife's personal goodwill." The court agreed with the expert that an "'arm's length' buyer of Wife's interest in CBB Inc. would almost certainly require a noncompete agreement from the Wife as a precondition to any purchase and sale transaction." The court noted how difficult it would be for any outsider to break into the thrift store business as a VVA operator without help from an existing operator who had strong ties with VVA. It adopted the statement by the wife's expert that the value of the wife's noncompete to a potential buyer would be $900,000.

The court also noted that a relationship with a key supplier, such as existed here, was a "strong element of personal goodwill apart from relationships with CBB, Inc.'s retail customers."

The court pointed out that the husband's first expert had developed his valuation on the mistaken assumption that VVA still used an open bid process. The court dismissed this expert's claim that his analysis of 58 transactions involving similar companies showed the market did not consider noncompetes important. The court noted that, on cross-examination, this expert admitted he had not given an accurate report of the examined data but had intentionally ignored certain transactions to support his claim that most transactions did not require a noncompete. The court further observed that the expert had never testified in a trial. Yet, said the court, he held firmly to his opinion on the noncompete issue, even as he admitted he had never been involved in a transaction where the buyer did not insist on a noncompete from the seller. This expert's testimony lacked credibility, the court concluded. It also dismissed the opinion of the husband's second on the goodwill/noncompete issue, noting his lack of experience.

In adopting the value conclusions the wife's expert proposed, the court found the value of the marital portion of the wife's interest in the company was $1.16 million for purposes of the court's equitable distribution analysis.

The breakdown was as follows: $800,000 in appreciation in 50 shares brought to the marriage plus $360,000 for 15 shares acquired during marriage, resulting in a total marital value of $1.16 million.

Finally, the court noted that, throughout the marriage, the husband had greatly benefitted from the wife's nonmarital assets and the increased value of CBB, while doing relatively little work himself. "Consequently, he will leave this marriage with significantly more than he had prior to the marriage," the court said.

Editor's note: On Sept. 1, 2017, the Florida 2nd District Court of Appeal affirmed the trial court's findings per curiam. The appeals court did not issue a written opinion.

* * *

Underdeveloped Comparability Analysis Means Exclusion of Reasonable Royalty Opinion

***Meridian Mfg. v. C&B Mfg.*, 2018 U.S. Dist. LEXIS 172243 (Oct. 5, 2018)**

This patent infringement case in which both parties raised *Daubert* challenges to the opposing expert's damages opinions provides a recap of key legal principles informing reasonable royalty and lost profits calculations. Among the contested issues was how an expert may use noninfringing alternatives when developing a hypothetical negotiation and what an expert, relying on prior licenses, must do to establish

comparability to the patented technology. The court here, as well as in other cases, makes it clear that an expert's "superficial recitation of the *Georgia-Pacific* facts, followed by conclusory remarks" does not make the testimony admissible.

Background. The plaintiff was the owner of a patent for an agricultural trailer that helps farmers transport large boxes of seeds to planters in the fields. The trailer features guide plates that facilitate centering the box on a wheeled bed. The guide plates are a special feature. The defendant, a manufacturer of consumer and industrial products, sold a seed tender that the plaintiff claimed violated its patent. After the plaintiff sent a cease and desist letter, the defendant continued selling its trailers. However, following a hearing in late 2015, the court found the defendant's seed tender infringed a specific claim of the plaintiff's patent and the defendant began to redesign its seed tender. The parties continued to disagree over whether the redesign solved the infringement.

Both sides filed pretrial motions, including motions to exclude damages expert testimony under Rule 702 of the federal rules of evidence and *Daubert*.

Defense expert admissible. The defendant's expert was an experienced CPA and certified financial forensic analyst who provided a reasonable royalty analysis and a lost profits analysis.

The expert stated that the defendant had advised her that the contested seed tender had a number of features and that the guide plates were a key feature. The expert therefore identified the latter as the "patentable feature," and, since this feature was only a portion of the tender, she found that apportionment between the guide plates and the tender's other features was necessary. The expert also determined that she lacked the information she would need for an apportionment analysis. Based on information from the defendant, the expert understood the redesigned seed trailer received a good response from dealers and customers because it was sturdier and less expensive to produce. Considering the difficulty of apportioning, the expert therefore proposed that a reasonable royalty in this case should be based on the production cost differences between the infringing design and the redesign. Put differently, "a reasonable royalty would not be more than the cost to [the defendant] to develop and implement an alternative, non-infringing design," the expert said. She proposed a lump-sum royalty of $15,000 to $30,000.

The plaintiff argued the expert's testimony was inadmissible. The expert lacked the qualifications to comment on technical matters, specifically to testify about a "patentable feature," the plaintiff said. The court quickly dismissed this objection, noting the expert would be able to explain how a particular feature informed her damages analysis.

The plaintiff also claimed the expert used an unreliable methodology in that she tried to limit reasonable royalty damages to the cost of developing a redesigned seed trailer and in that she considered the defendant's redesigned trailer to be an acceptable noninfringing alternative.

The court first explained the various ways for calculating a reasonable royalty. An expert might rely on an established royalty, the infringer's profit projections for infringing sales, or develop a hypothetical negotiation between the patentee and infringer. The Federal Circuit has found that there is no law that requires reasonable royalty rates be based on the cost of implementing an available noninfringing alternative. At the same time, the Federal Circuit also has held that, practically, the difference between the infringing product or technology and the noninfringing alternative placed a limit on the reasonable royalty rate because in a hypothetical negotiation the infringer would not have paid more than that difference.

The court in the instant case said that the defendant's expert did not put an "automatic cap" on damages based on the cost of redesigning the seed trailer. Rather, the expert concluded that, under the specific facts and circumstances, a reasonable royalty would not be higher than the cost of the redesign. This conclusion was admissible, the court found.

The plaintiff's objection to the defense expert's use of the redesigned seed tender as an acceptable noninfringing alternative for purposes of her lost-profits analysis focused on whether the redesigned product was "available" at the time of the infringement.

The court explained that, under the law, lost profits are not available to the patent holder if acceptable noninfringing alternatives were available at infringement. "Available," the court noted, does not necessarily mean the alternative product had to be on the market. Rather, it could be considered "available" if the infringer could have produced an alternative "and would have known it would be acceptable to consumers at the time of the infringement." Whether an alternative product was "acceptable" is a question for the jury to decide, the court noted.

Here, the defendant's expert understood from statements by the defendant that dealers and customers were reacting positively to the redesigned trailer and that it would have been possible to develop and build the redesign earlier. "If the necessary equipment, know-how and experience were available at the time of infringement, a substitution may be considered an acceptable, available alternative even if it was not on the market," the court said. It found that the defense expert's characterization of the redesigned product was admissible.

The court concluded that all the objections the plaintiff raised regarding the defense expert testimony were appropriate subjects for cross-examination. But they did not require exclusion of the testimony.

Plaintiff's expert partly admissible. The plaintiff's expert performed a reasonable royalty calculation that produced a range of reasonable royalty rates, from 3% to 10% of sales. The analysis was based on the *Georgia-Pacific* factors and particularly on the second factor that considers rates the licensee paid for use of other patents comparable to the patent in suit.

The expert explained that he “examined market rates for similar royalties paid in the industry,” using the RoyaltySource database to search for rates “in the machinery, agricultural, forestry and fishing industries.” He acknowledged there were limitations regarding the data but did not explain what the limitations were or how they affected the rates he chose for his analysis. Ultimately, the expert chose six licenses and developed a chart in which he briefly described the licensed technology, but he did not explain how these technologies related to the patented technology. He said he chose the six licenses based on his judgment.

In addition, the plaintiff’s expert mentioned other *Georgia-Pacific* factors, describing what these factors focused on. But he did not specifically tie the factors to the facts of the case. “Based upon the factors previously noted, I have identified four potential reasonable royalty rate data points,” the expert concluded.

The court found this expert opinion was inadmissible because the expert failed to provide sufficient support for his conclusions. Under case law, prior licenses that do not mention the patent in suit or that “show[] no other discernible link to the claimed technology” are not comparable, the court noted. Further, while those other licenses may cover more patents that the contested patent(s) and include additional terms or cover foreign property rights, the expert drawing on the licenses must account for any distinguishing facts. The court must consider to what extent the expert testimony might “skew unfairly the jury’s ability to apportion the damages to account only for the value attributable to the infringing features.” *See Ericsson, Inc. v. D-Link Sys., Inc.,* 773 F.3d 1201 (Fed. Cir. 2014).

The court noted that here the expert did not show how the six licenses he claimed were comparables were in fact similar to the patented technology or how they differed and how the differences affected a hypothetical license negotiation in this case. Citing prior case law, the court said “alleging a loose or vague comparability between different technologies or licenses does not suffice.” *See LaserDynamics, Inc. v. Quanta Comput., Inc.,* 694 F.3d 51 (Fed. Cir. 2012).

Regarding the expert’s treatment of the other *Georgia-Pacific* factors, the court said the expert failed to “complete the crucial step of explaining how those factors would influence the parties in a hypothetical negotiation to reach agreement as to his proposed reasonable royalty rates.”

For these reasons alone, the court found the plaintiff’s expert opinion on reasonable royalty was inadmissible.

All was not lost for the plaintiff, however, because the expert also performed a lost profits analysis based on a market share analysis that was sufficiently reliable to be admissible.

Relying on the industry analysis by the Line of Sight Group (LOSG), internal plaintiff and defense statements, and other studies and documentation, the expert assumed the

plaintiff would have made about 24% to 44% of the defendant's sales but for the defendant's infringement. This translated into about $2.4 million in lost profits, the expert concluded. The combination of reasonable royalty and lost profits damages amounted to total damages in a range of $3.7 million to $5.7 million, the plaintiff's expert asserted.

The defendant argued that the expert's lost profits opinion was unreliable because there were available and acceptable noninfringing alternatives. Moreover, the market share analysis was unreliable primarily because the expert "blindly relied" on a third-party analysis and plaintiff information. He failed to perform an independent analysis, the defendant claimed. Also, the profit margins he assumed were unreliable because they included profit margins for other products and certain margin changes.

The plaintiff countered that the market share analysis was permissible under the law and the third-party analysis was the best available evidence. This was the kind of analysis experts in the relevant field typically rely on, the plaintiff said.

The court explained that one of the elements a patent holder claiming lost profits must satisfy is that there are no acceptable, noninfringing alternatives to the patented technology. If there are such alternatives, a patent holder may show this element by proving, with reasonable probability, that the patent holder would have made sales the infringer made but for the infringement.

The court noted that experts routinely rely on the opinions of other experts the retaining party hired. Here, the expert explained what sources he used and said he had discussions with the plaintiff's management; he also relied on "public information about the industry." The court said the expert appeared to have done his own financial analysis of the plaintiff and the defendant. The expert's opinions on market share and lost profits were not so "fundamentally unsupported" that they had to be excluded. Moreover, the court found that the expert's decision to apply a historical average profit to the hypothetical sales absent infringement, instead of the actual profit margin for sales alleged to be affected by the infringement, did not make his opinion so unreliable as to be inadmissible. All of these objections can be explored on cross-examination, the court decided.

In conclusion, the court excluded the plaintiff expert's reasonable royalty determination but admitted his lost profits analysis. The court admitted the defense expert's reasonable royalty and lost profits analyses.

Editor's note: All cases referenced can also be found on BVLaw*.*

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ECONOMIC UPDATE AT A GLANCE

The U.S. economy—as indicated by GDP—grew at an annual rate of 3.5% in the third quarter of 2018, which is slower than the upwardly revised rate of 4.2% reported for the

second quarter of 2018. Still, the 3.5% rate marked the second highest quarterly GDP rate in four years and put 2018 on pace to have the largest annual average GDP figure in over a decade.

Total government spending increased, to 3.3%, in the third quarter, which was higher than the 2.5% rate in the second quarter. Private fixed investment, which includes residential and business spending, was down 0.3%, which marked its first decline in the past 10 quarters. The trade deficit was $54.0 billion, which is higher than the $45.7 billion reported in the second quarter of 2018. The goods deficit increased $0.6 billion in September, to $77.2 billion, while the services surplus decreased $0.1 billion, to $23.2 billion.

The Leading Economic Index increased 0.5% in September, coming in at 111.8 points. This marked the 12th consecutive month of gains, with the upward momentum suggesting that solid growth in the U.S. economy will remain through the rest of the year and into 2019. The strengths in the index were widespread in September, although momentum has slowed in recent months because of a slowdown in the housing market component due to the pressure in recent months regarding rising interest rates.

Employment in September increased by 134,000 jobs, as gains in professional and business services, healthcare, construction, and transportation and warehousing contributed to the rise. The figures in the job report for September were lower than expected possibly because of Hurricane Florence. The September jobs report did, however, contain an upward revision of 87,000 more jobs over the past two months after figures from July and August were increased from what were originally reported: July's figures went from 147,000 jobs to 165,000 jobs, and August's figures were revised from 201,000 jobs to 270,000 jobs.

In a separate report, the Labor Department said initial claims for state unemployment benefits remained near record lows. For the week ending September 8, there were 204,000 unemployment claims, the lowest mark since December 1969. In addition, the streak of 185 consecutive weeks below the 300,000 threshold, a figure that is associated with a strong labor market, is the longest such stretch since 1970, when the labor market was smaller.

The White House Council of Economic Advisers believes an 80,000-jobs-a-month pace is needed to maintain a low and stable unemployment rate. In September, unemployment was at 3.7%, which was 0.2 percentage point better than it was in August and the lowest rate since December 1969. The labor-force participation rate remained unchanged, at 62.7%.

Wages grew eight cents in September, increasing to $27.24. Real average hourly earnings, seasonally adjusted from September 2017 to September 2018, increased 2.8%.

In the third quarter, the Federal Open Market Committee (FOMC) met twice. In the first meeting, in view of realized and expected labor market conditions, and sustained rise near 2% inflation, the FOMC determined the federal funds rate would remain unchanged, at between 1.75% and 2.00%. In determining to maintain the existing level, the committee noted the strong labor market conditions but also stated that the market measures of inflation remained low.

During the second meeting of the quarter, the FOMC voted to raise the target range for the federal funds rate to between 2.00% and 2.25%. In determining to raise the federal funds rate, the committee cited that the economic outlook had strengthened and that market measures for inflation had increased.

The Consumer Confidence Index improved 3.7 points in September, to 138.4, extending the streak of gains to three consecutive months. At 138.4, the index hit its highest level since September 2000 and is not too far off from the all-time high set in the same year. Consumers' assessment of current conditions improved 0.3 point in September, to 173.1, from an upwardly revised score of 172.8 in August. The survey noted that, for now, consumers appear to be shrugging off the trade tensions. Households were upbeat about business conditions over the next six months, with many planning purchases of household appliances, motor vehicles, and houses. The Consumer Sentiment Index increased 3.9 points in September, to 100.1 points, climbing above the 100.0-point mark for only the third time since January 2004. The index was fueled by the optimistic expectations across all households for improved personal finances in the year ahead and the most favorable financial prospects since 2004. At its peak, consumer sentiment levels averaged 105.3 from 1997 to 2000.

The 3Q 2018 Wells Fargo/Gallup Small Business Index surged 12.0 points, to a record 118.0 points in its August report. The high indicators drove the quarterly reading from small-business owners on their overall financial situation, cash flow, and ability to obtain credit. The survey follows the news of 4.2% growth in the U.S. GDP during the second quarter, outperforming the average growth rate of 2.3% from the fourth quarter of 2012 to the first quarter of 2018.

The third-quarter survey asked small-business owners about their challenges in hiring. Eighteen percent of those small-business owners surveyed said hiring and retaining employees remained the top challenge they face. Thirty-five percent of those surveyed said they plan to hire new employees in the next 12 months. Other top challenges business owners cited included taxes and attracting new business, both at 9%. Small-business owners also listed hiring as their top challenge in the May, October, and July surveys.

Small-business owners expressed their confidence in the economy through their attitudes about their current and future financial situation. Seventy-eight percent of small-business owners reported their financial situation today is very or somewhat good, and 84% of small-business owners said they expect their financial situation will be very or somewhat good a year from now.

In addition, both current and projected future cash flow were key drivers of small-business optimism, with 69% classifying their cash flow over the past 12 months as very or somewhat good, up 6.0 percentage points from the previous quarter and the highest reading in the history of the survey. Over the next year, 77% expect their cash flow to be very or somewhat good.

Small-business owners also reported on their ability to obtain credit when they need it. Forty-nine percent said they expect obtaining credit over the next 12 months will be very or somewhat easy, which is up 5.0 percentage points over last quarter and the highest reading for this measure since 2007.

However, despite soaring optimism, small-business owners' sentiment about their company revenues remained relatively consistent with the previous quarter. Roughly half of respondents said their revenues increased over the last 12 months, and 61% said they expect company revenues will increase over the next 12 months.

The Present Situation Index (how business owners gauge their perception of the past 12 months) increased 7.0 points, to a reading of 52.0, and the future expectations index (how business owners expect their businesses to perform over the next 12 months) increased 5.0 points, to 66.0. During the second quarter of 2018, the Present Situation Index reported at 45.0 and the future expectations index was at 61.0.

Since August 2003, the Wells Fargo/Gallup Small Business Index has surveyed small-business owners on current and future perceptions of their business's financial situation. The Small Business Index is published once a quarter. This index consists of owners' ratings of their business's current situation and their expectations for the next 12 months, measured in terms of their overall financial situation, revenue, cash flow, capital spending, number of jobs, and ease of obtaining credit. Before the recession and financial crisis of 2008-2009, Small Business Index scores were generally in triple digits. The Small Business Index reached its peak of 114.0 in December 2006 and hit a low of -28.0 in July 2010.

Middle-market business sentiment ticked down 0.1 point in the third quarter, as the RSM U.S. Middle Market Business Index came in at 134.4 points. Despite the decline, the figure remains at a robust level. The report noted that strong net earnings, revenue, employment, and pricing figures reported by middle-market executives polled during the period bolstered the outlook. The survey noted that nearly 56% of respondents indicated the economy had improved somewhat or substantially over the past quarter, while the same amount expect the economy to continue to improve somewhat or substantially during the next half year. Executives also noted that policymakers at the Federal Reserve should proceed cautiously on interest rate hikes. While the economy and the middle market are sturdy enough to absorb rate hikes in September and December, by midyear 2019, Fed policy could become restrictive ahead of an impending decline in fiscal outlays one year from now. This may create the conditions for unwinding the economic strength that has characterized the middle market since 2014.

U.S. long-term growth rose in the third quarter after increasing at an annual rate of 3.5% based on the Bureau of Economic Analysis' advanced estimate of gross domestic product. The third-quarter rate is down from the 4.2% growth of last quarter but is on pace with the annual average in 2018 to reach the highest GDP in over a decade.

The manufacturing sector decreased 1.5 percentage points in September, to 59.8%, as measured by the Institute for Supply Management's manufacturing index. The decline follows a strong August reading, of 61.3%, which was the highest level for the index since May 2004. The report shows the economic activity in the **manufacturing sector** expanded in September for the 25th consecutive month and the **overall economy** grew for the 113th consecutive month. A reading above 50% indicates that the manufacturing economy is generally expanding, while a reading below 50% indicates that it is generally contracting.

The Federal Reserve reported that total industrial production increased 0.3% in September, after rising 0.4% in August. Total industrial production advanced at an annual rate of 3.3% in the third quarter. At 108.5% of its 2012 average, total industrial production in September was 5.1% above its level from one year ago. Capacity utilization for the industrial sector was unchanged in August, at 78.1%, a rate that is 1.7 percentage points below its long-run (1972-to-2017) average.

As measured by the Institute for Supply Management's services index (NMI), the services sector increased 3.1 percentage points in September, to 61.6%. The September figure represents continued growth in the nonmanufacturing sector for the 104th consecutive month and the overall economy for the 109th consecutive month. An NMI reading above 50% indicates the nonmanufacturing-sector economy is generally expanding, while a reading below 50% indicates the nonmanufacturing sector is generally contracting.

The U.S. stock markets posted mixed results in September, as three of the five major U.S. stock indexes declined. The Dow Jones Industrial Average advanced 2.0% in September and is up 9.0% in the third quarter. The Nasdaq Composite fell 0.8% but is up 7.1% for the quarter. The S&P 500 Index rose 0.6% and is up 7.2% for the quarter, while the S&P MidCap 400 retreated 1.1% in September but is up 3.5% for the quarter. The small-cap-focused Russell 2000 declined 2.4% in September but is up 3.3% for the quarter. Volatility, as measured by the Chicago Board Options Exchange Volatility Index, ranged between 11.1 and 15.6 and recorded an average of 12.9 for the month.

Throughout the third quarter, the yield on the benchmark 10-year U.S. Treasury bond steadily rose: At the start of the quarter, the 10-year Treasury yield was 2.87%; by the end of the quarter, the rate was 3.00%.

Housing starts declined in September, falling 5.3% when compared to August. The adjusted annual rate for September was 1.201 million units, which is 3.7% above the figures over the past 12 months. Gains were seen across two of the four regions, with a

sizable gain of 29.0% in the Northeast, but losses in the Midwest and South regions of 14.0% and 13.7%, respectively, dragged the overall figures down. Building permits authorized, which can be seen as a sign of how much construction is in the pipeline, fell by 0.6% in September but is 10.7% above the level of a year ago. Building permits for single-family homes increased 1.1%, but multifamily homes decreased 2.7%. Existing-home sales fell 3.4% in September, as sales of existing homes posted a seasonally adjusted annual rate of 5.15 million. The drop in September was the largest monthly decline in over two years and extends the streak of declines to six consecutive months. Economists had expected existing-home sales to fall to a rate of 5.30 million homes, according to a poll by Reuters. Distressed home sales remained at 3.0% of sales in September, which is the lowest level since October 2008, but down from 4% from one year ago. The National Association of Realtors Confidence Index for current conditions decreased 7.0 points in September, to 56.0. In September, the NAHB/Wells Fargo Housing Marking Index remained unchanged, at 67.0. Two of the three HMI components increased in September, as the component for current sales conditions rose 1.0 point, to 74.0; the component charting sales expectations in the next six months rose 2.0 points, to 74.0 points; and the component measuring buyer traffic held steady, at 49.0.

NAR's Realtors Confidence Index (RCI) for single-family houses reported a reading of 56.0 and is down 9.0 points over the past 12 months (strong = 100; moderate = 50; weak = 0). The RCI is a key indicator of housing market strength based on a monthly survey of over 50,000 real estate practitioners.

The National Association of Realtors' most recent Commercial Real Estate Outlook, analyzing the second quarter of 2018, found that sales volume rose 0.5% on a year-over-year basis and prices increased 5.1% over the same period. Leasing activity picked up, as vacancies experienced upward pressures, while low inventory remained the principal concern among realtors, as the wide pricing gap between buyers and sellers affected over 20% of respondents.

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