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3Q 2020

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- 1Q Delivered second week of December
- 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 five categories:

***BUSINESS VALUATION UPDATE* Q3 2020 CONTENT**
***BVWIRE* Q3 2020 CONTENT**
BLOG POSTS Q3 2020
LEGAL CONTENT Q3 2020
ECONOMIC UPDATE AT A GLANCE

Each article is separated by three asterisks (* * *) so you can easily identify where one article stops and the other begins.

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BUSINESS VALUATION UPDATE Q3 2020 CONTENT

Adult Nightclubs: Company-Specific Risk at the Extreme

The last time we looked, "employees slipping Mickey Finns to customers" was not on the typical list of factors to use when estimating a company-specific risk premium (CSRP). But if you ever value an adult nightclub, it may show up—and a lot more risks that you likely have not encountered before in other industries. These entities can end up at the high end of what's considered an acceptable range for this type of risk.

Risky business. During a February 6 webinar,[1] David Shindel (ShindelRock) and Rod Burkert (Burkert Valuation Advisors) pulled back the curtains of adult clubs to reveal their operating characteristics, special risks, and valuation nuances. Shindel has had extensive experience representing these clubs (including national chains), and Burkert has done a half dozen valuation engagements involving these entities.

There are about 2,500 such clubs in the U.S., and the number is dwindling due to the ongoing and increasing operating risks. It used to be that the typical adult club netted 40% of gross volume, so, with the required three-to-four-year payback, a rule of thumb value was 140% of gross sales. That is definitely not the case anymore. That 140% went down to 80% to 90% a few years ago and now is even lower. The reason? Class-action lawsuits, entertainer employment status trouble, inconsistent state and federal laws, and political and social pressures are just a few of the troubles that have made the operating environment for these establishments in the U.S. extremely challenging. Therefore, the old rules of thumb are no longer applicable, so you have to examine the specific facts and circumstances in each club to do a proper valuation.

Shindel also described a number of "other issues and contingencies" that you need to look for that can push the envelope with respect to CSR. They include:

- *Prostitution and drugs.* It can be a challenge for club owners to keep these illicit activities out, and, if clubs accumulate enough violations, they can "foul out" (like a basketball player) and lose their license.

- *Drugging of customers.* This is the Mickey Finn we referred to earlier, which is a drink spiked with "knockout drops" (such as chloral hydrate) given to an unsuspecting person in order to incapacitate him or her. It's like something you see in old movies, but it "is not uncommon" for employees or dancers to do this, says Shindel. The perpetrator then grabs the person's credit cards. In one case, a club owner was hit with a damages suit and lost his club.

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[1] Stripping Away the Mystery: Valuing Adult Cabaret Businesses, BVR webinar, Feb. 6, 2020; recording available at sub.bvresources.com/bvstore/cd3.asp?pid=CD694. (*Note: The recording is free to subscribers of the BVResearchPro platform.*)

- *Gangs muscle in.* Adult clubs can be a magnet for troublemakers. Shindel recalls a club in Toronto that was infiltrated by a motorcycle gang that pushed out the owner. These are not your typical business partners!

- *Civil RICO damages.* Clubs or some of the people involved in the clubs can be charged in civil Racketeering Influenced Corruption Organization (RICO) damages cases.

- *Overzealous bouncers.* Security employees may get carried away and injure customers who become drunk and unruly. Not long ago in a northern California club, a security guard kicked a customer in the head, resulting in permanent brain injuries—and a multimillion-dollar settlement, reports Shindel.

- *Stalking.* This is not something you consider with a typical business, but admiring customers can stalk adult club entertainers.

- *Employee embezzlement.* True, embezzlement can happen in any business, but it can be particularly rampant in adult clubs. Shindel once got a call from a club's private investigator who said that "every single employee at the club is embezzling." This also raises the question of how much integrity is in the financial data you are given.

- *Trafficking and underage entertainers.* This is a big issue, says Shindel, because it will put the club out of business in no time. There needs to be valid W-9 forms and proof that the individuals are old enough, but how well these clubs comply "is a challenge."

- *Itinerant entertainers.* Nany of the entertainers are itinerant and will, for example, work at a club in Alaska in Anchorage during the summer and then move to Florida during the winter. Will they come back? Maybe.

- *Star performers.* A few entertainers can bring in the majority of the dance revenue, which can concentrate the risk. These star performers are the ones that create most of the income for the club, so they are the ones that the clubs want to make sure they keep happy and don't lose.

- *Employee status.* Entertainers generally want to be independent contractors and not employees. In addition to the obvious reason of not wanting to report the income, they need to keep their vocation a secret from friends and family. Therefore, there is a lot of pressure from the employee-vs.-1099 worker issue and what contingencies that triggers.

In terms of these issues, appraisers will find they have more of an impact on the local independent club as opposed to a large national chain because the local owners often want to "run their own reality," says Shindel, and may not be inclined to play by the rules.

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The zoning issue. Zoning is another interesting issue for adult clubs, and it can cut both ways. Adult-use zoning can lead to greater value, but it can pose a risk and complicate a valuation if the zoning is grandfathered and the club is a nonconforming use. In one case, a club literally had blown up and was destroyed (no one was hurt) and, in doing the valuation for damages, it was discovered that the zoning was grandfathered. The club could not rebuild because of that, so the valuation for damages turned into a business destruction model.

In a grandfathered situation, you don't need to have the club destroyed before you lose your zoning. In some localities, if renovations are done that are equal to the value of the business at the time it became nonconforming, then the property has to be changed to a conforming use. That means it can't be used for an adult club anymore, so the business is lost.

What to do. As a valuation expert, what should you do if faced with an entity that has this level of risk? If Burkert, who has valued a number of these clubs, were to pick up an engagement like this tomorrow, one of the first things he would do is ask for some kind of representation letter from the attorney to get a handle on the kind of risk that the business is facing. Is the company a likely target of a class-action lawsuit? Where does the litigation stand? If it is grandfathered zoning use, what is the implication or the likelihood of using that grandfathered status?

Brad Schaeffer, an attorney who has worked with Shindel and who was also on the webinar, agreed with Burkert and says he has been asked for those letters before. But he advises valuation experts to phrase the question a little differently because it is not a question of whether the company will be sued (it most likely will) but rather a question of what type of defenses the company has. Is it operating correctly so that, even if there was a worker misclassification ruling, it would not be found liable? There are a number of ways to win a case like that, Schaeffer says, pointing out that he has never lost a pure misclassification case.

During the webinar, Burkert gave details of two of his valuation engagements for adult clubs and reiterated what Shindel said earlier. That is, valuation rules of thumb from just a few years ago are no longer valid because the industry today is "light years" away from what it was then because of the increased risks.

Outer limits. CSRP guidance offered by the professional business valuation literature identifies a reasonable maximum of approximately 10% for a company with higher risk than the average small, privately held company. Laro and Pratt say that a "10% adjustment could be warranted in extreme circumstances such as a startup company or a financially distressed company."[2] It's not a stretch of the imagination to envision an adult nightclub having "extreme circumstances." Of course, no matter what CSRP the appraiser eventually decides on, he or she must describe, explain, and defend the specific factors behind that estimate.

[2] David Laro and Shannon P. Pratt, *Business Valuation and Taxes,* 2nd edition, John Wiley & Sons Inc., 2011, page 174.

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Latest Update on Proposal to Upend Goodwill Accounting

Goodwill remains a very important valuation topic globally this year, and *Business Valuation Update* continues to cover the responses to initial efforts in the consideration of whether to upend the current goodwill impairment model and revert back to one of amortization of the world's goodwill assets. In addition to the recent batch of public comment letters and research papers, readers have made some candid comments to us on this matter.

Still in early stage. The process involves standard-setters around the globe, and it is still in the early stage. Regulators in the U.S., UK, and elsewhere have received an outpouring of concern from auditors, financial leaders, and the business valuation profession. The auditors tend to believe that the existing process of impairment testing is costly and provides insufficient benefit. Others tend to feel that annual acquisition goodwill tests force listed companies to defend their business strategies and the impairment results are the only way shareholders can learn about potential problems.

As the FASB is doing in the U.S., the International Accounting Standards Board is also exploring whether to reintroduce goodwill amortization. The IASB plans to release a Discussion Paper very shortly for a 180-day comment period to weigh stakeholder interest in amending IFRS 3, *Business Combinations,* and IAS 36, *Impairment of Assets.*

During a recent meeting of the trustees of the IFRS Foundation, the IASB explained that it hopes the feedback on the discussion paper will help it arrive at a consensus. Some board members support a reintroduction of goodwill amortization because they believe the existing impairment model is not providing information to the markets on a timely basis. Other board members want to leave the impairment model intact because they believe the model, even with its limitations, still gives investors useful information that holds management accountable for its decisions about acquisitions. The board's project will not only deal with goodwill and how it is treated, but also focus on possible new disclosures to help investors assess the subsequent performance of an acquisition.[3]

The European Financial Reporting Advisory Group (EFRAG) recently published a paper[4] that provides some useful context and background on the topic of goodwill and goodwill amortization. The paper is a literature review of frameworks and models for measuring and reporting on intangibles and their impact on company performance, market value, and users.

Given the fractured points of view, if the IFRS, IASB, or the FASB ultimately do anything to change the required valuation and reporting of goodwill, it will not be in 2020. As of the time of this writing, the FASB lists the project in "initial deliberations," a stage just prior to an exposure draft being issued.

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[3] cdn.ifrs.org/-/media/project/goodwill-and-impairment/in-brief-goodwill-and-impairment-factsheet.pdf?la=en.
[4] efrag.org/News/Project-403/Literature-review-on-intangibles.

CFAI comments. The CFA Institute (CFAI) recently submitted its lengthy and very thought-provoking comment letter[5] (41 pages) to regulators as part of the FASB's Invitation to Comment[6] process. CFAI argues that listed companies cannot afford the proposed "wasting asset' treatment of goodwill.

Citing the Carillion failure, CFAI says:

> Recent business failures in the UK and the related media attention have, again, raised the question of audit quality. There has been much in the press that has inflamed the reaction of many stakeholders (e.g., investors, politicians, pension trustees, and the broader public). We certainly don't disagree that such business failures are problematic and create significant consequences for not only investors but also other stakeholders to an organization. While extensively reported upon by the UK media, there is much reaction to, but not significant analysis of, the causes of such business failures and the degree to which audit failures, aggressive accounting, fraud, or market conditions that resulted in liquidity issues contributed to the lack of timely recognition of such business failures.

Perhaps most dramatically, CFAI analysts and international regulators "have not considered the magnitude of the goodwill balances they would likely put on a schedule to amortize over a period of ten years." How much are we talking about? CFAI concludes that amortization would require U.S.-listed companies alone to write off *$5.6 trillion* in balance sheet assets during this period—a noncash accounting adjustment that would put many listed companies into negative net income situations for the next decade. For this and other reasons, the CFAI has serious concerns about the reversion back to goodwill amortization.

The business valuation community is (for the most part) united in its opinion that, from a user perspective, the benefits of the transparency and information the current impairment model provides outweigh the costs. The cost-benefit issue was what triggered the international accounting regulators to revisit this issue in the first place. A coordinated effort is underway in the business valuation profession to continue to provide feedback to rule makers and to educate users on this important issue. For example, the Appraisal Issues Task Force (of The Appraisal Foundation) recently invited representatives of the FASB, SEC, and PCAOB to a meeting to discuss this matter.

Exceptional 'goodwill papers.' The International Valuation Standards Council (IVSC) has issued the second in a series of three papers. The paper, "Information Value of the Current Impairment Test: Leading or Lagging Indicator,"[7] analyses the accounting framework to better understand why goodwill impairments in certain situations fail to be a leading indicator. The IVSC identifies four primary reasons why goodwill impairments often lag

[5] cfainstitute.org/-/media/documents/comment-letter/2020-2024/20200113.ashx.

[6] fasb.org/cs/Satellite?c=Document_C&cid=1176172950529&pagename=FASB%2FDocument_C%2FDocumentPage.

[7] ivsc.org/news/article/information-value-of-the-current-impairment-test-leading-or-lagging-indicator.

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market sentiment and utilizes examples to articulate the fact patterns that lead to these outcomes.

These papers are very well thought out, and the first paper in the series concludes that goodwill is not a wasting asset, a conclusion supported by empirical evidence. The final paper, "Practical Solutions to Enhance the Current Goodwill Impairment Framework," is due out in April.

In addition, the IVSC released a free webinar panel discussion covering key issues in this ongoing debate. The panel, consisting of international business valuation experts, discussed this during the IVSC's Annual General Meeting in Singapore. A 54-minute video[8] of the discussion is now available, with Andreas Ohl (PwC), Kevin Prall (BDO), Eugene Hsiao (CFA Institute), Tatsumi Yamada (IVSC), and Wiley Pun (Savills). Prall has the byline on the goodwill papers, and he is also the technical director of the IVSC business valuation standards board. (*Note: Prall will be a featured speaker at the 15th Annual ASA/USC Fair Value Conference June 18 in Los Angeles.*)

Candid remarks. Informal discussions with many business valuers indicate that many in the profession think proposed changes to acquisition accounting are bad for investors, the clarity of financial reporting, and even the integrity of the audit process. There's also suspicion in some circles that the changes are motivated by a desire of the auditors at the Big Four to do less work, particularly as they absorb recent changes in accounting, such as for leases.

From the valuation profession, there are serious concerns that the concept of amortization of goodwill (rather than impairment testing) is not compatible with the principles of business valuation. As simply stated in the first of the IVSC goodwill papers, "If one were to assume goodwill is a finite lived and wasting asset, it would be inconsistent with the premise of going concern inherent in the consideration paid to acquire nearly all businesses" (the IVSC sees one possible exception being businesses comprised nearly entirely of tangible assets).

We have heard some less polite comments on the contradictions inherent in amortizing goodwill, such as:

- Acquired assets assigned to goodwill will be the only amortized asset ("why not amortize the Apple stock you bought last month?" one business valuer asked).
- Amortization assumes a finite life of acquisitions, such as 15 years. Several of our readers have commented that there's nowhere else in valuation or finance theory where assets have finite lives.
- The users of financial statements aren't asking for this change, and in fact many are concerned that this step removes a valuable "early warning" sign for investors concerned about problem acquisitions. It's noteworthy that the CFAI takes the

8 vimeo.com/375902891.

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position that its members (the investors) depend on current systems of acquisition asset impairment testing.

- The discipline required to review acquisitions with an eye toward potential impairment is beneficial to corporate leadership. One reader who works for one of the largest audit firms said she feels that impairment testing issues bring nonfinancial executives into the audit process, creating valuable alignment.

- Business valuation, built on its assumptions of "going concern" and "terminal value," looks longer term, which counters the prevailing tendencies that often focus on the most recent quarterly report. Amortizing goodwill would eliminate this balance between short-term goals and strategic results.

- Synergies in acquisitions often appear in the goodwill allocation, but no analyst looks at a deal and thinks that synergies will sunset. "If you project a 2% cost savings, that synergistic benefit will continue indefinitely. They don't go away and they aren't finite lived," one valuer told us. They continue into perpetuity.

- It appears that the debt issuers—whether banks or private capital—generally support continuing the current practice of testing assets.

Business Valuation Update will continue to cover this important topic. If you have any comments, please send them to the editor at andyd@bvresources.com.

* * *

Expanded 2020 Edition of *Mergerstat Review* Builds on Prior Enhancements

Amid the rapid pace of mergers and acquisitions, important changes have been made to the 2020 edition of *Mergerstat Review*, including the return of the Industry Analysis chapter and new tables of global transaction rankings. These enhancements are in addition to existing improvements, such as updates to historical data, 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.

BVU: *What is new in the 2020 edition?*

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Kenny Woo: In addition to the rankings for U.S. transactions, the 2020 edition has five new tables of Top 20 deals from Canada, the United Kingdom, Asia, Latin America, and the European Union. The tables include buyer and seller information, pricing, industry/sector, and P/E multiple.

BVU: *What else is a highlight of the 2020 edition?*

KW: Users commented on how useful they found the Industry Analysis section, so we have reincorporated that section back into the 2020 *Mergerstat Review*. This section was originally featured in all editions up to 2017, and it goes along with the FactSet sector analysis. Both of these are familiar tools for users to perform M&A analysis based on industry spotlights, multiples, premiums, and cross-border activity. Including both sections will allow FactSet Mergers database subscribers to conduct their screening searches the same as they would either in the *Mergerstat Review* or the online database. For users who do not subscribe to FactSet Mergers, a SIC-to-FactSet-sector mapping is provided.

BVU: *How many transactions were reported for 2019?*

KW: There were 12,598 reported transactions for 2019, and the breakdown by industry can be seen in the accompanying table. As you can see, M&A activity has reached levels not seen since the M&A boom period of the mid-2000s.

Exhibit. Industry Activity: Number of Transactions 2015-2019

BVU: *The publication went through major enhancements for the 2018 edition. One enhancement has to do with historical updates. Can you explain?*

KW: We were given full access to the FactSet Mergers M&A data feeds, which allowed us 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. Users now have more accurate and complete historical data as well as updated trend analyses, multiples, and premiums. The 2018 edition was the first one to feature the historical updates.

BVU: *Does that mean that editions from 2017 and before are not relevant?*

KW: No, those past editions are still relevant because they captured the M&A market from a point in time. Transaction data were updated starting with the 2018 edition and will be updated going forward as it allows clients with transaction data comparable to the current FactSet Mergers database.

BVU: *You also added tables that focus on premiums paid over the enterprise values of the target firms. Why?*

KW: That was in response to requests we received from users of the guide. Transaction

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premiums still feature the premium paid for the targets' share prices five days prior to the announcement, but several tables focus on premiums paid over the targets' enterprise values. The data take into consideration the fact that not all comparable companies have the same capital structure.

BVU: *Starting in 2018, deal pricing was changed from base equity price to transaction value. Why was this done and what is transaction value?*

KW: The switch was done to better reflect the net debt associated with the purchase. Transaction value includes the assumption of net debt, when applicable. It excludes transactions in the finance sector, where selling companies have debt-heavy balance sheets.

BVU: *What was another major change in the 2018 edition?*

KW: Foreign seller ownership roles were more clearly defined. In prior editions, seller ownership roles were classified as either public, private, divestiture, or foreign. Seller ownership is now broken 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.

BVU: *Anything else you'd like to tell us about the 2020 edition?*

KW: It will be available in mid-April in PDF format and early May for the print edition. It also includes the *Mergerstat Monthly Review*, a regular update on M&A activities, trends, and deal data by industry.

For more information on the 2020 edition of *Mergerstat Review,* go to bvresources.com/products/2020-factset-mergerstat-review.

* * *

Market Volatility and Its Impact on the Valuation Advisors Pre-IPO Database

The recent stock market volatility highlights the general risks inherent in capital markets. Often, this is felt the most by companies in the process of an initial public offering (IPO). This has ripple effects on pre-IPO studies, which are used to estimate a discount for lack of marketability (DLOM). During a January 29 BVR webinar,[9] Brian Pearson (Valuation Advisors) addressed several risks pre-IPO shareholders face. Pearson is a senior valuation practitioner and creator of the Valuation Advisors Lack of Marketability Discount Study, an online database with close to 15,500 pre-IPO transactions spanning over 25 years.

[9] Pre-IPO Revival: Up Your DLOM Game in 2020, BVR webinar (Jan. 29, 2020); a free recording is available at sub.bvresources.com/trainingeventpast.asp?WebinarID=752.

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Survivor bias? Pre-IPO studies examine the price of stock transactions before the stock is publicly traded and compares it to the price at some future event, such as when the IPO price is set or when the IPO actually occurs. The use of pre-IPO studies for estimating a DLOM has been accepted by courts and supported by authoritative texts and professional education courses in business valuation. There have been some misconceptions and criticisms about the use of pre-IPO studies; many of them have been effectively rebutted. For instance, an old criticism was that “the discounts only reflect successful offerings.” In other words, “survivor bias” overstates the DLOM because the less successful companies (those with lower values and lower implied discounts) likely canceled their IPOs or could never go public and therefore are not in the pre-IPO studies.

Pearson notes that this argument only reinforces the opposite: that pre-IPO discounts may likely understate overall discounts if you count all the companies that could never go public or have to postpone or pull their IPO due to market conditions. Another possible impact of such market conditions is a reduced IPO price, which results in lower discounts in the “successful” transactions database. For those companies that postpone their IPO permanently or can never go public, the presumed discount is likely much higher than the so-called “successful offerings.”

Recent example. In 2019, GFL Environmental, the fourth largest waste disposal company in North America, filed to go public and later pulled its offering, finding the market conditions unacceptable for the stock pricing it desired ($20 to $24). The company refiled to go public in January 2020 and set a price range of $20 to $21. On March 3, it priced its IPO at $19, below the range it desired. To make matters worse, the stock fell 8% after it first day trading, and the company increased the size of its offering to compensate for the lower IPO price. This means that existing shareholders were further diluted due to the increased share offering and the pre-IPO discount figures from its pre-IPO transactions in the Valuation Advisors database are lower also (an example of one of the many factors that result in lower, not higher, reported discounts).

More important than just the absolute percentage of the reported pre-IPO discount, the GFL example points out one of the many risks private-company investors face: Market conditions can and do significantly impact the marketability of their shares.

As with any approach or database, the Valuation Advisors Pre-IPO database can be a valuable tool if used properly. That is, you must understand the underlying data and the issues and limitations of the data and address all of that in your written analysis. Also, you should not rely on only one approach for estimating a DLOM. Evidence from several sources should be assembled and integrated into your analysis. A 2018 BVR survey showed that restricted stock studies and pre-IPO studies are the two primary methods used, and most respondents also routinely use the *Mandelbaum* or similar factors in their discount analysis.[10]

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10 bvresources.com/articles/bvwire/how-valuation-experts-estimate-dlom.

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Is History Repeating Itself? A List of BV Guidance From the 2008 Financial Crisis

We have been receiving emails from valuation experts asking questions about how to address the coronavirus in the valuations they are currently working on. Some of the issues are not unlike those in the wake of the 2008 financial crisis. Of course, the current coronavirus crisis is unlike any in recent history. Still, valuation experts can glean some insights from those who have experienced an environment of uncertainty and turbulence. Fortunately, business valuation history is right at your fingertips with the search capabilities of the BVResearch Pro platform.

We did a preliminary search and have listed here some past articles and webinars that you may find helpful during these troubled times. Subscribers to the BVResearch Pro platform have full access to all of this material and more.

Past articles from *Business Valuation Update*

Valuation Issues in the Coming Wave of Goodwill and Asset Impairments (April 2009), Bala Dharan (CRA International, Inc.)

Top Ten Issues to Note When Selecting COC Data in Volatile Times (July 2009)—conference coverage, Robert Reilly (Willamette)

Management Projections, Always Suspicious, Now Receive Even More Review (July 2009)—conference coverage, Jeff Dunn (Capstone Valuation Services) and Scott Nammacher (Empire Valuations)

How Should You Value Closely Held Businesses During These Crazy Times? (August 2009), Gary Trugman, CPA/ABV, MCBA, ASA, MVS

Do Not Be Afraid to Take Much Higher Discounts During the Recession (August 2009), Lance Hall, ASA

Wrestling With Guideline Public Market Evidence: What You Need to Know (March 2009), interview with Robert Schlegel, ASA, MCBA (Houlihan Valuation Advisors)

Adjusting Risk-Free Rates Is Not the Best Answer (April 2011), Joel Rakower, CPA/ABV, and Nannette Watts, CPA/ABV

The Market Approach During Recessionary Times Is a Harbinger of Risk (October 2012)—webinar coverage, Rob Schlegel (Houlihan Smith & Co.)

Beware of Distortions of Market Multiples During a Recession (May 2013), Alina Niculita, ASA, CFA, MBA

Past BVR Webinars (recordings and transcripts available)

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Subsequent Events (May 19, 2009), Jay E. Fishman, FASA, FRICS; James Hitchner, CPA/ABV, ASA; Frank Lewis; and Shannon P. Pratt, CFA, ARM, ABAR, FASA, MCBA, CM&AA

Subsequent Events: Dealing With the Unknown and Unforeseeable (Jan. 8, 2010), Jay E. Fishman, FASA, FRICS; Z. Christopher Mercer, ASA, CFA; and Chuck Rettig, attorney at law

Developing Discount and Cap Rates in a Troubled Economy: New and Emerging Views on Old Issues (Oct. 19, 2009), Donald DeGrazia, CPA/ABV/CFF; Stacy Preston Collins, CPA/ABV, CFF; and Ronald L. Seigneur, MBA, CPA/ABV, ASA, CVA, CGMA

Companies in Distress: Valuing the Impaired and Currently Unprofitable (Feb. 5, 2010), R. James Alerding, CPA/ABV, ASA; James D. Ewart, CPA/ABV/CFF, CVA; and Robert Shortle, CPA, MBA

Goodwill Impairment in a Troubled Economy (Oct. 19, 2009), R. James Alerding, CPA/ABV, ASA; H. Edward Moris, ASA, CBA, BVAL, CPA/ABV, CFF; and R. Brian Steen, CFA, ASA, CIRA

The Market Approach Today: Deciphering Messages From Markets, Courts, and Common Appraisal Errors (Aug. 2, 2012), Robert Schlegel (Houlihan Valuation Advisors), Alina Niculita (Morones Analytics), and Chris Treharne (Gibraltar Business Valuations)

Third-Party Resources (all available on BVResearch Pro)

"Problems With Cost of Capital Estimation in the Current Environment—Update," Roger J. Grabowski, FASA, American Society of Appraisers *Business Valuation Review*™ (Winter 2008)

"Preliminary Look: Valuation Issues With Bailed-Out Companies" Donald Sonneman, ASA, American Society of Appraisers *Business Valuation Review*™ (Summer 2009)

"The Market Approach—ESOP Employer Stock Valuations During Economic Turmoil" (Jan. 21, 2010), *Willamette Insights*

"Bankruptcy-Related Valuation and Financial Advisory Services" (March 26, 2010), *Willamette Insights*

"2007: A Year to Forget for Banks" (May 12, 2008), Mercer Capital's *Value Matters*

This is just a sliver of the more than 15,000 articles (and counting), webinar transcripts, legal digests, and more from the world's foremost thought leaders in business valuation. For more information on the BVResearch Pro platform, go to bvresources.com/products/bvresearch.

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A Veteran Valuer's Guidance on COVID-19 and the 'Soul' of a Business

Business Valuation Update had the privilege of talking with Robert Schlegel, FASA, MCBA, to get his perspectives on our current economic environment and how that affects the business valuation community. Rob has been a frequent contributor to this newsletter. He is a principal with Houlihan Valuation Advisors, a past international president of the American Society of Appraisers, and has taught business valuation classes for all the major societies since 1995. Currently, he is scheduled to lead sessions at the forthcoming international conferences for NACVA and the ASA, unless, as he says, "he is coronaed out." This editor was fortunate enough to be a student in one of his ASA classes, so it's only natural to look to one's teacher for guidance.

BVU: *Rob, what are some of the immediate impacts of the current crisis on how business appraisers do their work?*

Rob Schlegel: We have to keep in mind that appraisal work floats on the tide of commerce. Many of the discretionary assignments from business or marital dissolution are slowing down for us because of the forced stay-at-home requirements. With tax deadlines delayed, much of the estate and gift work is taking a pause. Merger and acquisition markets are stalled. But, once we get through this crisis and the healthcare system is stable, our work will likely balloon from pent-up demand. In fact, as business appraisers, we may emerge as an ongoing trusted advisor since our perspective is to measure value, leading into the wider issues of value creation.

Date of value is something that is given to us by the legal system or client directive— we don't select the date of value. *Economic and industry research as of the date of value will become more vital.* Was the economic meltdown "known" or "foreseeable" as of Dec. 31, 2019? Perhaps, particularly if the appraiser is able to pick up industry market evidence changes as of that date. In terms of our research, public-company analysis is now more imperative because these exchanges reflect economic and industry pressures known by investors as of our date of value. Yet, given the volatility of the swings, some appraisers may look at longer-period market evidence. In divorce work, some states allow judgement is what date to use—such as a date of filing (or service) through the date of the trial. Consequently, some divorce assignments may require two dates of value. IRS regulations allow estates to select "an alternate date of death" six months after someone's passing. So many estates created in late February to when we "recover" may give us that alternative date of value. But keep in mind that, if the estate selects this alternate date, all assets must be appraised at the alternate date.

BVU: *What are the potential impacts on other approaches/methods in BV work?*

RS: Asset valuation models will be more difficult because of the unstable and hard-to-predict value of the components. Thumbing through DealStats and BIZCOMPS may take more of a back seat because these exchanges occurred largely under better, less-risky, industry environments. These recorded exchanges assume that the knowledgeable buyer

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understood the potential risks as well as the rewards, which are probably far different than today. Current COVID-19 restrictions prevent buyers from undertaking thorough due diligence. If we use historical transactions at all with a mid-2020 date of value, one might select lower multiples from the peer group to accommodate risk—something like goosing up the discount rate because of an overly optimistic projection—but the logic and rationale have got to be stated. Still, the current interruption in small-business activity undermines the thought that future years will be like former years. Where should we get a multiple for historical performance? Should a 2009 multiple be considered with vastly slimmed down 2019 results? Another thing to keep in mind is that in many industries the EBIT, EBITDA, or SDE multiples (denominators) are fairly consistent over time—it is the lower performance (numerators) that sink during periods of business stress that yield lower values.

Income methods are always germane, but the components are likely to change while we are plummeting through a recession. We will be under more attack to defend our reasoning to project future performance during recovery and how competition may shift. Cost of capital measures such as risk-free rates, ERPs, industry risks, capital structures, and the ever-popular company-specific risk premium must be acutely defended with a 2020 date of value. To the extent that BVR, the Center for Research of Security Prices, Duff & Phelps, Dr. Damodaran, and the Fed can help us with more current evidence, the more solid our appraisal conclusions will be. I noted something recently from Roger Grabowski that he suggests an ERP of 6% and risk-free rate of 3%, implying a base U.S. cost of capital of 9%. DLOM calculations may increase because irregular market conditions increase buyer risk in an illiquid security.

BVU: *You mentioned the importance of economic and industry aspects influencing valuation thinking. What guidance would you offer to appraisers given our current environment?*

RS: There is no doubt that, as we ponder this economic tsunami (in late March), Grizzly Adams has trumped Ferdinand the Bull. Last year, a lot of us were saying that 2020 was going to be a risky year with a likely correction or recession. Manufacturing sectors, trade pressures, and other negative signals were bubbling up in the latter half of 2019. Unfortunately, now the economy is in a deep freeze and COVID-19 was the lead straw that broke the proverbial camel's back. By the time this is published in April, we will know more about how our healthcare system is able to catch up to the crisis.

From a layman's point of view, recessions are usually measured by two successive negative GDP quarters. The unsettling fact for appraisers is that government bureaucrats will not complete the second-quarter measurements until July or August. The hardest hit industries such as travel, senior living/nursing homes, retail, and entertainment will have tremendous value pressure, while others such as biolabs, delivery services, and toilet paper makers will probably see an uptick in value if they can keep their workforce healthy. I hear noises of the economy bouncing back quickly, with the same rate of production and consumption. Unfortunately, this is probably optimistic thinking: The resumption of American consumer demand will be drawn out over years after our hunkering down period. Lack of consumer confidence and investment caution drives recessions, so be prepared for a long-term economic headache. With recessions, construction companies may struggle, and the $3

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trillion commercial mortgage industry—despite the low federal interest rates—will be troubled by the inability to pay per contracted terms.

I've said before that *debt is a four-letter word.* During periods of expansion, debt can accelerate your ROI, but the reverse happens during recessions. Highly leveraged businesses in threatened industries will face not only strain on their earnings, but also increased pressure from lenders, who will likely jack up interest rates, put them in workout, and, in the worst cases, call loans and collateral especially if the collateral value is sinking. I think Warren Buffet said, "[I]t is only when the tide goes out that you see people swimming naked." We saw a lot of skin in 2009 to 2011, and we're likely to see carnage again.

Government edicts effective in April pressure small businesses to continue to pay employees and provide health insurance. In response, small employers can avoid payroll taxes and file claims for refunds. These temporary fixes are likely to play havoc on a normal operating business with higher administrative costs and unstable cash flow. An appraiser must understand risks to future cash flows in our client businesses. What's going on now is hitting these small firms right down to their very core, so, to fully understand the impact on the subject company, the appraiser needs to understand the soul of the business and how (or if) it will recover.

BVU: *From your perspective, what is the "soul" of a business?*

RS: Quite simply, it is the unseen driver of a going-concern business that propels activity, reacts to competition, and remixes assets and liabilities to achieve future objectives. Usually business objectives—which some people call goals—are measured in increased long-term cash flow, which is the primary measure for business appraisers. But, while we can measure historical cash flow from an accounting standpoint, it is really hard to gauge the future outcomes of a business with all of the moving parts of expected (and unexpected) competition, and dynamic supply and demand, which is flavored by economic and industry conditions. Good quality financial statements are like an X-ray showing us the skeletal structure of historical business performance. What we have difficulty in seeing in this X-ray is the blood flow, or the muscles, or the "soul," to conclude the quality of management inside this business, especially in these uncertain economic times. Keep in mind that the difference between business accounting and business appraisal is like the difference between timing speed skating and judging figure skating. A whole lot more of understanding is necessary for an analytical appraiser who is going to give an opinion of value (or a conclusion of value) because valuation is based on our estimated future performance against market evidence that should mirror elements of risk.

BVU: *I don't recall seeing any reference to a firm's "soul" in any of the authoritative textbooks or courses on business valuation. Did I miss something? Why is this important?*

RS: I think you will find sufficient references to understanding the "nature of the business" and "intangible factors" in Shannon Pratt's books as well as Gary Trugman's *Understanding Business Valuation.* Take a look at Revenue Ruling 59-60! There have been plenty of articles suggesting that what we do is more than just quantitative analysis. We've got to

support and defend our judgements in things like discounts and interpretation of market evidence beyond the mechanical application. It doesn't matter whether you call yourself an analyst or an appraiser; the opinion (or conclusion) we provide has got to be based on what a knowledgeable buyer would investigate. How many times have you seen someone buy a company without interviewing management and without walking the premises? Buyers don't buy net assets—they buy a system geared to offer a return on their investment. Use your common sense to understand how the business works.

BVU: *How do I begin to understand it for my subject company?*

RS: Researching how the industry functions is one element. Developing a "questioning attitude" provides the basis for learning about the company is another. Preparation *prior to* the management interview is essential, which includes the basic financial analysis with ratios, trends, and comparisons to "similar" businesses. Developing an understanding of how the subject company fits into a Porter analysis is also useful. How do they compete? What are the strategic weaknesses, and how does management plan to address them? If we get a projection (or forecast), testing the projected earnings against balance sheet realities often uncovers unrealistic assumptions. Dig into how the company has performed in past business cycles and whether prior projections were overly optimistic or pessimistic. Strong management learns from mistakes. In fact, a company that has stumbled before and recovered is better able to realign resources for future opportunities *because they have learned*.

BVU: *Can I see signs of it by looking at financial statements or tax returns?*

RS: Signs, yes, but understanding the future in the eyes of a hypothetical equity buyer is the key. One generality is that the results of the company next year is likely to be similar to the company's results last year, a notably hoary assumption given our present economic morass. Scrutinizing the financial statements can suggest a variety of good and bad results, under more or less risk, and hint at trends upward or downward. A robust financial analysis is fundamental to asking probing questions of the future prospects of the company. But historical financial analysis only gets you to first base, not all the way home.

BVU: *What questions could I ask management that will help me with this?*

RS: First of all, do a thorough management/owner interview following your meticulous preparation! You should have the preliminary spreadsheets of historical operating statements, balance sheets, cash flows, trends, common size ratios, and comparative market ratios (like RMA) at your fingertips with areas of concern circled. I like to have management complete the background questionnaire before we do a site visit and the interviews. *Prepare an agenda for the discussion.* Beyond asking for a financial forecast/projection (which can be scary), you should seek to understand the subtle strengths and weaknesses that could pose significant success or failure in coming years. Pose questions such as:

- If a buyer of your company knocked on your door, what would you first say?

- If you had a magic wand to correct one thing in your company overnight, what would you fix?

- How is your company vulnerable to competitors?

- Did you foresee the 2020 economic situation?

- How has your business been affected in the present economic slowdown?

- Does this slowdown offer opportunities for your business to take market share, or do better in the future?

- What will your company management look like in five years? 10 years?

- Who are the key people in your company?

- Do you know of other companies in your industry that have recently acquired? What were the primary reasons for that acquisition?

BVU: *What should I look for during a site visit that may reveal some clues about it?*

RS: Look at the people. Are they busy? Ask for an organization chart. Unless your assignment is really secret (as in a potential sale of the company), interview other key managers. Try to understand ideas of management succession and any internal problems within the staff. The best companies operate within an environment of *controlled tension* to encourage performance. If, after interviewing a variety of employees, you find "all institutional smiles" and "very relaxed atmosphere," then you probably have a nice functioning bureaucracy operating within an unthinking budget. Some private-sector companies are like that, enjoying good demand and historical market share. But, in most of those cases, it is only a matter of time before competition eats their lunch. Even companies with sustainable intellectual property will face changes in customer/client patterns, leading to changes in the business model in the mid- or long term. Owners and management should have an adaptive personality. If not, their life is limited.

Many years ago, a very successful, junior high school graduate, owner of a tool and die firm, took me on a tour of the machine shop. Upon entering, he stuck his nose up in the air and took a whiff. *"We're making money."* How? Because of the humidity, viscosity, and general activity that he could see, signifying *"we're busy … no one is waiting around."* The actions are called heuristics, or simple factors that experienced owners know about their business.

BVU: *You do a lot of valuation report reviews. What do you see (or don't see) in a report that indicates that the expert does (or does not) have a good enough grasp of the business?*

RS: Yes, I see a lot of reports prepared by others in all disciplines. Some of these reports reflect analysis that is just plain dumb, usually because the appraiser/analyst doesn't

understand theory or makes some outlandish assumption of the future. I get frustrated when reviewing reports from apparently certified appraisers who essentially torture numbers and slide results into a recipe without any thought. I recall one not too long ago where the author, in a discounted cash flow model, used a 35% growth rate in the terminal year. In that situation, it would be only a matter of time before this small company takes over the economy of the world! I saw another last week where the analyst used both a DCF and a single-period CAP model without understanding that the assumptions conflict. There have so many reports with an absent or screwed-up interpretation of DealStats or BIZCOMPS that I can't count them all. Perfunctory regurgitation of economic and market conditions without indicating how these conditions affect the needle in valuation judgment also drives me nuts.

BVU: *How do I communicate to users of my valuation report (client, attorney, trier of fact) that I understand the soul of a business?*

RS: Basically, you must impress them with the depth of your questions and, ultimately, your analysis of the intangibles and not hide behind arithmetic and jargon. Tell the story of the business in terms of how a prospective financial buyer would describe it. DCF models could have scenarios, in which you interact with the owners/managers on which key variables to wobble. I often present early versions of the market evidence to the owners/management to discuss some of the similarities and dissimilarities and to ensure they understand this approach. If the company is asset-heavy, I usually inspect the assets (unless we have an independent qualified appraisal) and talk through the plus/minus of value-in-use. While draft reports are often frowned upon, we usually provide an "incomplete—work product" inspection copy to go through for comments and questions. Doing a business valuation is a thinking process, not just writing a term paper on financial metrics.

BVU: *OK, where do we end up with this?*

RS: In 2021—hopefully when we're through this crisis with new healthcare solutions—buttoned-up disagreements will surface, and estate tax issues may balloon with tax law changes. Despite the *$2.2 trillion* federal stimulus, the business world will change, and the horrendous national debt issue may become more of a problem for U.S.-domiciled enterprises. We are likely to be confronted with more robust automated valuation models (AVMs) that, with better artificial intelligence, could push clients toward a quicker, cheaper value conclusion.

BVU: *Any silver lining to all of this?*

RS: As I said before, economic meltdowns usually slow our work in the early portions but enhances our workload as the economy recovers. Despite my earlier Warren Buffet comment, economic contractions also spread the spotlight on inadequate appraisal work. USPAP arose out of FIRREA, in the mid-1980s, following the savings and loan business collapse. I suppose that, by 2021 or 2022, we will have weeded out some incompetents because poorer work will be more scrutinized, but the bulk of the profession should shine given our understanding of measuring business value in a competitive environment. The better the "soul" of the business during periods of pressure, the more long-term value it has.

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ESOP Case Appeal Stokes Controversy Over DOL Valuations

A series of court cases the government has been winning that claim ESOPs are purchasing sponsor company stock based on inflated valuations have stung the ESOP valuation community. These cases have generated controversy over the tactics and valuation methods the Department of Labor (DOL) has been using, including claims that the DOL has improperly redefined the term "fair market value," does not follow generally accepted valuation principles nor standards, and continually uses an expert the valuation community deems "unqualified." Members of Congress and the American Society of Appraisers (ASA) have objected to the DOL's aggressive litigation-driven strategy and use of flawed valuation methodology.

New appeal. It was recently learned that the latest case in this troubling saga, *Pizzella v. Vinoskey*,[11] is being appealed to the 4th Circuit Court of Appeals. In this case, the DOL claimed the trustee caused the ESOP plan to overpay for the company owner's shares and a federal district court ruled for the government on liability and awarded $6.5 million in damages *to the plan*. The court followed a framework laid out in a prior case (*Brundle*), in which the 4th Circuit upheld the trial court's liability and damages findings against the trustee.[12]

If an ESOP pays more than fair market value for sponsor company shares, the trustee overseeing the acquisition of the stock breaches his or her fiduciary duty under ERISA, and the DOL (on behalf of ESOP members) can sue to recover any overpayment, as in the *Vinoskey* case. The appeal is sure to fan the flames of the controversy and trigger more claims that the DOL was able to prevail despite seriously flawed valuations that were prepared by an expert whose qualifications the valuation community has questioned, including by way of *Daubert* challenges.

Serious criticism. The DOL has a history of aggressive oversight of ESOPs. This approach has prompted criticism on several fronts. The ASA has expressed strong opposition to the DOL's ESOP-focused enforcement projects, and, in 2018, it filed an amicus brief on behalf of the ESOP trustee in the *Brundle* case.[13] 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.

[11] For a case digest of *Pizzella v. Vinoskey* (earlier *Acosta v. Vinoskey*), 2019 U.S. Dist. LEXIS 129579 (Aug. 2, 2019) as well as the other cases discussed here, go to *BVLaw* (bvresources.com/products/bvlaw).

[12] "Strong win for DOL in *Vinoskey* ESOP trial," *BVWire* #203-2, Aug. 14, 2019; bvresources.com/bvwire/issue-203-2.

[13] "ASA vigorously supports trustee and appraiser in *Brundle* ESOP litigation," *BVWire* #190-2, July 18, 2018; bvresources.com/bvwire/issue-190-2.

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Also, in 2018, members of Congress concluded that the DOL's actions were undermining ESOPs. In a letter to the White House, congressional members accused 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 letter said. 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.[14]

Redefining FMV. There are those in the valuation community who feel the DOL is improperly redefining the term "fair market value." James Joyner (Integra Valuation Consulting LLC), a certified business appraiser who has served as trustee for almost 100 ESOPs, finds it particularly troubling that the 100-page *Vinoskey* opinion contains no meaningful discussion of the standard of fair market value.[15]

Joyner notes that the court seemed concerned exclusively with what a hypothetical buyer (the ESOP) would agree to pay when the fair market value standard also requires consideration of what a willing seller would accept to close the deal. As fair market value is traditionally understood, both sides must be considered, Joyner says. He contrasts this decision with certain U.S. Tax Court decisions in which Tax Court judges rigorously framed their discussion of fair market value in terms of a hypothetical willing buyer and a hypothetical willing seller, both parties seeking to achieve an economically advantageous outcome.

The ASA, in its amicus brief in *Brundle*, also noted that the DOL was departing from the fair market value definition, saying that "the appraisal must make an unbiased estimate of the range of the company's 'fair market value,' without taking either a buyer's perspective or a seller's perspective."

Control issue. Joyner notes that the *Vinoskey* decision "advances the DOL's position that, if the ESOP does not gain 'unfettered control' over the company immediately after the acquisition of all company stock, appraisers must apply a discount for lack of control (5% in this case) against the indicated equity value." The ASA brief in *Brundle* brings up the same point, stating that "an investor need not acquire the entire bundle of control rights in order to reflect some degree of control value in the purchase price." Regardless, the ruling in that case "improperly objects to the ESOP valuator's use of a 10% control premium even though there was evidence that the ESOP had some control." Market-observed control premiums are often in the 35%-to-40% range, so the 10% figure was "modest," the brief said.

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[14] "Congressional members accuse DOL of undermining ESOPs," *BVWire* #193-3, Oct. 17, 2018; bvresources.com/bvwire/issue-193-3.
[15] "Expert comments on *Vinoskey* ESOP ruling," *BVWire* #203-2, Aug. 14, 2019; bvresources.com/bvwire/issue-203-2.

'Underqualified' DOL expert. There is also an ongoing controversy about the qualifications of Dana Messina, a trial expert who frequently testifies on behalf of the DOL. The ASA, in its *Brundle* brief, accused the district court of "second-guessing" the ESOP appraiser's sound contemporaneous analysis and value conclusions by relying on the "rough" and "after-the-fact opinion" of the plaintiff's "underqualified 'expert.'" The DOL's expert approached the valuation both from a litigation perspective and with the benefit of hindsight, the brief says. It further notes that this expert was not an "independent qualified appraiser," as required under the applicable regulations.[16]

The expert in question has served as the DOL's "primary valuation consultant and expert on leveraged ESOPs" and performs as an advocate who "sides with the DOL and his valuations fundamentally depart from fair market value," the brief says. Further, the expert lacks the education and training of an appraiser. Defendants in another ESOP case involving this expert made similar arguments in their partly successful *Daubert* motion. Despite a strong defense argument that the DOL expert lacked relevant valuation and ESOP-specific knowledge, the court declined to exclude him under the Rule 702 qualification prong.

The same expert was used in the *Vinoskey* case and faced a *Daubert* challenge, but, while the court struck some of his testimony, it rejected the defendants' argument that the expert was unqualified. The court noted instead that the expert had significant experience in the private equity industry, a background that "provides guidance on the sort of diligence required in this transaction." Members of the ESOP community have objected to the court's decision, noting the same expert has disavowed any relevance of USPAP or any other professional valuation standards.[17]

DOL expert responds. Last year, in the wake of the *Brundle* case, we heard from Dana Messina, who served as expert for the prevailing party (the DOL acting as the plaintiff) in that case and also has served as an expert for the DOL in numerous other ESOP cases. When asked about criticism from the ESOP community and others, including members of Congress, that the DOL has been too aggressive in its oversight of ESOPs, in 2019, Messina responded: "The industry should embrace the actions by the DOL in *Bruister, Bankers Trust* and *Brundle*, the most recent ESOP valuation cases to go to verdict.[18] In each of these cases, the actions of the trustees and valuation firms are largely indefensible. The trustees paid a just and heavy price for their willingness to approve transactions that were not exclusively for the benefit of the hard-working employees at each these companies." Messina added: "I have had many candid conversations with some terrific ESOP valuation professionals regarding the facts involved in each of these cases. Universally, they tell me the courts got these cases right. Lastly, I've worked with the DOL on quite a few cases over many years and honestly have not seen them pursue a single case that I would categorize as a close call."

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[16] 26 U.S.C. § 170(a)(1).
[17] Appraisals and ESOP Litigation: Top 10 Causes of Trustee Troubles, BVR webinar, James Joyner, June 27, 2019.
[18] "Experts comment on recent *Brundle* ESOP decision," *BVWire* #199-1, April 3, 2019; bvresources.com/articles/bvwire/experts-comment-on-recent-brundle-esop-decision.

Suggestions. The comments from the valuation community and the DOL expert clearly show a level of disconnect. In the letter from members of Congress, it was suggested that the DOL be persuaded to work with the ESOP community to develop guidance on valuation and other key issues. This appears to be a good idea, and it has worked in other areas of valuation. For example, the Appraisal Issues Task Force is a voluntary group of valuation professionals who work with the FASB and the SEC to evaluate proposals and recommend methodology, assumptions, and approaches in the area of fair value for financial reporting. A similar mechanism could be set up between ESOP valuation professionals and the DOL.

It has also been suggested that the complexity of ESOP cases requires them to be tried by a specialized court. The *Vinoskey* case "shows why federal district court judges should no longer adjudicate ESOP lawsuits," says Joyner. "The complexity of ESOP litigation demands a special master who has the financial skills that are found among Tax Court judges, patent law judges, or the Delaware court judges."

Stay tuned. It will be interesting to see how the *Vinoskey* appeal plays out and whether we will see any rapprochement as concerns some of these issues between the DOL and the ESOP community going forward.

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IRS Ruling on Subsequent Events and Valuation

In a private letter ruling, the IRS says that a pending merger is to be considered in valuing a company's stock for gift tax purposes. In this case, a hypothetical purchaser could have reasonably foreseen the merger, so "to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation," the IRS says in the ruling. For a copy of the ruling (201939002), click here. *Note: The IRS issues a private letter ruling at the request of a taxpayer for the purpose of getting the agency's opinion on a specific transaction or issue facing the taxpayer. Although anyone else can't use it as precedent, it is useful in that it usually reflects the attitude of the IRS toward a particular tax matter.*

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New Paper Offers Improvement to the Gordon Growth Model

"Capitalization 2.0—Terminal Value Under Changing Capital Structure" is a new paper by Mike Adhikari (Business ValueXpress Software), a valuation and M&A advisor. The Capitalization 2.0 methodology is designed to improve on the simple Gordon growth model (GGM) and uses a recently developed advanced growth model (AGM) formula. GGM assumes that the capital structure of the business will remain constant and that the debt principal will never be repaid. Because of this, GGM can overvalue a business by 10% to 50%, according to Adhikari. AGM considers that, even when the business is growing at a constant rate, the debt principal may have to be paid down, and hence the capital structure will change. Unlike the GGM formula, the AGM formula is complex (although it has only three more input variables), so the paper includes a link to a spreadsheet of both the GGM and the AGM formulas that can be downloaded for free.

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'Giving Back' Differentiates Appraisers

One factor that differentiates one valuation expert from another is giving back to the profession, either by volunteering, teaching, writing, and so on. A recent list of "Questions to Ask Your Business Appraiser" from UHY Advisors contains three questions that relate to this:

- Have you done any presentations on valuation-related subjects? If so, when and to whom?
- Have you written any articles on valuation-related subjects? If so, please describe.
- Have you ever held a position as officer or board member for a professional organization involved in business valuation? Please describe.

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These activities also help to establish your authority in a particular niche, whether it be an industry or specific area of valuation.

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Global BV News: IVSC Issues Exposure Draft on Inventories

The International Valuation Standards Council (IVSC), the independent standard-setter for the global valuation profession, has issued proposed new standards for the valuation of inventory. Comments on the draft, IVS 230—Inventory Exposure Draft, are due April 30 and can be sent to comments@ivsc.org. "The valuation of inventory project resulted from feedback received during the agenda consultation process conducted by the IVSC in 2017 and 2018," writes Mark Zyla (Zyla Valuation Advisors) in a cover letter to the exposure draft. The project has been led by the Business Valuation Board, with support from the Standards Review Board, which is chaired by Zyla. Depending on the comments and feedback, a final standard could be issued in mid-2020 with an effective date no earlier than January 2021.

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Global BV News: IVSC Launches New Europe Board

To give a greater European voice to the International Valuation Standards, the IVSC has appointed a number of experts to its new Europe Board, which met for the first time in Paris on February 26, according to an announcement. The board, which is chaired by former Duff & Phelps European leader, Yann Magnan, is comprised of valuation, finance, and regulatory experts who will "encourage and support the implementation of internationally-agreed valuation principles." The formation of this new board also helps to ensure that European-specific input continues to the IVSC's standards boards and standards consultations.

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Coronavirus Fallout Impacts the Valuation Community

The unpredictable coronavirus is disrupting work plans of valuation and accounting firms and impacting the global market. Firms are limiting travel, encouraging virtual meetings, and promoting other ways to help prevent the spread of the disease. Here are some recent developments and issues to consider.

Deloitte confirmed a case of coronavirus in its London office, so the firm closed the floor on which the individual worked, did a "deep clean," and gave the building's remaining staff the option to work at home. The ICAEW has issued guidance to help firms navigate the audit challenges the coronavirus presents.

Risk-free rates are in uncharted territory as the entire yield curve for U.S. bonds fell below 1% for the first time in history. This past Monday, the 10-year T-bond yield was 0.49% and

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the 30-year rate was 0.89%. “This is a good time to revisit the implied ERP rather than the historical ERP,” advises Dr. Michael A. Crain (Florida Atlantic University). “The implied ERP reacts to changes in the risk-free rate but the long-term historical average ERP changes very little.” Ron Seigneur (Seigneur Gustafson LLP) offers this word of caution: “Much like the manufactured rate drop during the great recession to help the economy, using a build-up model with these low ‘risk-free’ rates, keeping all else equal, creates an illusion of value that does not exist,” he says. “Overall market risk is increasing in most sectors, as is volatility risk, so the analyst needs to make up the delta elsewhere.”

Just 7% of business executives said their companies had made a minor downward adjustment to their profit and revenue forecasts due to virus concerns, while 51% said they had made no change but were closely monitoring the situation, according to a recent AICPA survey. But this survey was taken just as the crisis was unfolding, and, while 42% said they didn’t expect to have to make any coronavirus-related adjustments, responses late in the survey cycle showed much less confidence.

The SEC and PCAOB issued a warning on the coronavirus impact on financial reporting and will possibly grant relief from filing deadlines. The PCAOB says it is now restricted from examining firms based in China.

As the disruption lingers, there is more potential for asset impairments, such as for financial instruments, goodwill related to operations in coronavirus-affected areas, and inventory where supply chains have been impacted.

Professor Aswath Damodaran (New York University Stern School of Business) gives his take on the coronavirus and the recent market meltdown in this post in his blog on valuation and corporate finance. He lends a calm voice to the current crisis by suggesting that “rather than listen to the experts on either side of this debate tell you what to do, you should make your own best judgments, recognizing that they can and will change as more facts emerge, and act accordingly.”

What is your firm and its clients doing in response to the coronavirus? Let us know, and we’ll share it with readers. Send your comments to info@bvresources.com.

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Advisory Services Overtake Audit at Big Four

Business valuation and related services typically fall under the “advisory services” practice area at the Big Four and other accounting firms. Advisory services now total 40% of all revenue for the Big Four firms, according to *GlobalData’s International Accounting Bulletin World Survey 2020* (select tables are available here). Audit and accounting services trail behind, only generating 34% of the Big Four’s total income for 2019. The revenues generated from different service lines have changed dramatically since 2008, when audit and accounting services amounted to 52% of total fee income, and advisory a mere 24%, reports the *International Accounting Bulletin,* which tracks fee income and staff information

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from accounting networks and associations. Outside of the Big Four, audit and accounting services still make up 49% of fee income, compared to 25% from tax and 19% from advisory services. The services line breakdown has seen little change since 2008 when audit and accounting made up 53% of their total fee income.

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Millennials and Auto Trends in D&P 'Valuation Insights' 1Q20

Surprisingly, millennials place a material value on car ownership, and a high percentage expect to make another car purchase in the next five years, according to a recent survey from Duff & Phelps. This finding suggests that "common assumptions about car ownership should be tossed out along with tired millennial stereotypes like poor work ethic, a sense of entitlement and bad attitudes," the report says. It's also surprising because millennials tend to live in cities and have easy access to public transportation. In any event, this is "good news for automotive companies currently facing headwinds for the first time this decade," the report says. The survey is discussed in "Valuation Insights," first quarter 2020, which also covers: industry market multiples for North America and Europe, how the FASB's new method for recognizing credit losses is expected to have a major impact, the importance of IP for high-growth firms globally, and the new international cost of capital module for the D&P Navigator.

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Healthcare M&A Activity in 4Q19, per Levin Reports

Several recent reports from Irving Levin & Associates examined healthcare M&A activity in various sectors for the fourth quarter of 2019 versus the third quarter:

- M&A activity in the Physician Medical Group sector continued to decline in Q419, down 45% from 3Q19;

- Deal volume in the Home Health and Hospice sector rose slightly, up 5%;

- In the Hospital sector, deal volume dropped 21% compared with the third quarter;

- Activity in the Behavioral Health Care M&A market slowed in the fourth quarter of 2019, down 21%; and

- Seniors Housing and Care Acquisitions in the fourth quarter of 2019 jumped 7%.

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Global BV News: New Guide Bridges Canadian Valuation Standards to IVS

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The CBV Institute is Canada's valuation professional organization (VPO) whose members have the Chartered Business Valuator designation. They adhere to the CBV Institute Practice Standards, which do not contradict the International Valuation Standards (IVS), although some differences do exist. To assist its members in applying IVS, CBV Institute has published *A Bridge From CBV Institute Practice Standards to IVS* to highlight areas of differences between the two sets of standards. You can find the guide and more information on IVS if you click here.

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This BV Practice Management Tip Will Surprise You

Ever think of attending CLE events to build your BV practice? That's what James Koerber (The Koerber Co. PA) did, and it worked like a charm. He had been struggling with his new solo practice and almost gave up when he started using tactics like this—and now he has one of the more successful valuation and litigation services firms around. As he explained during a recent interview with Rod Burkert (Burkert Valuation Advisors LLC), attending CLE events helps build name recognition and you stand out, since you probably are the only nonlawyer in the room. At one CLE class, Koerber was among 150 attorneys who asked him "Why are you here?" and he responded that as an expert he was there to learn. The speaker called on him to give his perspective on the topic, so there he was talking in front of a slew of potential referral sources. The interview was part of Burkert's webinar series, Practice Development INSIDER, that features some of the leading valuation practitioners revealing their time-tested ideas behind building a practice. The next webinar will be April 3 and will feature Barbara Price (Mercer Capital). For more information on the series, go to Burkert's website.

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Risk Levels of Legal Cannabis Firms

Appraisals of legal marijuana firms continue to be challenging and risk is a major factor, say Ron Seigneur and Ryan Cram, who are both with Seigneur Gustafson LLP, a firm based in Colorado, one of the first states to legalize adult recreational marijuana. During a March 10 webinar, they cited an engagement in which an additional risk premium of 20% was added to the discount rate to account for specific company and industry risk, bringing the total discount rate to 45.8%. This is on a par with the cost of equity for first-stage or "early-development" companies, they pointed out. Seigneur and Cram recently co-wrote a BVR Briefing: "Cannabis and Hemp Valuations: A Market Analysis."

> *Extra:* Cannabis sales are getting a boost in California to "ease minds" over the coronavirus, according to a report in the *Hollywood Reporter*.

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A 'Gem' of a Book From Reilly and Schweihs

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That's what Roberto H. Castro (Central Washington Appraisal, Economics & Forensics LLC and Gravis Law PLLC) says in his review of *Best Practices—Thought Leadership in Valuation, Damages, and Transfer Price Analysis*. The book, by Robert F. Reilly and Robert P. Schweihs, is 1,200 pages long, covering a wide range of topics, including the valuation of private-company securities and intangible assets, valuation for property tax purposes, valuation for ESOPs, fair value measurement for financial accounting purposes, transfer price analysis, and economic damages measurement. Castro's review will appear in the April 2020 issue of *Business Valuation Update*.

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Global BV News: D&P's Valuation Insights in China

Duff & Phelps has released the 1Q20 Greater China edition of its *Valuation Insights* series, which examines issues such as the Hong Kong Stock Exchange's proposed rules on weighted voting rights for corporate shareholders, SFC issues circular for PE firms seeking license, U.S.-China trade deal phase one to impact intellectual property and tech transfer, new rules expand CFIUS jurisdiction over foreign investment in the U.S., China welcomes wholly foreign-owned futures companies in 2020, and the IVS 2020 update.

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Thoughts and Advice on Valuations Amid the COVID-19 Crisis

As the coronavirus pandemic continues its relentless march across the globe, we have reached out to members of the *Business Valuation Update* Editorial Advisory Board to begin to gather their thoughts on the impact of the crisis on valuations. We will assemble the full comments of the board into a free document and make that available soon. In the meantime, here are a few observations and pieces of advice we have received so far from experts the world over.

From the U.S.: Gary Trugman, Trugman Valuation (Plantation, Fla.): "Developing cost of capital in troubled times should be nothing new. We saw this in 2008 after the financial crisis and it should be dealt with in a similar fashion. What is critical to remember is that we value businesses based on what is known or knowable at the valuation date and we must consider what the investing public is thinking at the date of the valuation. While many tried to deal with risk-free rates and the 'flight to safety' back in 2008, that almost became the new normal. Thought must be given to the fact that the risks associated with the cash flow of the particular business that you are valuing is what the discount rate must be based on. If all you do is a mechanical computation to build up a discount rate, you are most likely going to be wrong. You need to use common sense and think about how the risk of receiving the cash flows is impacted at the date of the valuation."

Ron Seigneur, managing partner, Seigneur Gustafson LLP (Lakewood, Colo.): "My sense in all of this is the 'risk-free' rate is not really risk free and we will see more emphasis on how

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to get our arms around the unsystematic risk associated with investments as this is where I think the extra risk we now have ahead of us should be captured. All that said, ask me again tomorrow and next week on all of this as it sure seems like we are in that sort of environment just now."

Gilbert E. Matthews, chairman of the board and a senior managing director of Sutter Securities Inc. (San Francisco): "Since volatility is a factor in discounts for lack of marketability (DLOM), the extreme volatility of the market in recent weeks will materially increase DLOMs. In addition, I would argue that DLOMs should be adjusted upward because:

- "The abnormal conditions in the market will necessarily cause buyers to be reluctant to invest in illiquid securities; and
- "The restrictions being put in place to limit the spread of COVID-19 are limiting the ability of prospective buyers of restricted securities from conducting due diligence and even to meet with financial and legal advisors.

"There is no data to quantify these factors, but they should be considered, and valuators should use their professional judgment."

Harold Martin, partner-in-charge of valuation and forensic services for Keiter (Richmond, Va.): In terms of what was known or knowable, "the issue actually goes back to late February and early March when the virus started to spread, and the stock market began to reflect the expected economic impact. For purposes of assessing the impact on a valuation completed on or after those dates, an appraiser would essentially do what they always should do for any valuation:

- "Perform an analysis of the current and expected economic and industry conditions based on what was known or knowable as of the effective valuation date;
- "Assess the impact of these factors, as well as the financial and operational characteristics of the subject company, on the subject company's expected growth rate; and
- "Assess the risk resulting from these factors on the company's ability to achieve projected future cash flows and reflect this in the company-specific risk component of the discount rate.

"Further, to the extent that there is a lapse of time between the valuation date and the report date, the appraiser should consider reporting material developments as a subsequent event."

From the UK: Andrew Strickland, former corporate partner at Scrutton Bland Chartered Accountants (UK), now a consultant to the firm: "In the UK, the short-term risk-free rate was reduced from 0.75% to 0.1% in short order. The impact on the cost of equity must be far

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more than that movement of 0.65%, and in the opposite direction from that indicated by CAPM. Times like these lead us to challenge the very fundamentals of our training. But challenge and enquiry are always positive attributes, making us into better valuers."

From Australia: John-Henry Eversgerd, senior managing director of the valuation and litigation consulting practice in the Sydney office of FTI Consulting: "I'm expecting some significant asset impairments in a number of industries, particularly in Australia, since we have some every strict 'continuous disclosure' rules. Those rules require public company boards to announce almost immediately any impairments or other factors that would impact the share price significantly. It is a very low bar, which means boards have little choice but to impair."

From Hong Kong: Edwina Tam, partner at Deloitte in Hong Kong: "For the development of cost of capital, given the market uncertainty, one needs to critically consider the impact of the current market uncertainties (COVID-19, U.S.-China trade war, etc.) on the business operations in developing the forecast. In determining the nature and extent of the impact on the business and valuation assumptions, the following potential issues may need to be considered:

- "Store or facility closures;
- "Loss of customers or customer traffic;
- "The impact on distributors;
- "Supply chain interruptions;
- "Production delays or limitations;
- "The impact on human capital;
- "Regulatory changes; and
- "The risk of loss on significant contracts.

"Implicitly, these uncertainties need to be reflected in the cash flows; however, a risk-appropriate discount rate also needs to be considered. There is no set approach to account for market uncertainties as the impact will be different for different businesses in different regions."

We will bring you more thoughts and advice in future issues of *BVWire* and *Business Valuation Update.* For now, we leave you with these words from Andrew Strickland: "We are in a privileged position. We are members of a profession which has developed the techniques to value that which cannot readily be valued: fractional holdings in private companies are assets for which there is no ready market, yet we are prepared to ascribe values to them using our professional judgement and training within a discipline developed

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over many years. We all see further by standing on the shoulders of giants. We therefore have the skills to value businesses when the lubrication in the market runs dry."

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COVID-19 Updates and Guidance From the Valuation Community

Valuation professional organizations, special interest groups, and valuation and accounting firms are issuing updates and guidance amid the coronavirus pandemic. Here's some of what's going on in that regard.

The ESOP Association is developing a joint committee article on the pandemic's impact on valuation and the potential need for updated valuations for distributions.

The AICPA has formed a task force from its BV and forensic committees to examine the impact of COVID-19. At its first meeting, members discussed general valuation issues, liquidity risks, and the potential for an increase in fraud (such as virus-related charity donation fraud).

The ASA's in-person classes and events are in the process of being rescheduled or converted to online access, according to the organization's COVID-19 update web page, where you'll also find news about ASA office closures, memberships, and credentialing.

The Big Four are issuing alerts on understanding the impacts of the coronavirus on business operations, such as this one from PwC.

Houlihan Lokey has a series of COVID-19 updates on various industries, including transportation and logistics, human capital management, valuation of structured products, marketing services, and facilities services.

Duff & Phelps has a COVID-19 Resource Center with links to a number of alerts and resources on how the coronavirus is impacting businesses globally.

We'll keep you informed as these resources develop.

> *Extra:* The Big Four as well as many other public accounting firms have temporarily shut their doors and implemented mandatory work-at-home policies.

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Global BV News: Global VPOs Issue Guidance and Support to Valuers During Crisis

Valuation experts can look to the latest edition of the International Valuation Standards (under Section 103: "Reporting") for guidance on valuations during this time of uncertainty, points out Nick Talbot, chief executive of the International Valuation Standards Council (IVSC) in a statement. He also urges valuers to check in with valuation professional

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organizations that are part of the IVSC's member network for further guidance and support—you can find a list of VPO links here. The IVSC's technical boards are also "convening virtually to monitor market developments in order, where required, to issue additional support and direction to valuers in the application of IVS within the current context," he says, adding: "On behalf of the IVSC, I offer my thoughts and best wishes to all our stakeholders, their staff, members, clients, and families at this challenging time."

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How to Deal With COVID-19 for Dec. 31, 2019, Valuations

Several *BVWire* readers have asked about how to treat the COVID-19 issue when you have a valuation date of Dec. 31, 2019. One reader, **Judy O'Dell** (O'Dell Valuation Consulting CPA LLC) of Rockport, Maine, was doing a Dec. 31, 2019, valuation for an ESOP transaction with a report date of March 11, 2020. The company, a construction firm with projects underway, is based in Maine and does not conduct business outside of the state. As of the date of the report (March 11, 2020), there were no COVID-19 cases in Maine. "I considered the virus a subsequent event," O'Dell tells us. "The transaction will close shortly and the trustee raised the issue of whether the value should be decreased knowing what we know now. I referred him to AICPA SSVS 1 concerning subsequent events." Following SSVS, O'Dell included an appendix to the report that included the language of SSVS No 1 VS Sec 100.43. Here is the appendix (client data redacted):

> **Appendix A—Subsequent Events—COVID-19**
>
> The following disclosure information is provided for information purposes only and does not affect the determination of value of 100% of XXX at 12/31/2019.
>
> The AICPA's Standards on Valuation Services (SSVS No 1 VS Sec 100.43) addresses the analyst's responsibility regarding subsequent events:
>
>> *"The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimated value. Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date. An event that could affect the value may occur subsequent to the valuation date: such an occurrence is referred to as a* subsequent event*. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or condition. Moreover, the valuation would typically not include a discussion of those events or conditions because a valuation is performed at a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date. In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be*

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of such nature and significance as to warrant disclosure in a separate section of the report in order to keep users informed."

It appears that the first reported case of COVID-19 virus was in China and was reported on 12/1/2019. As of 12/31/2019 there were no reported cases in the United States. The first reported case in the U.S. was 1/14/2019 which is after the valuation date. We considered the COVID-19 virus in the United States to be a subsequent event. Because this valuation is prepared for an ESOP transaction, we consider this valuation to be meaningful to the intended users and thus are providing this disclosure.

The valuation of XXXX does not consider the possible effects, if any, of the COVID-19 virus on the Company. The valuation reflects conditions as of the valuation date, 12/31/2019.

We ran this by veteran business valuer Harold Martin (Keiter) who responded that the expert, "for the most part, has done essentially what I would have done, i.e., citing the applicable professional standards to which the expert is subject (in this instance, AICPA SSVS1) and then describing factually the circumstances that existed as of the effective valuation date. For valuations as of 12/31/19, I would agree with the position taken by the expert.

"Given that the purpose of the valuation was for an ESOP, I would also recommend that the guidance from the U.S. Department of Labor's Proposed Regulation relating to the Definition of Adequate Consideration be cited. The Proposed Regulation requires that the *'fair market value must be determined as of the date of the transaction involving that asset.'* [emphasis added] I would also cite the guidance provided in IRS Rev. Rul. 59-60: *'Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.'* [emphasis added]

"I would also recommend clarifying the nature of the subsequent event. For example, the issue is that the coronavirus resulted in a pandemic that has adversely affected market conditions. Finally, I would also recommend citing a reputable source for the discussion of the chronology of events to support the appraiser's conclusion that these events are, in fact, subsequent to the valuation date."

Our thanks to Judy O'Dell for allowing us to share this with readers and to Harold Martin for his perspective.

Feedback? Do you agree with this approach? Would you do anything differently? Let us know, and we'll share it with others if you wish.

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Legal Avenues for Businesses Coping With COVID-19 Disruption and Damages

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In Franchising in the Time of COVID-19, an ABA panel recently discussed the scope of the disruption the pandemic has caused for franchisees and franchisors as well as legal doctrines on which franchisees/franchisors might rely to deal with the monetary damages to their businesses.

This excellent webinar took place on March 23, and the speakers were Kristin Lawrence Corcoran (Franchise World Headquarters LLC), Michael R. Gray (Lathrop GPM), Nicole Liguori Micklich (Urso, Liguori & Micklich), and Tao Xu.

Business interruption insurance: In an effort to stem losses resulting from the pandemic, businesses may consider filing a business interruption claim with their insurance. What losses are covered depends entirely on the individual policy, the speakers say. Consequently, while policies may be similar, they may include different riders and endorsements. Many policies have virus exclusions. Check yours.

The speakers note that, to make a valid claim, a business usually has to show that it suffered a “direct physical loss or damage to property.” Earlier this month, a restaurant in Louisiana filed a case arguing it suffered direct physical damage to the property in that employees who proved to have the virus actually contaminated the workspace, requiring the restaurant to shut down for decontamination. The insurance company should be liable for the cost of deep cleaning as well as loss of income.

The premise of the claim is that health experts know the virus can survive on surfaces up to 28 days. Further, health professionals have acknowledged the waiting times to test potentially affected persons and obtain test results. This delay allowed the virus to linger and contaminate the physical space, the argument goes.

The speakers note that insurance companies are much less likely to entertain arguments for “presumed contamination,” i.e., injury based on the general knowledge (assumption) that the virus is omnipresent. The speakers also note that some insurance policies may cover government-ordered closures; others may not. Again, the language of the individual policy controls the claims businesses can file. Diligently document all losses, file claims, and await the response from the insurance company, the speakers advise. They note that responses to claims and the development of claims are evolving.

Force majeure clauses: In this unrivaled crisis, franchise owners and holders may try to invoke force majeure (FM) clauses to escape certain contractual obligations. This French term, which means “superior force,” generally refers to events beyond the control of a party to the contract that make it impossible to perform under a contract. The ABA panelists note that there is no standard legal definition for FM. The language of a specific contract explains what events may allow a party to abandon the contract. Often, FM clauses in contracts expressly exclude health crises. It is not clear whether federal, state, or local orders that prohibit or make difficult movement, the performance of certain services, and access to certain supplies qualify as FM. The panelists caution that parties to a contract cannot escape performance just because doing so has become too expensive. Anyone thinking of pursuing this avenue must pay close attention to notice deadline requirements, the panelists advise.

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D&P Increases Recommended U.S. ERP to 6.0%

Duff & Phelps has increased its recommended U.S. equity risk premium (ERP) from 5.0% to 6.0% for use as of March 25, 2020, according to a client alert. This new rate, used in conjunction with a normalized risk-free rate of 3.0% (reaffirmed), implies a "base" U.S. cost of equity capital estimate of 9.0% (6.0% + 3.0%). "To be clear, this means that for critical quarter-end valuations dated March 31, 2020, the recommended ERP is 6.0%," the firm says. "However, several economic and financial risk factors that we evaluate were already present during the week of March 9, 2020."

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The IRS to BVers: We Want You!

No, not for an audit—the IRS is looking for experienced business appraisers to fill six open positions across the U.S. The salary ranges from $92,568 to $137,045 per year, and the jobs include telecommuting opportunities, "great benefits including pension, and a true 40-hour work week," the agency tells us. To get all the details, including job description, experience requirements, locations offered, how to apply, and more, just click here.

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Will BV Experts See a Spike in Divorce Business?

Yes, it's likely if the trend in China spreads to here. Divorce rates there have risen significantly because "couples are spending too much time together at home" during coronavirus self-isolation, according to an article in the UK's DailyMail.com. The divorce rush has triggered at least one city in China to put a daily limit to allow no more than 10 couples to divorce per day.

> *Extra:* The AAML/BVR National Divorce Conference (September 10-12 in Las Vegas) is adding flexible attendance options to make it easy for you to attend live or online. Plus, there is a risk-free cancellation policy with 100% full refunds being issued up until August 10 (a month before the event). To register, click here.

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List of Links to COVID-19 Updates From the Valuation Community

If you click here, you can get a list of links to the latest insights, research, and guidance in relation to the COVID-19 pandemic published by various valuation organizations and professional bodies. The International Valuation Standards Council (IVSC) compiled the list

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as a convenience. (*Note: The IVSC is not responsible for, nor can it guarantee the veracity of, the content published, the organization says.*)

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Global BV News: EIU: Global Economy Will Contract by 2.2%

In the wake of the coronavirus outbreak, the Economist Intelligence Unit (EIU) has revised its growth forecasts for all countries across the world, and the picture is "bleak," it says in a report.

Across the G20, all but three countries (China, India, and Indonesia) will register a recession this year, it says, finding that the global economy will contract by 2.2%. The U.S. economy will contract by 2.8% this year, partly due to the administration's initial poor response to the coronavirus, allowing the illness to spread quickly, the report says. "We assume that there will be a recovery in the second half of the year, but downside risks to this baseline scenario are extremely high, as the emergence of second, or third waves of the epidemic would sink growth further," says Agathe Demarais, the EIU's global forecasting director.

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Shift More Emphasis to Numerator, Panel Says

During this time of crisis, the numerator of the valuation equation needs much more attention than before, said a panel during yesterday's free BVR webinar. While the effort should always have tipped in favor of cash flow and forecasts over the cost of capital, we're hearing that some are now using an 80-20 mix, i.e., spending 80% of their time on the numerator and 20% on the denominator for valuations.

Stacy Preston Collins (Financial Research Associates), Michelle Gallagher (Adamy Valuations), Harold Martin (Keiter, Stephens, Hurst, Gary & Shreaves PC), and Gary Trugman (Trugman Valuation) presented the free 100-minute webinar, Extreme Uncertainty: How Valuation Experts Should Respond to Today's Volatility and Risk. The panel answered many questions from the audience on topics including year-end 2019 valuations, what was known or knowable, the CARES Act, impact on the three valuation approaches, cost of capital, family law considerations, and more. A free replay of the webinar will be available shortly.

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IRS Discusses Tax Implications of COVID-19 Legislation

In an excellent ABA webinar that summarized and analyzed the COVID-19-related legislation Congress passed to alleviate the economic harm on businesses and persons, IRS Chief Counsel Michael Desmond spoke to some of the efforts the agency is making to achieve implementation. Here are a few takeaways from this item-packed discussion.

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The presentation took place on April 2 and also included leaders from the ABA Tax Section: Sheri Dillon, Jennifer Breen, Lisa Zarlenga, as well as Anne Gordon (Tax Counsel, U.S. Senate) and Sunita Lough (IRS deputy commissioner services and enforcement).

CARES Act: This legislation was signed into law on March 27 and includes relief for small and large business through loans, guarantees, and other investments. Of particular note are provisions to provide qualifying employers with a refundable payroll tax credit of up to $5,000 for each employee's wages paid from March 13, 2020, through Dec. 31, 2020. To qualify, a governmental shutdown order must have fully or partially suspended an employer's operations during the COVID-19 crisis or the employer must have experienced a drop in gross receipts by more than 50% compared to the same quarter in 2019.

Further, the legislation seeks to make available additional cash flow and ensure liquidity by temporarily repealing the 80% of taxable income limitation on using the net operating loss carryovers that the 2017 TCJA imposed. Specifically, for a taxable year beginning before Jan. 1, 2021, a taxpayer can fully offset taxable income in that year with NOLs from prior taxable years. Also, taxpayers may carry back NOLs arising in 2018, 2019, and 2020 to their prior five taxable years. (This is the Tax Code § 172 provision.) Speakers noted that, if you are thinking of carrying back five years to offset prior income and get a refund, you may also have to amend state tax filings.

A key question was how quickly taxpayers could monetize their losses and get refunds. Chief Counsel Desmond said this issue was top of the list and two sets of guidance were coming soon, one addressing substantive issues and one procedural issues.

IRS notices: IRS Notice 2020-18 provides for an extension of the federal income tax filing date from April 15, 2020 (whether due date or extension) to July 15, 2020. The extension is automatic. Taxpayers may defer any amount of federal income tax payments until July 15, 2020. Note that this notice does not address payments due for other quarters or fiscal year taxpayers. Taxpayers with a different filing or payment due date other than April 15 must abide by the original date as of now. This may create a situation where Q2 estimated income tax payments are due on June 15, 2020, while Q1 estimated income tax payments are postponed from April 15, 2020, to July 15, 2020. IRS Notice 2020-20 provides the most up-to-date guidance and augments the relief by including Gift Tax and Generation-Skipping Transfer Tax returns.

IRS representatives also noted that, in the spirit of the "People First Initiative," the agency is trying to "help people and businesses during these uncertain times." The agency "generally" will not start new audits but will work on refunds "where possible," without in-person contact. For audits in the works, the IRS will continue the work, the idea being that most taxpayers want the audit over with. Also, IRS appeals will continue to work cases. Taxpayers are encouraged to promptly respond to requests for information in these cases.

Note that the IRS continues to process tax returns and to issue refunds and seeks "to help taxpayers through its self-serving tools."

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Follow-Up Comments: How to Deal With COVID-19 for Dec. 31, 2019, Valuations

Harold Martin (Keiter) has the following additional comments regarding the appraisal discussed in last week's *BVWire* article dealing with a valuation date of Dec. 31, 2019, and whether the impact of the coronavirus should be considered a subsequent event:

> As I noted in the article, for valuations with an effective valuation date as of 12/31/19, I would agree with the position taken by the appraiser that the economic impact of the coronavirus should be considered a subsequent event and therefore, the event would have no impact on the valuation. The appraiser's report should also include a discussion noting the subsequent event. However, there is an additional issue in this instance given the purpose of the valuation that requires that I clarify my initial comments. The appraiser noted that the purpose of the valuation was for an ESOP transaction. Further, the appraiser noted that the transaction had not yet closed as of the report date of March 11, 2020. As I noted in my comments in the prior article, the guidance from the U.S. Department of Labor's Proposed Regulation relating to the Definition of Adequate Consideration requires that the "fair market value must be determined as of the date of the transaction involving that asset." Given this guidance, the appraiser should consider preparing a valuation report with an effective valuation date as of the date of the transaction, or alternatively, prepare a bridge letter updating the previous value as of December 31, 2019, to the value as of the transaction date. Under either alternative, the more current valuation date would require consideration of the impact of the coronavirus pandemic as it would no longer be considered a subsequent event.

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Global BV News: VRG Releases Free Webinar on Global Valuation Impacts of COVID-19

A spotlight on pandemic-related market developments in China and Hong Kong, India, Spain, and the U.S. is available as a free webcast from Valuation Research Group. A recording and transcript are available if you click here. PJ Patel, co-CEO of VRC, moderated a panel with VRG experts Simon Chan, executive director, and Kevin Chan, senior director (VRG China); Rajeev Shah, managing director and CEO (VRG India); and Sandra Daza, managing director (VRG Spain).

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Look Globally During Pandemic, Panel Advises

We're in more of a global economy today than during previous crises, but the coronavirus crisis will impact pockets around the world differently, points out a panel of global valuation

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experts in a free webinar the iiBV hosted. After one or two quarters of a plunging economy, certain locations will recover in a "V" shape, such as China. Not so for the U.S. and Europe, which will see more of a "U" shape recovery. And, within the locations, certain industries will bounce back more than others. Yes, this is a crisis unlike any other, but governments are reacting much faster than prior upheavals, with interest rate cuts and massive easing measures. But keep in mind that growth will occur from a lower base. And there's one key question: Will consumer activity completely bounce back after this is all over? Watch out for the possibility of a fundamental change in consumer behavior long term.

The panel also discussed asset impairments, projections, cost of capital, and more. A recording of the webinar, iiBV's Impact of COVID19—Global Perspectives, is now available. Moderated by Michael Badham, executive director of the International Institute of Business Valuers (iiBV), the panel consists of Yann Magnan, IVSC European Board chair (UK); Andre Toh, deputy chair of IVAS-Standards & Technical Committee (Singapore); Carla Nunes, Duff & Phelps (USA); and David Pearson, Leadenhall (Australia). The program was done in collaboration with the International Valuation Standards Council (IVSC), Singapore Accountancy Commission (SAC), Duff & Phelps, and Leadenhall.

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What Family Law Practitioners Need to Know About COVID-19-Related Legislation

In a recent webinar, hosted by the American Academy of Matrimonial Lawyers (AAML), high-caliber presenters examined provisions in the mammoth COVID-19 federal legislation that are of particular significance to family law practitioners (attorneys and business valuators).

The discussion took place on April 9, and the speakers were Michelle F. Gallagher (Adamy Valuations), a nationally recognized BV expert, and Brian C. Vertz (Pollock Begg), a divorce attorney specializing in complex child support issues, business valuations, and other divorce-related issues.

No double dipping: In broad strokes, the Families First Coronavirus Response Act (FFCRA) provides emergency paid-leave benefits for employees who work for an employer that has fewer than 500 employees and who are unable to work because they are sick with the virus, care for someone with COVID-19, are in quarantine or self-isolation, or have children who cannot go to school because of mandatory school closures.

Employers affected by the employee's absence may apply for refundable tax credits (from payroll taxes) to offset the cost of this extra paid leave. The FFCRA provisions apply to wages paid beginning April 1, 2020, and ending on Dec. 31, 2020.

Specifically, if an employee cannot work because he or she has COVID-19, the employer may get a refundable credit at the employee's regular pay, up to $511 per day, for a total of 10 days. For other employees, including those caring for someone with the disease, an

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employer can claim up to $200 per day for up to 10 days. Gallagher notes that the IRS is still working on the forms an employer has to submit to get reimbursed.

The CARES Act includes an employee retention credit provision that says an employer may qualify for a refundable tax credit of up to $5,000 for each employee's wages paid from March 13, 2020, through Dec. 31, 2020. To be eligible, an employer's operations must have been fully or partially suspended because of the crisis by a shutdown order from a governmental entity or because gross receipts dropped by more than 50% in comparison to the same quarter in 2019.

Michelle Gallagher points out that there is no double dipping in the sense that, if an employer uses wages to qualify under the FFCRA, it cannot also use the same wages to secure benefits under another provision, i.e., the employee retention credit.

Employers struggling to pay employees and stay in business may be eligible for SBA loans that may be forgiven in part or even entirely. Under the paycheck protection program (PPP), smaller businesses (those with less than 500 employees), sole proprietors, independent contractors, and self-employed workers may apply. The SBA will forgive loans if the employer keeps the same headcount of workers and wages for eight weeks after disbursement of the loan. For full forgiveness, only about 25% of operating costs may go to nonpayroll costs, including rent. Under recent SBA guidance, lenders must disburse the loan proceeds within 10 days of loan approval. The eight-week count for the employer begins with the first disbursement of the loan.

Gallagher notes there is also no double dipping as concerns the PPP loan. An employer who wants to take advantage of the loan cannot also receive an employee retention credit.

Valuation considerations: Both speakers note that it's important to consider the impact of the various remedies available to business owners and individuals in a business valuation or in calculating income for spousal support purposes for divorce purposes. Find out what the effect of the crisis has been on cash flow and what legal remedies a business has taken advantage of. Consider whether the PPP loan might be a windfall for the business owner. Consider the valuation date, Gallagher says. If, in an ongoing case, the most recent valuation was for Dec. 31, 2019, it may make sense to alert the attorney on the case to explore the possibility of doing an updated valuation. Note that different states have different valuation date requirements (date of separation, date of trial), but that courts, in this extraordinary situation, may allow for an updated valuation (which means more work for the valuator).

Extra: On the PPP loans, the SBA just issued FAQs, which you can access by clicking here.

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IRS Update on How to File Carryback Refund Applications

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In a recent ABA webinar including IRS representatives, new practical information related to the carryback provisions in the recently passed CARES Act emerged. Here's a quick update.

The CARES Act represents an effort by Congress and the U.S. Department of Treasury to make available additional cash flow and ensure liquidity. The Act's carryback provision temporarily repeals the 80% of taxable income limitation on using the net operating loss (NOL) carryovers that the 2017 TCJA imposed. Specifically, for a taxable year beginning before Jan. 1, 2021, a taxpayer can fully offset taxable income in that year with NOLs from prior taxable years. Also, taxpayers may carry back NOLs arising in 2018, 2019, and 2020 to their prior five taxable years. (This is the Tax Code § 172 provision.) Speakers noted that, if you are thinking of carrying back five years to offset prior income and get a refund, you may also have to amend state tax filings.

A key question has been how quickly taxpayers could monetize their losses and get refunds.

In the April 14, 2020, webinar 2020 Tax Filing, Payment, and Refund Deadlines, we learned that, beginning April 17, taxpayers may fax certain tentative carryback applications to the IRS (there's a 100-page limit).

There are two forms, Form 1045 and Form 1139 (available on the IRS website).

The fax number for Form 1045 is **844-249-6237.**

The fax number for Form 1139 is **844-249-6236.**

Only claims allowed under the Act's sections 2303 and 2305 may use this procedure (Minimum Tax Credit refunds and 2018, 2019, or 2020 NOL Carrybacks).

Also, the IRS has set up a COVID-19 disaster relief hot line. If you have a question, docket attorneys will call back. The general number is **202-317-5436.**

Things are happening fast. Know that the IRS website is being constantly updated, sometimes more than once a day. Check there for the latest notices, guidance, and other news at irs.gov/coronavirus.

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M&A Impacts Discussed During Recent BVR Town Hall

There were several questions about M&A activity amid the coronavirus crisis during BVR's town hall webinar, held on April 7. Several audience members were business brokers, who commented that deals were still getting done to some degree. Here's what they report:

- "Our firm handles both Main Street and lower middle market deals—80% of deals that are 'essential' businesses are still moving forward. Strategic buyers remain fairly confident, but PEGs are less confident. Financial buyers (Main Street) are mixed.

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Some are canceling and others are delaying closing dates until stay-at-home orders are lifted."

- "We have only had one buyer back out because of COVID-19. We have several other deals moving forward. One buyer is a PE and sees this as an opportunity. Also, the big SBA banks, such as Huntington, are automating as much of the PPP [Paycheck Protection Program] processing so they can work on transactions. The SBA 6-month payment of principal and interest on new deals is a major incentive to get deals done by Sept. 27, 2020."

- "We also work as a business broker for financial advisors and while M&A is slightly on hold, we are still seeing deals and financing happening."

- "Banks are not canceling financing already approved. Buyers are the ones going on hold. However, banks are busy hence not looking at new deals."

As to the extent to which there has been an adjustment to private-company valuations amid the market turmoil, the panel referred the audience to an article that points out the difficulty of discerning valuation trends from the data points in the deals being done.

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Long-Term View of the Economic Rebound

It's a little too early to pinpoint the exact impact of the coronavirus on the economy, but a return to the level of economic activity that existed in early 2020 will probably occur at the "back end of 2021," according to **Simon Rubinsohn,** chief economist for the Royal Institution of Chartered Surveyors (RICS). He spoke during a recent free webinar, "Impact of COVID-19 to Global Business Valuation and Appraisal," that various valuation professional organizations (VPOs) sponsored. While there is a massive and unprecedented intervention by governments and financial institutions around the world, this will only cushion the blow, not eliminate it, he noted. A recording of the webinar is available if you click here.

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AICPA Issues a Subsequent Event Toolkit

In the April 1 issue of *BVWire*, BVR presented one valuation expert's way of dealing with the coronavirus in valuation reports before it was known or knowable. In an appendix to her report, she considered the coronavirus a subsequent event as of the valuation date (Dec. 31, 2019), explained why she did so, and stated that the determination of value does not consider the effects of the virus. She also cited the language of the standards she was following, namely, the AICPA's Standards on Valuation Services (SSVS No. 1 VS Sec 100, paragraph 43). This treatment is essentially consistent with the recently released AICPA VS Section 100 Subsequent Event Toolkit, a helpful resource that includes frequently asked questions and sample disclosure language. The Toolkit reminds valuers who adhere to VS

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100 that the disclosure of a subsequent event is not required—it is up to the analyst to decide whether or not it is appropriate to make the disclosure.

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Poll: Some Valuation Experts Expect an Increase in Business

During BVR's April 7 town hall webinar on the valuation impacts of COVID-19, 25% of the audience said they expect business valuation engagements to "increase slightly" and 21% said business will stay the same. The rest expected business to drop, with 19% saying it will drop a "little" (meaning 10% or less), 22% saying "some" (11% to 25% drop) and 13% saying it will decrease "significantly" (more than 25%). We received over 900 responses to the poll.

Panel members commented: "I anticipate possible increases in business over the next six months, especially in the family law area," says Michelle Gallagher (Adamy Valuations). "We are doing multiple valuations potentially in the estate and gift area for transactions happening right now or in the very near future." She also felt that her firm will be busy with litigation. Gary Trugman (Trugman Valuation) also expects to get busier. "Obviously, we have a big litigation practice. I have four trials and two depositions already cancelled, which is not good for business, but we are still getting phone calls about other types of valuation," he says. "We are just rethinking how we bid those jobs so that we can keep the jobs coming to keep our own cash flow going."

We hear that some firms, especially those that include a traditional CPA practice, are finding a new niche: counseling clients through the government stimulus programs for small business and then handling the recordkeeping for inevitable audits (especially for the forgivable loans).

Are BV firms' hiring plans impacted? "We are planning on hiring a new associate," reports Harold Martin (Kieter). "Our firm is taking the position that we will obviously watch things very closely, but we are proceeding with the expectation that we will come out of this." He recalls being with two of the (then) Big Eight firms that delayed hiring during a tough time, and, while they saved costs in the short term, "it came back to bite us two years down the road when we were missing all those staff." Stacy Preston Collins (Financial Research Associates) made an interesting point as to the difficulty of training someone 100% remotely during the current lockdown. "I have done a little bit of that in the short term, but I would worry a little about hiring someone and having them work from home full-time," she says. "I think I would want to wait until people were back in the office just in terms of a learning issue. But barring that, I don't foresee any issues. I just want to have a situation conducive to a new person learning because so much of it is on the job."

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PwC Survey: CFOs Become Less Optimistic About Recovery Time

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“Hopes that the outbreak will dissipate quickly are receding,” according to the PwC COVID-19 CFO Pulse Survey. “Only one in five respondents now believes they’ll be back to business as usual within a month once the outbreak ends. In contrast, during the week of March 9, as shelter-in-place orders started taking hold in the U.S., 66% of U.S. and Mexico respondents estimated that their companies could recover within a month.” PwC is conducting a biweekly survey of finance leaders in the U.S., Mexico, and 19 other territories.

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Appellate Court Ruling Unfavorable to Cannabiz

Section 280E of the tax code prohibits taking tax deductions for business expenses related to marijuana because of its status as a Schedule I controlled substance. Legal cannabis firms can deduct cost of goods sold, but not being able to deduct operating expenses is a major problem—these firms could actually pay more in taxes than they make in profit. There has been some hope that Section 280E would be found unconstitutional, but a new case is not good news in that regard.

New case: A medical cannabis dispensary in Denver has lost an appellate court battle to prevent the IRS from obtaining business records from state regulators. The IRS is auditing the firm to see whether it took improper business deductions. The U.S. Court of Appeals for the 10th Circuit ruled that the IRS auditor did not act in a way that was overbroad or violated the rights of the company owners. The court also said that, despite the dissent in another case (*Northern California Business Associates)*, Section 280E does not violate the 16th Amendment, stating: “The dissent opined that Congress had exceeded its Sixteenth Amendment authority in enacting §280E.… We are unpersuaded by this dissent. We agree with the majority, which ruled that §280E falls within Congress’s authority under the Sixteenth Amendment to establish deductions.” The case is *Standing Akimbo, LLC et al. v. United States of America,* which can be accessed if you click here.

We thank Ron Seigneur (Seigneur Gustafson LLP) for alerting us to this case. Seigneur is co-author of “Cannabis and Hemp Valuations: A Market Analysis” (a BVR Briefing) and *The Cannabis Industry Appraisal and Accounting Guide*.

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Global BV News: IPEV Issues Special Guidance for March 31 Valuations

The International Private Equity & Venture Capital Valuation Guidelines Board (“the IPEV Board”) has issued special guidance with respect to applying the IPEV Valuation Guidelines when estimating fair value at March 31, 2020, which will be “very challenging.” While the alternative asset industry is “strong and robust,” the COVID-19 crisis is “different from crises in 2001/2 and 2008/9,” says IPEV. “The current crisis has impacted more people, more businesses, more rapidly than any crisis in recent history.” The special guidance addresses equity and debt investments as well as limited partnership interests and includes this caution on “double dipping,” which can apply in other valuation contexts as well:

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> Care should be taken not to “double dip” with respect to valuation inputs—if performance metrics have been adjusted to take into account lower expected performance, an appropriate multiple should be applied rather than a multiple derived from comparable public companies whose results have not yet included lower expected performance. The same concept applies when using the income approach, discounted cash flow (DCF). If future cash flows have been adjusted the increase in the discount rate may be less than the increase in the discount rate if cash flows have not been adjusted for the impact of the crisis.

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ESOP Plaintiff Appeals Dismissal of Lawsuit, Leaning Heavily on Controversial *Brundle* Case

In appealing the dismissal of her lawsuit with the 4th Circuit Court of Appeals, an ESOP plaintiff frequently invokes the *Brundle* case in which the same appeals court affirmed a $30 million judgment for the ESOP. The dismissal was a rare victory for ESOP defendants after several major court rulings in favor of ESOP plaintiffs.

No harm done: At issue was the 2016 sale of shares in a construction company to an ESOP. An independent trustee oversaw the transaction and an experienced ESOP appraisal firm prepared the valuation underlying the transaction and subsequent annual valuations. The ESOP paid $198 million for an 80% ownership stake in the company (8 million shares). The transaction was financed with a loan from the company and the selling shareholders received warrants that would enable them to acquire additional voting stock. A 2016 year-end annual appraisal, which came about a month after the ESOP's formation, valued the shares at $64.8 million.

The plaintiff, a former company employee, sued. The gist of the allegations was that the $64.8 million valuation showed the trustee (and other defendants) caused the plan to overpay for company stock. Last fall, the district court dismissed the case, finding the plaintiff had not shown an “injury in fact.” The plaintiff had no standing “to pursue her claims in this Court.”

The court said the plaintiff “fundamentally misunderstands” the transaction and the subsequent valuation. According to the court, the ESOP had taken on debt to obtain the stock. The expected value of the ESOP's shares, in the short term, would be zero**.** However, the $64.8 million year-end valuation meant the shares had already appreciated in value by about 33% in less than a month. Rather than suffering an injury, the ESOP “realized an immediate equitable benefit.” The court analogized the situation to obtaining a mortgage when buying a home and ultimately finding the home is worth more than the mortgage. The buyer would be able to buy the house at a discount and “be left with a tidy profit” if she sold the house after paying off the mortgage, the court postulated.

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Premature dismissal: The appeal argues the district court prematurely decided the *merits* of the plaintiff's claim when it dismissed the case on jurisdictional grounds. The court's decision was based on "irrelevant and unsupported factual findings." The appeal maintains the complaint showed the plaintiff had a "personal stake in the outcome of the controversy" by alleging that the contested transaction negatively affected the plaintiff's retirement account. At this early stage in the litigation (prediscovery), the issue was whether the plaintiff's complaint stated facts sufficient to show an injury, not whether the plaintiff's claims had merit. U.S. Supreme Court and 4th Circuit precedent required the district court to take the plaintiff's allegations as true, the appeal says. The district court violated precedent.

The appeal frequently refers to the heavily litigated *Brundle v. Wilmington Trust* case. *Brundle* presented facts similar to those the plaintiff alleged here, the appeal says. It points to the "same unique warrant structure" and says the ESOP valuation here, performed by the appraisal firm that had done the *Brundle* appraisal, "contained similar errors as those in *Brundle*." For example, the ESOP valuation failed to consider that the warrants could "dilute the ESOP's share of ownership to just 60% of the Company" and the warrants allowed the sellers to "retain elements of control over the Company." The district court failed to address, "much less assume the truth of," the plaintiff's allegation that the ESOP valuation was inflated for these reasons.

The plaintiff calls the district court's mortgage analogy flawed. For one, it focused on equity values *after* the contested transaction when the proper inquiry would have been whether the ESOP paid more than fair market value at the time of the transaction. Further, the mortgage analysis assumes the price the ESOP paid was correct and "entirely sidesteps the proper analysis of whether the ESOP paid too much for [company] stock," the appeal argues. The plaintiff asks the 4th Circuit to reverse the district court and let the case proceed to discovery so she can prove her claims.

Stay tuned for further developments in this case.

A digest of the district court's ruling in favor of the defendants in *Lee v. Argent Trust Co.*, 2019 U.S. Dist. LEXIS 132066 (Aug. 7, 2019), and the court's opinion are available to subscribers of *BVLaw*. Digests for *Brundle v. Wilmington Trust N.A.*, 241 F.Supp. 3d 610 (E.D. Va. 2017); *Brundle v. Wilmington Trust N.A.*, 258 F. Supp. 3d 647 (E.D. Va. 2017); and *Brundle v. Wilmington Trust N.A.*, 919 F.3d 763 (4th Cir. 2019), and the courts' opinions also are available at *BVLaw*.

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Pension Rights Center Files Amicus Brief in Support of ESOP Plaintiff

A nonprofit consumer organization whose mission is "to protect and promote the retirement security of American workers, retirees, and their families" recently filed an amicus curiae brief in support of the appeal the plaintiff in *Lee* filed with the 4th Circuit (see above).

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The Pension Rights Center expressed concern over the ability of participants in and beneficiaries of ESOPs to bring a lawsuit aimed at enforcing ERISA's fiduciary rules. ERISA rules are "even more crucial in the case of private company ESOPs than for other retirement plans because of the unique structure of these plans," the brief says. "ESOPs pose special risks for participants," the brief claims. It also notes that "ESOPs are not a gift to employees" but represent a form of deferred compensation.

The plaintiff in the *Lee* case "plausibly alleged" that the trustee breached its fiduciary duties, caused the plan to enter into a prohibited transaction, and caused financial injury, the brief says. In dismissing the plaintiff's claims at the pleading stage, the district court erred.

The brief notes that *Brundle* "and numerous other cases" show the plaintiff's allegations are plausible.

> Workers' retirement savings are lost when an ESOP pays an inflated price for employer stock. If the ESOP pays too much, some of the participants' potential retirement savings are transferred to the selling shareholders. This happens if the ESOP trustee did not conduct adequate due diligence before approving the purchase price or failed to engage in hard bargaining to get the best deal possible for the ESOP.

The brief explains the prohibited-transaction allegation. "A corporate insider's sale of stock to an ESOP is *per se* prohibited because such transactions are 'likely to injure the [ ] plan.'" The transactions are only permitted if the trustee can demonstrate that the ESOP did not pay more than "adequate consideration," i.e., fair market value. "In fact, the trustee's duty of undivided loyalty to the ESOP participants requires it to act like a real-world buyer who would negotiate with the sellers to try to get the best possible price for the ESOP," the brief says.

It notes that cases such as *Brundle, Perez v. Bruister,* and *Pizzella v. Vinoskey* illustrate that ESOP trustees don't always conduct "real world'" due diligence or try to obtain the best price possible for the ESOP.

The brief says the plaintiff "sufficiently alleged an injury in fact" and asks that the 4th Circuit reverse the district court's dismissal and allow the plaintiff to conduct discovery. According to the amicus brief, "[i]f the instant case comes back to the 4th Circuit, it may very well be in the same posture as *Brundle*—an appeal following a trial in which the trial court ordered a substantial judgment based on a finding that the ESOP trustee violated its fiduciary obligations."

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DOL Announces Big ESOP Settlement With Wilmington Trust

In yet another ESOP development, the Secretary of Labor recently announced that it reached a settlement with Wilmington Trust NA, an international financial services firm with expertise in serving as trustee in major ESOP transactions.

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The DOL's news release, dated April 30, 2020, says the settlement ends three DOL lawsuits and 18 investigations by the Employee Benefits Security Administration (EBSA) against Wilmington Trust. All proceedings alleged that Wilmington Trust breached its ERISA duties by causing the respective ESOP to overpay for company stock.

The settlement requires Wilmington Trust to pay $80 million to 21 ESOPs as well as $8 million to the government for the losses it allegedly caused to the ESOPs. In agreeing to the settlement, Wilmington does not admit or deny the allegations.

For more details on the companies whose ESOP transactions gave rise to the suits and allegations, click here.

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Should You Consider a Special COVID-19 Premium?

During a recent webinar, a question came up as to whether or not valuation analysts should be separately identifying a risk rate associated with the impact of COVID-19 on a subject company. This notion has been kicking around for a while, apparently surfacing back in the 2008-2009 financial crisis. The webinar presenter, Jim Alerding (Alerding Consulting), cited from an article written during that time: "Distressed entities generally have higher risk profiles and lower profitability levels compared to their healthy competitors, and a proper discount for distress, usually at least 20%, therefore must be built into the valuation."

While most valuers would certainly agree with the first part of this statement, the idea of a rule of thumb for a separate discount is another matter. "I'm not sold on this," says Alerding. "It's better to build the risk into the cash flows and discount rate." Of course, when you do that, you have to be careful not to double count the risk. Plus, Alerding advises that, when you do come up with a final cost of capital rate, you need to take a step back and ask whether it makes sense for the subject business.

David Lurvey, Timothy O'Brien, and George J. Schultze wrote the article quoted above, "Hidden Treasures: Techniques for Valuing Distressed Enterprises," which was published by the Turnaround Management Association.

A recording of Alerding's webinar, Valuing Distressed and Impaired Companies in the Time of Coronavirus, is available if you click here (purchase required for nonsubscribers).

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NACVA Adds to Credentialed Ranks

In the first quarter of 2020, 96 members of the National Association of Certified Valuators and Analysts (NACVA) earned the Certified Valuation Analyst (CVA) credential, according to an announcement. Also, two members earned the Master Analyst in Financial Forensics

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(MAFF) credential. These members completed the training, exam, and credentialing processes for the two credentials.

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Global BV News: IVSC Extends Comment Period on Inventory Guidance

The International Valuation Standards Council (IVSC), the independent standard-setter for the global valuation profession, has extended the comment period to June 30 for its exposure draft on the valuation of inventory. The exposure draft addresses several themes, with particular attention to changes in the top-down method. Comments on the draft, "IVS 230—Inventory Exposure Draft," can be sent to comments@ivsc.org. The valuation of inventory project resulted from feedback received during the agenda consultation process the IVSC conducted in 2017 and 2018, and the Business Valuation Board, with support from the Standards Review Board, has led it.

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Alternate Market-Based Valuation Methods Amid COVID-19

When using the market approach in the wake of the coronavirus, the approach may depend on the valuation date and the date the impact of COVID-19 was felt in the market. It's generally recognized that mid-February was the point when the virus began to impact the capital markets. Therefore, "when the valuation date occurs after mid-February, analysts may wish to consider whether adjustments to the analysis are appropriate," according to Daniel R. Van Vleet and his colleagues at the Griffing Group, who offer alternative market-based methods to consider for valuation dates occurring after mid-February.

Example: For the guideline M&A method, here is one alternative to consider if the purchase price of the target reflects the impact of COVID-19 (affected purchase price) but the earnings used in the calculation of multiples do not (unaffected earnings):

1. Calculate the multiples based on the affected purchase price and unaffected earnings of the target. This calculation will provide the affected M&A multiples.

2. If COVID-19 has affected the earnings of the subject company (affected earnings), adjust the affected earnings to quantify the unaffected earnings of the subject company.

3. Apply the affected M&A multiples to the unaffected earnings of the subject company to estimate the value of the subject company as affected by COVID-19 (COVID-19 value).

An article in the upcoming June 2020 issue of *Business Valuation Update*, "Alternate Valuation Methods in the Era of COVID-19," offers optional ways to adjust the guideline M&A method and guideline public company method. It also discusses considerations for the

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income approach and cost of capital. In addition to Van Vleet, the authors of the article are Joseph W. Thompson, William P. McInerney, and David J. Neuzil.

They also offer this advice: "Analysts may want to revisit some of the valuation distortions that occurred during the Great Recession of 2008. It appears that the initial economic impact of COVID-19 may be at least as severe as the Great Recession. However, it also appears that the duration of the damage period may be shorter. Let's hope so."

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Supreme Court Rules on Willfulness Requirement to Obtain Infringer's Profits

In a trademark infringement case that turned on whether the plaintiff had to show willful infringement by the defendant to obtain the infringer's profits, a unanimous U.S. Supreme Court recently answered no. The case went to the Supreme Court because a number of U.S. Courts of Appeals had been split on whether willfulness was a precondition under the applicable section of the Lanham Act.

The plaintiff was Romag Fasteners, which sells patented snap fasteners under a registered trademark. The defendant was Fossil Inc., which designs, markets, and distributes fashion accessories. It does not manufacture products but has contracts with overseas factories, including in China. Fossil and Romag had an agreement that Fossil would use Romag's fasteners in its products. Later Romag discovered that certain Fossil products (handbags) made in factories in China used counterfeit snaps.

Romag sued Fossil, alleging patent and trademark infringement and asking for injunctive relief and monetary damages, including a court order to hand over profits Fossil had made by infringing Romag's trademark. The district court rejected the request, noting Romag did not prove the infringement was willful, and, in "this" circuit (2nd Circuit), "a finding of willfulness remains a requirement for an award of defendants' profits." The Federal Circuit Court of Appeals affirmed. At the same time, some other circuits did not agree with the 2nd Circuit's willfulness rule.

Romag asked the U.S. Supreme Court for review. This was a statutory-interpretation case. The Lanham Act prohibits unfair competition, fraud, and the "deceptive and misleading use of [trade] marks." Section 35 of the Act specifies remedies for certain trademark violations, including the plaintiff's right to the defendant's profits (besides actual damages and attorney's fees).

The Supreme Court said the statutory language was clear. It required a showing of willfulness for a profits award for a section 1125(c) violation. But the statute "has *never* required a showing of willfulness for a violation of section 1125(a)." Romag proved a violation of section 1125(a), "a provision establishing a cause of action for the false or misleading use of trademarks," the high court noted.

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The Supreme Court emphasized that, “in cases like that, the statutory language has *never* required a showing of willfulness to win a defendant’s profits.” The court went on to say that reading into a statute words that aren’t there is something the court was careful to avoid, particularly “when Congress has (as here) included the term in question elsewhere in the very same statutory provision.” In other words, the absence of the term meant something.

The court was not receptive to policy arguments from either side and amici. For example, Fossil argued that a showing of willfulness should be required, if only to serve as a deterrent to “baseless” trademark suits. Romag argued that its position, against requiring willfulness, would promote greater respect for trademarks in the “modern global economy.” The court was not the venue for reconciling competing policy goals, Justice Neil Gorsuch wrote. The court’s role was limited “to read and apply the law [] policymakers have ordained.” The task in this case was clear, the court said.

The Supreme Court’s opinion can be found here.

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No Act of God Excuse for Victoria’s Secret Buyer—February Agreement Excepted Pandemic

In the wake of COVID-19, a number of buyers have resorted to force majeure (aka act of God) clauses to withdraw from deals. But, as the *New York Times* recently reported, this was not an option for the buyer of Victoria’s Secret because of a salient exception in the acquisition agreement.

According to the *Times,* the buyer, Sycamore Partners, a private equity firm, and the seller, L Brands, signed the agreement on February 20, one day after the stock market indexes hit their all-time highs. Lawyers for L Brands, the seller, even then had the foresight to include specific exceptions to acts of God, “including a pandemic.” Therefore, a pandemic would not be an excuse for the buyer to walk away from the $525 million deal. Courts take contracts seriously and are not inclined to find loopholes where none exist, particularly where both parties are sophisticated deal-makers and represented by sophisticated lawyers.

How could L Brand’s lawyers know and why didn’t the buyer’s lawyers push back? Contract lawyers are supposed to anticipate unforeseeable events, the *Times* article says, while noting that no one at that moment knew how devastating COVID-19 would be to the economy.

Once the effect of the virus started to become evident, the buyer engaged in negotiations with the seller to “adjust” the purchase price. When these talks went nowhere, the buyer filed suit in Delaware, creating a number of other arguments for why it should not have to go through with the deal. The buyer was aware that it could not use force majeure as an affirmative defense.

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The *Times* quotes Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, saying he had never seen a reference to a pandemic “in that context.” The law firm representing L Brands (Davis Polk & Wardwell) “earned its fee,” Elson added.

In a later development, on May 4, the *New York Times* reported that the parties mutually agreed to terminate the deal. An L Brands executive said retailers faced an “extremely challenging business environment” and the company would rather focus on “navigating this environment” than “engaging in costly and distracting litigation to force a partnership with Sycamore.”

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March *EOU* Tracks Beginning of Tough Financial Times

The Leading Economic Index (LEI) decreased 6.7% in March, the largest monthly decline in the 60-year history of the index, according to the March 2020 *Economic Outlook Update (EOU).* Here are a few other highlights from the report:

- Retail sales fell 8.7% in March, the largest monthly decline since the beginning of the data series in 1992;
- The national median existing-home price for all housing types was $280,600 in March and is up 8.0% from a year ago;
- The Consumer Confidence Index fell sharply in March, by 12.6 points, to 120.0, as the economic impact of the coronavirus deteriorated the short-term outlook of the U.S. economy; and
- The Small Business Optimism Index decreased 8.1 points, to 96.4, in March, with the global spread of the coronavirus causing the largest monthly decline in the survey’s history. The survey noted that nine out of the 10 index components declined and that the economic disruptions are causing small-business owners to struggle to keep their businesses open.

The 42-page March 2020 *EOU* contains expansive research from leading authoritative resources, which you can use 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: First Edition of European BV Standards From TEGoVA

The first edition is available of the European Business Valuation Standards (EBVS) developed by the European Group of Valuers’ Associations (TEGoVA). These standards are tailored to the needs of real estate valuers who also undertake business valuations as

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well as real estate valuers seeking to diversify into the field of business valuation. The standards are effective immediately, but, given the current restrictions on movement, the formal launch event will take place this October. TEGoVA is a European nonprofit association composed of 72 valuers' associations from 38 countries representing more than 70,000 valuers in Europe.

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Global BV News: ASA Signs an MOU With Nigerian VPO

The American Society of Appraisers (ASA) and The Nigeria Society for Professional Valuation (SPV) have signed a Memorandum of Understanding (MOU). The intent of the partnership is to pursue future collaboration in the areas of education, publications, research, and standards.

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Discounts Inappropriate in Valuing Minority Interest in Mandatory Buyback, Appeals Court Rules

When a minority shareholder in an Indiana company was terminated as a director and officer, a dispute arose over whether, under a buyback agreement, the use of discounts for lack of control and marketability was permissible in valuing his shares. The trial court said yes, but the appeals court, citing case law, reversed.

Compelled buyback: The plaintiff was a founder as well as a director and officer of a company that fabricated and installed natural gas and pipeline equipment. He owned a 17.77% interest in the business. When he was terminated (involuntarily), his departure from the company triggered a provision in the controlling shareholder agreement requiring the company to buy back his shares. The valuation was to be based on the "appraised market value of the last day of the year preceding the valuation, determined in accordance with generally accepted accounting principles by a third party valuation company within the twenty-four months preceding the transfer of shares."

The retained outside appraiser said it was engaged "to estimate the fair market value of the property.... This valuation was performed solely to assist with the valuation requirement in a shareholder agreement due to a triggering event involving [the plaintiff]." The appraiser found the plaintiff's interest was worth about $3.5 million but applied discounts for lack of control (DLOC) and marketability (DLOM) and concluded the final value was $2.4 million.

The plaintiff sued, and the company countersued. Both sides filed motions for summary judgment. The issue for the trial court was whether, as a matter of law, under the buyback provision, the valuation could include discounts. The trial court found for the company and granted its motion.

The plaintiff appealed the decision. The gist of the plaintiff's argument to the Court of

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Appeals was that, under the controlling case, *Wenzel v. Hopper & Galliher,* discounts were inappropriate because the transaction involved a compulsory sale. Further, the language of the shareholder agreement regarding the appraisal method precluded the use of the fair market value standard because the sale of the contested shares did not take place in the open market and the buyer already controlled the company.

Avoid windfall: The appeals court found *Wenzel* was applicable to the situation at hand. In *Wenzel*, the Court of Appeals rejected discounts in the context of a law firm's purchase of a departing partner's interest in the firm. The case was brought under the state's professional corporation act. The court differentiated between fair value and fair market value and rejected the use of minority and marketability discounts in fair value cases where a controlling interest holder buys back the stock. Minority and marketability discounts were "open market concepts" that did not apply where a shareholder is compelled to sell to the majority, the court found. The use of discounts would mean a "windfall" to the buyer.

In the instant case, in rejecting the company's argument that using the fair market value was consistent with the shareholder agreement, the court said:

> The Shareholder Agreement itself recognizes that the mandated buyback of shares to the Company differs from a sale to a third party on the open market and thus, different interests must be recognized by implementing an appraised market value rather than the open-market valuation method of fair value or fair market value.

The appeals court concluded the trial court erred as a matter of law when it allowed the discounts.

A digest of *Hartman v. BigInch Fabricators & Construction Holding Co., Inc.*, 2020 Ind. App. LEXIS 183 (May 5, 2020), and the court's opinion, will be available soon at *BVLaw*. A digest and the court's opinion in *Wenzel v. Hopper & Galliher*, 779 N.E.2d 30 (Ind. Ct. App. 2002), are available to *BVLaw* subscribers.

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AICPA Issues FAQs on Valuing Distressed or Impaired Businesses

Strong companies may see the current pandemic as an opportunity to fortify their balance sheets and other assets, according to the AICPA's FAQs on Valuation Considerations When Valuing Distressed or Impaired Businesses. "The COVID-19 pandemic may have only short-term implications and strong companies may emerge stronger, while competitors with 'heavy' debt obligations may need to close and/or liquidate assets," the document states. It quotes Professor Aswath Damadoran (New York University Stern School of Business), who points out: "I think it still makes sense to look at growth, profitability and reinvesting, pre-crisis, to get a sense of how much punishment companies can take. In businesses that already had anemic revenue growth, low margins and poor investment efficiency, the effects of the crisis will be far more devastating than in businesses with higher growth, margins and efficient investment." Josh Shilts (Shilts CPA), with contributions from Maureen Rutecki

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(EFPR Group) and Steve York (Stern Brothers Valuation Advisors), wrote the FAQs.

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Put Extra Scrutiny on Market Comps, Panel Advises

The market approach is obviously troublesome now, which makes it even more important to scrutinize your comps, according to a panel that participated in BVR's second free Town Hall event on the impact of COVID-19 on valuations. The panelists were Stacy Preston Collins (Financial Research Associates), Michelle Gallagher (Adamy Valuation), Harold Martin (Keiter, Stephens, Hurst, Gary & Shreaves PC), and Gary Trugman (Trugman Valuation). They pointed out that valuation has not changed, and the market approach still needs to be considered. This holds true whether you are looking to private transactions (e.g., via DealStats) or public companies (e.g., via the Guideline Public Company Comps Tool). Of course, if there are no transactions, you may have to skip that method. In that case, can you use data from public companies? Yes, assuming you have multiples based on guideline public companies that are comparable to your subject company. Given the volatility in the market, one issue will be whether to use multiples based on the stock price that day or, say, a 30- or 60-day moving average. This should be considered on a case-by-case basis based on the array of public companies and the disparity of pricing.

A holdover question from the first Town Hall asked about putting more weight on the guideline public company method over the DCF, which the questioner felt could have major issues with the forecasts and certain elements of the cost of capital. That may be reasonable, but that decision should not be made until you finish your analysis and understand why your values differ under both approaches.

> *Extra:* The presenters also received many questions about projections and DCF, and Trugman and Martin presented a separate webinar on that topic on June 4—Discounted Cash Flow: Speculative or Convincing.

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Willamette's Spring 2020 *Insights* Focuses on ESOP Valuations

The spring 2020 *Insights* from Willamette Management Associates focuses on ESOP employer stock valuations and contains a number of articles, such as "Employee Stock Ownership Plan Financial Feasibility Analysis: Financial Considerations for Shareholders" (Robert F. Reilly), "Valuation Treatment of the Repurchase Obligation Liability" (Kyle J. Wishing), "The Fiduciary Process for the Annual Update of the ESOP Share Value" (Frank "Chip" Brown), "*Pizzella v. Vinoskey:* A Costly Lesson to Learn" (Lisa H. Tran), and more.

> *Extra:* Wishing and Brown recently did a BVR webinar along with attorney Chelsea Mikula (Tucker Ellis LLP). The webinar, Projection Issues Raised in ESOP Litigation, discussed some controversial matters in recent ESOP cases, such as the DOL improperly redefining the concept of fair market value and the lack of

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qualifications of the agency's expert.

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Global BV News: KPMG on Cost of Capital in Austria

KPMG Austria recommends a risk-free rate of 0.0% and an equity risk premium of 8.5% to 9.0% as of March 31, 2020, for the Austrian market, according to its latest quarterly brief. As of April 30, 2020, a risk-free rate of -0.9% and an equity risk premium of 8.5% to 9.0% is recommended for the Austrian market.

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Global BV News: Two New Members Join the IVSC

The International Valuation Standards Council (IVSC) has announced two new members: the European Mortgage Federation (Institutional Member) and the University of Economics, Prague (Academic Member). If your organization is interested in becoming a member of the IVSC, click here.

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BLOG POSTS Q3 2020

10 Unique Factors That Drive Paving Company Value

When looking to appraise or value paving companies, there are many unique factors to consider that set this industry apart from others: the seasonality of the business, specific bidding requirements for federal, state, and local governments, as well as contracted set asides for businesses owned by women, minorities, and veterans. There are even special rules for determining what qualifies for these ownership types.

In a chapter from *What It's Worth: Valuing Paving Contractors,* the author covers 10 unique factors that drive paving company valuations including how companies bid and compete for work, varying commodity prices, types of work companies do, and more.

1. Bidding

A paving company's profitability is often predicated on the ability of the company to successfully bid for fixed price jobs in a way that enables it to win the bids and get the work. Then, the company must be able to successfully complete the work at a cost at which it earns money on the bid. Because of this, companies need to be able to accurately estimate costs and manage materials and resources.

2. Payment cycle

The payment cycle for paving contractors is a value consideration in terms of government versus nongovernment payments. Government entities tend to pay slower than private markets do. In some departments of transportation, for example, the paver must have a field engineer sign off on the work performed and perhaps the number of units performed, or the paving company may be working with a school board that needs to approve payment.

3. Material and resource costs

Prices and costs vary based on the shifting prices of commodity resources such as petroleum, which impacts the cost of fuel and asphalt, and steel, which is a commodity cost. Paving companies use price escalation clauses and futures contracts to try to protect themselves against shifting costs.

As pavers bid on multiple projects, crews and equipment must also be provisioned in such a way that the paving company has the resources to complete tasks but minimizes idle time of both workers and equipment. Companies may also bring in subcontractors to complete components of jobs, either as specialized expertise or to satisfy bid requirements that a certain amount of funds be allocated to minority-, woman-, or veteran-owned businesses.

4. Generalist vs. specialist

Being a specialist implies that a paving company is bringing something unique to the market—it has a specialized product that can deliver value and demands a premium. So, it is either a premium for that product or a premium for the service delivered. To put this in percentage terms, the gross profits of the companies that perform some sort of specialty service or deliver a specialty product often range above 30%. Relate that to firms that do not specialize—the more cookie-cutter-type contractors or generalists that just facilitate the management of a project. They are probably lucky to see gross profit ranging from 15% to 20%.

5. Quick service

Several firms differentiate themselves by providing timely service. Some contractors do work that is not particularly complex, but they have the logistics down so that they are able to perform a contract within a day of being notified about the work. So they get the contract, they turn around, and they get a premium for that quick service.

6. Environmental concerns

Paving contractors go through a lot of fuel, and, if the paver has its own asphalt mix plant, there may be environmental issues that can result in the need for a marketability discount or a specific risk from a valuation perspective.

Paving contractors may have a lot of fuel on their yard, binding agent for the asphalt, and other components—maybe there was a spill, and it poses environmental risks. To make sure there isn't a hidden liability for the company, valuers should ask "Have you had any recent spills? Have they been cleaned up? Where is the release?"

7. Prequalification

For many jobs, both government and nongovernment, the entity must be prequalified to bid for work, which adds some cost. Essentially, the paving company must be able to prove prior to the bid that it has the resources and the ability to complete the job. These prequalifications can be much more stringent when it comes to private-sector bidding.

8. Seasonality

Depending on where the paving company is located and the areas in which it works, there are limits to the number of working days it can reasonably expect each year.

Paving contractors and heavy highway contractors are lucky to have 240 to 280 possible working days. Weekend days are included in that count of working days. Other issues that come up include how much overtime a company will incur to meet its work periods or the kind of management of labor and crews that will be needed to capitalize on the available working days.

9. Underbillings and overbillings

Let's say a contractor starts performing work, the job doesn't go according to the budget plan, and estimates aren't adjusted. In that case, the costs are accruing in a way that make the job appear to be 70% complete, but it is only 50% complete. The result is that the paving company probably can't bill for that work, so it is an underbilling on the balance sheet. These types of situations can potentially be risky because it means decreased profitability on a contract. The underbilling is an asset on the balance sheet that needs to be credited and then debited as some sort of loss.

Overbillings can occur when there is an established customer relationship and the customer will finance the project. The paving company doesn't have to worry or maintain the cash flow to get through the project, but overbillings can also be a sign that a project is going a lot better than was originally planned, so there needs to be an accounting of potential profit beyond what was anticipated at the time of the bid that will be recognized as the contract closes into account when valuing it.

10. Bonding and backlog

A bond is something a customer will require of pavers to ensure that a job gets completed. These generally cost 1% to 2% of a contract. How this impacts the paving company is the determination of the contractor's overall bonding capacity. Working capital factors into that capacity as well as total net worth and availability of an operating line of credit. Even the personal net worth of an individual can impact how much he or she will be bonded for on a project.

Conclusion

Revenue, contracts, client base, and sales are the kinds of things that drive the value of all businesses. Yet, unique factors drive the value of paving companies and set this industry apart from others. Whether you're looking to buy, sell, or value a paving contractor business, it's important to consider valuation from several different angles.

To learn more about valuing paving companies, be sure to check out BVR's special report, *What It's Worth: Valuing Paving Contractors*. Preview the table of contents and look inside the report to learn more about special considerations for valuing paving companies, the current market in the industry, an in-depth case study, and much more.

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Valuing Residential and Nonresidential Construction Companies: Opportunities for Business Appraisers in Today's Market

In many ways, the construction industry is no different from other industries in the sense that it faces constant changes and fluctuations over time. When looking to appraise or value both residential and commercial construction companies, there are many unique factors to consider that set this industry apart from others. In BVR's new special report, *What It's*

Worth: Valuing Residential and Commercial Construction Companies, expert Pasquale Rafanelli covers the opportunities these types of valuations can provide for business appraisers, which we've excerpted here.

Over the next five years, from 2019 to 2024, the global construction industry is expected to have a wealth of opportunities in the residential, nonresidential, and infrastructure industries. Global Construction Perspectives and Oxford Economics recently released their global benchmark study, which estimates that the construction industry is expected to grow at a compounded annual growth rate (CAGR) of 3.9% and is forecasted to reach an estimated $15.5 trillion by 2030, with the United States, China, and India leading the way. The industry as a whole is seeing an increasing demand for:

- Green construction to reduce carbon footprint;
- Bridge lock-up device systems to enhance the life of structures;
- Building information systems for efficient building management; and
- The use of fiber-reinforced polymer composites for the rehabilitation of aging structures.

Here are some of the other more prominent trends and opportunities in the residential and nonresidential construction marketplace:

Residential Trends

- **Consolidation.** The easiest way for a company to enter new markets and strengthen its position in existing markets is to continue to grow through acquisitions. Larger firms, which stockpiled cash and land during the economic downturn, are looking to expand, especially as home values and buyer demand start to stabilize.
- **Nonhomebuilding services.** In today's market, it is not uncommon for builders to branch off into other related fields such as:
    - Modular and manufactured housing;
    - Construction materials;
    - Commercial construction;
    - Mortgages; and
    - Insurance.

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Some builders have even established mortgage banking arms to provide financing for home buyers. This service typically focuses on the operations to originate mortgages and then to sell them to other investors.

- **High-tech homes.** We live in a high-tech world—one that is constantly changing—and builders are starting to respond to the current consumer demand by building more new houses with advanced data and other communication capabilities. Consumers raised on electronics and computers expect structured wiring that supports smart home technologies such as learning thermostats and internet-enabled security and monitoring features.

- **Green construction.** Although a green home can cost more than a conventional house, some lenders are offering mortgage incentives for energy-efficient homes. Some of the green building innovations include:

  - More porous materials in walkways and patios to prevent erosion from rain runoff;

  - Engineered recycled lumber in building; and

  - The conversion of wood or drywall construction waste on-site into landscape mulch.

- **Millennials becoming homeowners.** Millennial home buyers, particularly those who have started families, are navigating toward more affordable residential areas that promise high job growth. The suburbs are successfully attracting first-time home buyers and younger individuals because these areas are typically much less expensive than those nearest major metro areas.

- **Internet marketing.** An active online presence can dramatically improve traffic to sales centers, increase conversion rates, and improve customer satisfaction by enabling builders to stay connected with customers through the entire home ownership cycle. With internet and mobile application technology, potential buyers can visit a number of different developments, view the types of models available, and take virtual tours through model homes.

- **Special-purpose housing developments.** The changing demographics of the U.S. population suggest that demand for second homes and retirement communities will increase. The large baby-boomer generation is now in its peak years of earning power and asset accumulation, potentially giving them the means to buy second homes for vacations.

- **Multifamily and for-rent apartments.** High demand for apartments and condos has resulted in many traditionally single-family homebuilders turning to multifamily construction. In today's changing market, many people are unable to afford to buy a home or cannot qualify for a mortgage, which creates stronger demand for rental

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properties. Builders are starting to follow the trend by increasing their presence in building apartment complexes and condo communities.

Nonresidential trends

While a lot of the trends are the same for residential and nonresidential construction, there are a few additional worth referencing.

- **Design-build.**
  The growing design-build movement encourages collaborative project development in all phases of design and construction. Significant cost and schedule savings as well as increased quality can result from collaboration on technologically sophisticated projects.

- **Modular construction.**
  Permanent modular construction can enhance the speed and efficiency of project completion. Modular components can be built off-site in a factory or warehouse and are then transported and placed. Advancements in modular technology allows for more durable, versatile structures.

- **Urbanization.**
  The world's population is becoming increasingly concentrated in urban areas, a trend that drives demand for structures such as airports, office buildings, parking garages, restaurants, and shopping malls. According to the United Nations, in 2014, approximately 50% of the world's population resided in urban areas, and, by 2050, it is projected that more than 60% of the population will live in urban areas.

- **Green building.**
  Demand is growing for environmentally friendly building, which includes construction materials, practices, and certification. According to the United Nations Environment Programme, buildings are responsible for more than 40% of global energy use and one-third of global greenhouse gas emissions. Construction companies with green building capabilities are positioned to benefit from increasing efforts in the commercial and government sectors to build and operate more environmentally friendly buildings.

- **Emerging markets.**
  Developing countries provide some of the greatest opportunities for construction expansion. According to Global Construction Perspectives and Oxford Economics, it is predicted that the U.S., China, and India will account for more than half of global construction growth between 2015 and 2030.

There are plenty of opportunities in the market for business owners to consider and take advantage of to grow their businesses. As a result, this has increased the need for appraisers not only to play a pivotal role in providing valuation services for their clients, but also to act as their advisor and give them the help and tools they need to better position

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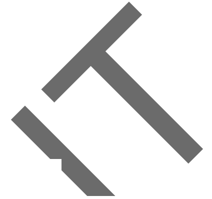
themselves in the market. For more on valuing residential and nonresidential construction companies, be sure to check out BVR's special report, *What It's Worth: Valuing Residential and Commercial Construction Companies*.



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How BVR Is Helping to Keep You Connected During Coronavirus

As the world continues to feel the crippling effects of coronavirus, we can't help but observe the ingenuity and compassion that citizens are showing for their communities. Musicians are hosting live concerts on social media, online subscriptions are discounted left and right, and events all over the world are transforming to webcast versions for all to utilize. We are entering an era of adaptation in a way the world has never seen—and BVR is here for it. Here are some ways BVR is supporting the valuation community during this unpredictable, uncertain time.

Online training programs

BVR is proud to offer world-class professional training—accessible from anywhere in the world. Between our Training Passport, Passport Pro, eLearning Courses, and the Desktop Learning Center platform, users can access specialized training at any time, on any device.

Two of BVR's most popular training programs, Training Passport and Passport Pro, offer year-round access to unparalleled webinars, workshops, and special series, featuring the brightest minds in business valuation. We know in this unprecedented time you and your colleagues need access to online training and CPE. To enable your team to continue expanding their business valuation knowledge, BVR is making it easy and cost-effective to join the Training Passport program. Contact sales@bvresources.com to learn more about the best option for your firm.

Watch our training video to learn how to stay connected to valuation experts through BVR's training programs.

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Access to important additional resources

BVR hosted a free town hall-style event with Gary Trugman, Harold Martin, Michelle F. Gallagher, and Stacy Preston Collins, where they talked through key impacts of COVID-19 on valuation issues. From cost of capital to family law to guideline companies, the impact on the inputs, approaches, and the businesses we value is profoundly felt. These experts have weathered financial crises before and are doing a yeoman's job of keeping current with the ever-changing information. If you haven't already, please view the webinar recording.

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BVR's webinar with business valuation professional Jim Alerding, Valuing Distressed and Impaired Companies in the Time of Coronavirus, was held on April 22. In this session, Alerding analyzed the valuation perspective needed to value a distressed or impaired business and will focus on the particular issues that need to be considered relating to the pandemic.

In addition, healthcare valuation professionals may be interested in Healthcare Valuation in the Corona Virus Era: That Was Then, This Is Now with Mark O. Dietrich, where he forecasted the likely impact on the healthcare industry of the current crisis. To see a complete list of upcoming and past training events, please visit us online.

Conclusion

For the latest news and updates involving coronavirus and the business valuation community, please visit our coronavirus resource page. Finally, we encourage you to subscribe to *BVWire*, BVR's free ezine that brings you current news every Wednesday. From the buzz of the latest tax court case or the best new financial research resources to the impacts of COVID-19, *BVWire* guarantees you won't miss a thing.

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Business Interruption and Other Legal Claims Arising Out of COVID-19 Crisis

Just as the novel coronavirus causing COVID-19 brought businesses and economic activity to a sudden halt, an ABA panel discussed the grave effects on businesses and the legal

doctrines available to business owners to mitigate the economic injury stemming from business interruption and unforeseeable circumstances.

Many business owners have turned to business interruption insurance to find relief from the mounting losses resulting from a breakdown in the supply chain and the business's inability to offer services and produce goods. But, as the ABA panel discussion makes clear, not every insurance policy provides virus protection and not every claimed injury from the virus will satisfy the required legal showing.

Any business interruption claim has to start with a review of the individual policy and an understanding of what losses are covered or exempted from coverage, the panel explains.

Further, businesses may also seek recourse in so-called force majeure (FM) clauses to avoid certain contractual obligations. Whether this legal doctrine is applicable in a given case also depends on the language of a particular contract, the ABA speakers explain.

Read more about the analysis underlying the use of these legal doctrines here.

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Business Interruption Cases and the Role Financial Experts Can Play

Filing a business interruption claim has become one of the go-to moves for businesses as they try to mitigate the impact of COVID-19. A discussion of two cases that were adjudicated just before the COVID-19 crisis came into relief explains the trajectory many claims, including claims arising out of the COVID-19 crisis, may take and points to opportunities for damages experts. As the discussion makes clear, prevailing on a business interruption case is not an easy task for the plaintiff. At the same time, these cases often make it necessary for plaintiffs wanting to prevail to retain the services of a qualified financial expert.

The first case, arising under New York law, involved a company that custom-made precast concrete products for the construction industry. A dispute between the company (the plaintiff) and the insurance company arose when the latter denied the business's claim for profits lost during the time a critical piece of equipment was inoperative. After the plaintiff prevailed in trial court on summary judgment, the insurance company appealed the decision with the court's appellate division, arguing that the plaintiff failed to meet the requirements of the controlling insurance policy. The appellate court rejected the insurer's interpretation of what the plaintiff had to show in terms of losses pursuant to the policy.

A different case involved a fledgling Rhode Island business that suffered extensive property damage after two major storms hit the area about a month after the company had started operations. The insurance company denied the company's business interruption insurance. This case also went to appeal, after the trial court denied the insurer's motion for summary judgment on the company's breach of contract claim. A key issue was whether a business that had hardly been operating before the storms could claim the insurer's failure to pay

promptly caused damages of over $4 million and ultimately resulted in the company's insolvency. The plaintiff presented some financial evidence from a consulting expert.

The appeals court affirmed the denial of summary judgement, finding there were genuine disputes of material facts making it necessary for the case to go to trial.

For takeaways on both cases and a tip for financial experts, click here.

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Novel Beta Method Occasions Rebuke From Court of Chancery in Appraisal Case

***Manichaean Capital, LLC v. SourceHOV Holdings, Inc.*, 2020 Del. Ch. LEXIS 38, 2020 WL 496606 (Jan. 30, 2020)**

An appraisal action in the Delaware Court of Chancery featured a privately held company that, through a business combination, became a publicly held one. The case had several unusual aspects. For one, the company disavowed its trial valuation expert and proposed a fair value conclusion that was well below the expert's. Further, the company's expert amended his valuation, based on feedback from the opposing expert, and his revised value conclusion was 63% higher than his original one. Finally, for his DCF-based model, the company's expert used a novel approach to estimate beta that, the court found, raised serious questions as to not only the admissibility of the testimony under *Daubert,* but also the expert's entire valuation. The court adopted the petitioner expert's valuation, with a slight adjustment to a key input.

Backstory. The subject (respondent) was SourceHOV Holdings, a privately held company that provided process outsourcing and financial technology services to various industries. The petitioners were minority stockholders. Other investors, including HandsOn Global Management LLC (HGM), which was not a party to this suit, owned the remaining interests. HGM, a family investment business, owned about 80% of SourceHOV's common stock.

HGM's top executives, Parvinder Chadha and Jim Reynolds, ran SourceHOV. Together, they also made up SourceHOV's board of directors. The governance structure, the court noted, "was not a model for best practices." For years, there were not board meetings and investors seldom received financial statements for the company.

Formed in 2014, SourceHOV grew through acquisitions, transforming itself into a global company with 16,000 employees. This growth strategy left the company in a highly leveraged state. The company had raised debt through two separate agreements, a "First Lien," which included a $780 million term loan and $75 million in revolving credit, and a "Second Lien," which included a $250 million term loan. Both loans remained outstanding until the business combination occurred. Both agreements required SourceHOV to maintain a defined leverage ratio. A designated schedule required the company to achieve certain "stepdowns," either by reducing total debt or increasing EBITDA, or both. The company had to certify compliance with the leverage ratio or risk being in default.

In late 2016, SourceHOV considered acquiring Novitex, a document management services company. SourceHOV, on advice of one of its financial advisors, Rothschild Inc., considered a business combination among SourceHOV, Novitex, and Quinpario, a special purpose acquisition company that was listed on the Nasdaq. Any deal faced time pressure because Quinpario's investors had the right to redeem their shares rather than roll them into a post-acquisition company. The longer the deal negotiations went on, the greater the risk that the amount Quinpario could contribute in cash to the deal would dwindle.

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A few months before SourceHOV signed a letter of intent with the other participants in the planned business combination, SourceHOV faced stepdowns related to the First and Second Liens. SourceHOV sought investment from existing equity stockholders to ease the liquidity pressure and allow it to focus on the business combination. In a March 2017 going concern memorandum, the company certified that it did not "anticipate any defaults" in 2017.

The contemplated business combination meant SourceHOV and Novitex would merge into separate Quinpario subsidiaries. Quinpario would assume the name Exela. Stockholders of SourceHOV and Novitex would roll over their equity into Exela. Quinpario and other private investors would contribute at least $275 million in total (cash condition). To satisfy the cash requirement, SourceHOV had to secure a margin loan, which necessitated that SourceHOV merge into another company, Ex-Sigma LLC, immediately before the business combination. SourceHOV stock would convert into Ex-Sigma membership units. Ex-Sigma would hold the Exela stock as security until the loan was paid off.

During the negotiations, Chadha and Reynolds solely acted on behalf of SourceHOV. There was no independent committee. The record showed the company made no effort to run a sale process. No board meeting took place to discuss the contemplated transaction. One of Source HOV's financial advisors, Morgan Stanley, had conflicts of interest. After the Ex-Sigma merger, Chadha and Reynolds served as Ex-Sigma's sole managers. They had full discretion to decide when and whether to repay the margin loan. As the court noted, "[t]his dynamic put SourceHOV's former-minority stockholders in a particularly illiquid position."

The Ex-Sigma merger and the business combination closed in July 2017. Exela's closing stock price on July 12, 2017, was $8.61 per share. The market value of the consideration provided to Ex-Sigma implied an aggregate equity value of SourceHOV of $694 million, or $4,200, per share.

Regular projections. Management regularly provided projections in connection with SourceHOV's acquisition strategy. Three sets were relevant to the instant litigation.

The company primarily used the Equity Case and a derivative, the Lender Model. Both models assumed a 5% annual revenue growth rate. Management "stood behind" the Equity Case, which it developed in an iterative process with input from the board, sales team, operations team, investors, and financial advisors.

The Lender Model reflected a minor "haircut" to improve the accuracy of the Equity Case, the company said.

Both models, using a 5% growth rate, were used in investor presentations, interactions with financial advisors, lender pitches, reports to credit rating agencies, public filings, and in working with accountants. The company called the 5% models "conservative" or "base models."

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The third model, the Bank Case, used a 2% growth rate after 2018. The company used it seldom.

Valuation backdating. In February 2017, Rothschild, one of the financial advisors to the deal, for purposes of a "fairness or unfair opinion," used the Equity Case for revenue projections and came up with an equity value of $931 million. This was the last presentation to the SourceHOV board before the business combination concluded.

"But this is not what Chadha [one of SourceHOV's board members] wanted the outside world to believe," the court said. Instead, as the litigation eventually revealed, several months after the litigation began, Chadha asked Rothschild for a "revised" valuation. In January 2018, Rothschild offered a "retrospective valuation update as of July 2017 [deal date]." This version used lower revenue growth projections and resulted in an equity value of $675 million. Chadha, through his son-in-law, then asked Rothschild to change the date on the cover page accompanying this valuation to July 2017, which Rothschild did.

The proxy statement for the deal showed SourceHOV's existing equity value was about $645 million for Exela shares paid to Ex-Sigma. This valuation applied a 25% "IPO discount," apparently to reflect a "pre-listing value," i.e., "the price that investors would receive in a regular IPO."

Minority stockholders asked the Delaware Court of Chancery for a fair value determination under Delaware's appraisal statute (8 Del. C. § 262(h)). During discovery, the petitioners obtained the Rothschild July 2017 backdated valuation, but the company (respondent) did not make available the underlying documentation that showed the valuation actually was created in January 2018. Even in deposition, Chadha and his son-in-law stated the valuation was presented to SourceHOV before the business combination closed in July 2017. The court noted that only on the eve of trial did the company admit there was no Rothschild "July 2017" presentation.

Chadha later served as the company's "centerpiece" (court's word) in its effort to present a picture of SourceHOV as in grave trouble at the time of the business combination. The purpose was to dispute the higher valuation the petitioners offered. He testified that SourceHOV's equity at the relevant time was worthless. The company had trouble attracting investors and was shut out from the debt markets. All efforts to keep the company in business, other than the business combination, were hopeless, Chadha said.

"Chadha simply was not believable," the court said. It found his "litigation-driven effort to persuade Rothschild to create the Backdated Valuation to appear as if it had been prepared before the Business Combination was bad enough." His failure to acknowledge the scheme during discovery "taints all of his testimony."

Applicable legal principles. Under the appraisal statute, the court must determine fair value of the shares "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation." In the appraisal context, "fair value" represents

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a "jurisprudential concept" that seeks to capture "the value of the company as a going-concern, rather than its value to a third party as an acquisition."

The statute says the court must consider "all relevant factors." State courts have interpreted this requirement to mean "all generally accepted techniques of valuation used in the financial community." The Delaware Supreme Court, however, also has noted statutory appraisal is a "flexible process" and gives the Court of Chancery "significant discretion" when determining fair value. The latter may select one of the valuations offered by the parties or prepare its own valuation. The court is not required to prepare a valuation that is "completely separate and apart from the valuations performed by the parties' expert witnesses." Rather, the court may adopt one expert's model, methodology, and mathematical calculations "*in toto*" "if that valuation is supported by credible evidence and withstands a critical judicial analysis on the record." (This in essence happened here.)

Both parties have the burden of establishing fair value, "which effectively means that neither party has the burden and the burden instead falls on this court," the Court of Chancery in the instant case said.

Although recent case law from the Delaware Supreme Court urged the use of market indicators to determine fair value under certain conditions, here the court and the parties agreed that there was no reliable market evidence because the company's stock was not publicly traded and company managers made no effort to perform a proper sales process.

Accordingly, the parties' experts relied on "traditional valuation methodologies," i.e., the DCF, or a variation of it. The court approved of this approach. Both experts were highly qualified.

Petitioners' expert valuation. The petitioners' expert considered three methods, the DCF, the capital cash flow (CCF) method, and the guideline publicly traded company (GPTC) method, but decided that only the DCF and CCF (both income approaches) were appropriate ways to determine fair value here. The GPTC was not useful, he found, because he could not find transactions featuring companies sufficiently similar to SourceHOV where the transaction closed within a reasonable period before the business combination.

He explained that the CCF was a variation of the DCF and more suitable where a company's capital structure was expected to change. He said the DCF and CCF were "algebraically equivalent."

In terms of forecasting cash flow, he primarily relied on management's lender model, noting it was the "most conservative" of the updated projections. He also decreased cash flows projected by management by including the continued amortization of goodwill and accounting for certain fees and expenses.

For the DCF analysis, the petitioners' expert applied an 11.2% discount rate. The WACC discount rate was based on the capital asset pricing model. To determine industry beta, the expert chose 19 publicly traded guideline companies. The selection was based on

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SourceHOV's public filings, its financial advisor's (Rothschild's) choices for the February 2017 valuation, and the expert's own research.

As the court noted with emphasis, beta measures the *systematic* risk of a stock. "It shows the tendency of a specific stock's price to correlate with changes in the broader market."

Here the expert unlevered each guideline company's beta to focus on industry risk rather than risk created by a company's specific capital structure. He said he wanted to be conservative and "selected the highest unlevered equity betas of the guideline company group of 1.203 and 1.210." He relevered the beta to account for SourceHOV's projected capital structure.

For the size premium, which accounts for an increased risk in investing in a smaller company, he used the 2017 Duff & Phelps *Valuation Handbook.* His analysis considered companies with market capitalization between $569.279 million and $1.030 billion. He achieved a size premium of 2.08%.

For the CCF analysis, the discount rate was based on the unlevered cost of equity capital (UCEC). The expert used the same unlevered guideline company beta of 1.21 that he had used in his DCF analysis. Under this analysis, the petitioners' expert calculated a 12.4% discount rate.

He weighted the results of the DCF and CCF analyses equally and ultimately determined that the fair value of the company as of the business combination was $798 million, i.e., almost $5,100 per share.

Company's (respondent's) valuation. The company's valuation expert initially proposed an equity value of $286.4 million, i.e., $1,700 per share. However, during his deposition, he amended the valuation to $468 million, i.e., over $2,800 per share. He said he considered input from the opposing expert and adopted portions of that expert's analysis that were persuasive. The court lauded the company expert's willingness to make these adjustments.

The expert used an adjusted present value (APV) model, a variation of the DCF analysis, to calculate cash flows. He explained that his model was "mathematically virtually identical" to the opposing expert's CCF model. Both approaches try to simplify valuing a company with a changing capital structure, the court noted.

The expert used management's equity case as the basis for his cash flow analysis. His discount rate calculation was based on the Modigliani and Miller theorem (M&M theorem), which assumes "that the risk (beta) of the firm's debt must always be less than the risk (beta) of the firm's equity." The company's expert said this notion served as the "methodological basis for how [to] estimate the unlevered cost of equity for SourceHOV." He explained:

> I use the available evidence to determine the minimum reasonable cost of debt of a standalone SourceHOV as of the valuation date, which then yields an implied

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minimum reasonable debt beta based on this minimum reasonable cost of debt. I then conservatively use this implied debt beta as a minimum possible estimate of the overall beta of SourceHOV's assets (also called the unlevered equity beta). Because I use the APV approach, instead of the WACC approach, all I need to calculate the appropriate unlevered equity discount rate is the unlevered equity beta, which in theory cannot be less than the beta of the firm's debt as explained above.

He said he was not able to use "indirect or regression-based betas … to estimate SourceHOV's unlevered equity beta." There were no companies sufficiently similar, he said. Therefore, he decided to calculate the company's beta directly by using yields and interest rates on the first and second liens. He admitted he had "not seen" this approach before or "done" the calculation in this way before. He also admitted he "thought of [his method] for this case" and said he hoped this approach would "catch on" in the future.

As to the size premium, which was another input over which the experts disagreed, he also used the 2017 D&P *Valuation Handbook.* However, he found SourceHOV had a smaller market capitalization and increased the company's size premium from 2.08% to 2.68%. He said he based the decision on Exela stock's trading prices after the business combination closed.

At trial, the company distanced itself from its own expert's valuation, contending the valuation was still too high. The company claimed the company's equity was $271 million based on the rarely used bank case, which only allowed for 2.2% revenue growth per year. The court noted this valuation was "a far cry from Rothschild's Backdated Valuation (which valued SourceHOV's equity at $675 million)." The court dismissed the company's fair value proffer, noting the company's reliance on "witnesses whose credibility was impeached."

Court finds one expert's valuation is credible. The court found the DCF was the "only reliable means by which to appraise SourceHOV." But, even though both experts used essentially the same method, their value conclusions were "solar systems" apart. Disagreements between party experts were nothing new, the court observed. What added "a twist" to this proceeding was that the company "disagrees with its *own expert*."

As to the experts' divergent inputs, the court noted the "most consequential point of disagreement" was over how to calculate the company's equity beta. It observed that the petitioners' expert, using a generally accepted method, calculated beta *indirectly* based on 19 publicly traded comparable companies. In contrast, the company's expert, claiming he could not use "indirect or regression-based betas," calculated beta "*directly* by looking to market evidence" of the company's debt, the court said with emphasis. It observed that the debt was not publicly traded; these were private loans that traded only by appointment. Also, debt pricing services had observed incorrect and incomplete information as to the company's debt.

The court noted the company's expert admitted he came up with this approach for this particular case and that there was no support for it "in the academic literature." The court said, "[N]othing connects this expert's opinion evidence … to existing data except the *ipse*

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dixit of the expert." (internal quotation marks omitted; citation omitted) The expert's willingness "to go out on a limb to support a forensic valuation opinion" raised serious admissibility questions under *Daubert* and also about "the credibility of his entire valuation analysis," the court said.

According to the court, the company's expert was "[u]sing the courtroom as an incubator for his experiment." In a footnote, the court added that it was "ill-equipped to assess the merits of the theoretical debate" in which the parties' experts engaged as to the implications of this novel theory for beta approximation, "much less who will ultimately prevail should the debate continue in the academy where it belongs."

The crux was that the method the company's expert applied was new, as the expert admitted, and the petitioners' expert's method was "tried and tested." "As lay fact finder, I place my trust in the generally accepted methodology," Vice Chancellor Slights said.

The court also rejected claims by the company that the "traditional, indirect method" the petitioners' expert used to estimate equity beta was unreliable because the expert used companies that were not comparable and because the expert's portfolio included companies less levered and much larger than SourceHOV.

The court pointed out that the expert used a lot of the same companies SourceHOV's management, accountants, and its financial advisor, Rothschild, had used to calculate beta before the business combination. "[I]t is generally accepted that when a company is privately held, a comparable companies analysis is the best tool available to derive beta, even if the comparable companies are larger or less levered," the court said.

According to the court, to adjust for differences in leverage between the subject company and the guideline companies, the petitioners' expert used a delevering process that the valuation authorities (Pratt and Grabowski) the parties had relied on recommended. The expert also used the highest beta from his analysis to counteract the risk of underestimating SourceHOV's beta, the court observed.

The court found the petitioners' expert was conservative in the way he approximated beta and his beta value was "reasonable and credible." In contrast, the opposing expert's "admittedly novel process does not survive judicial scrutiny—at least not on this record."

On the other hand, the court agreed with the company's expert as to the size premium estimate. The court said using the higher 2.68% size premium was "more accurate given that it incorporates information that was knowable as of the Business Combination." Specifically, the company's expert considered a post-closing decrease in Exela's stock price resulting from the preference of many of Quinpario stockholders to redeem their shares rather than participate in the business combination. The decrease in stock price lowered the value for SourceHOV to below the $569 million market capitalization threshold for decile 9. The court said with emphasis this outcome "was *knowable* before the Business Combination." It also noted that the market price SourceHOV received for Exela stock in the

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business combination included synergies related to the transaction and therefore overstated SourceHOV's value.

Court's value conclusion. Using its own "critical judicial analysis," the court decided not to perform its own valuation. "I have more confidence in Petitioners' presentation than I have in my own ability to translate any doubts I may have about it into a more accurate DCF valuation," the vice chancellor said.

Accordingly, the court adopted "*in toto*" the fair value determination of the petitioners' expert, finding his DCF model accurately reflected the company's value. The only adjustment to the model was an increase in the size premium, from 2.08% to 2.68%. The court's modification lowered the petitioner expert's $5,100-per-share price to $4,600 per share.

* * *

Trustee's Post-Trial Attack on DOL's Pursuit of Monetary Relief on Plan's Behalf Crumbles

***Pizzella v. Vinoskey* (*II*), 2020 U.S. Dist. LEXIS 15464; 2020 WL 476669 (Jan. 29, 2020)**

In the latest twist, the trustee in the fiercely litigated *Vinoskey* ESOP case filed a motion for a new trial based on the argument that the U.S. Secretary of Labor and, by extension, the Department of Labor, did not have the statutory authority to seek damages on behalf of the ESOP plan. This argument went nowhere with the court and, for now, the $6.5 million judgment against the trustee and owner of the company stands.

Background. Because we reported in detail on the earlier proceedings in this case, this backstory is short. The impetus for this lawsuit was a 2010 transaction in which the owners of a successful Virginia company sold their remaining 52% interest to the company's employee stock ownership plan. In 2004, the ESOP had bought 48% of the owners' interest in the company. The 2010 transaction would mean the ESOP would own 100% of the company.

Evolve Bank and Trust (Evolve) was retained as the independent trustee and the appraisal firm that had worked on the prior ESOP transaction and performed the annual appraisals served as ESOP appraiser.

The Department of Labor filed a complaint in which it alleged the trustee breached its fiduciary duties of prudence and loyalty to the ESOP by causing the plan to pay more than "adequate consideration." The DOL claimed the owner was liable for knowingly participating in the prohibited transaction and as co-fiduciary. In a separate count, which the court dismissed for failure to show damages, the government alleged the trustee violated its fiduciary duty by allowing the per-share value of stock held by the existing participants in the plan to decrease.

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The overpayment claim went to trial and, in a 100-page decision, the district court, guided by the analytical framework the 4th Circuit has provided in the controlling *Brundle* case, ruled for the DOL. *See Brundle v. Wilmington Trust, N.A.*, 919 F.3d 763 (4th Cir. 2019) (a digest and the court's opinion are available at *BVLaw*.)

In the instant case, the court found that the trustee, Evolve, had caused a "prohibited transaction" by failing to ensure that the ESOP paid no more than "adequate consideration" for the stock in the 2010 transaction, where "adequate consideration" has come to mean the deal price: (1) reflects the stock's "fair market value"; and (2) is "the product of a determination made by the trustee in good faith." Evolve also breached its fiduciary duties to the plan by conducting a "rushed and cursory" due diligence process and by failing to apply due scrutiny to the appraisal underlying the transaction, the court said. It concluded the trustee did not act "solely in the interest of the plan."

The court also held the owner/seller liable for the trustee's breaches as a "knowing participant in a prohibited transaction and as co-fiduciary."

But the court downwardly revised the government's proffered damages calculation ($11.5 million) to $6.5 million. The court said this was how much the ESOP overpaid for the acquired stock. (A digest of *Pizzella v. Vinoskey*, 2019 U.S. Dist. LEXIS 129579 (Aug. 2, 2019), and the court's opinion are available at *BVLaw*.)

Untimely and unpersuasive argument. Following the court's judgment, the trustee filed a motion for a new trial, based primarily on the argument that the ERISA provisions under which the DOL sued did not authorize the Secretary of Labor to seek monetary relief against the defendants in this case. The statute only allowed the secretary to ask for injunctive relief, the trustee claimed. Relatedly, the court did not have jurisdiction to hear the DOL's claim, the trustee argued.

The court dismissed the arguments. It noted that this was the first time in the case that the trustee made these assertions. The court agreed with the DOL that the objection "comes far too late in this litigation."

The court also pointed out that, under the applicable law, a motion for new trial is appropriate in three situations: (1) the verdict is against the clear weight of the evidence; (2) the verdict is based on false evidence; and (3) the verdict will result in a miscarriage of justice. The trustee did not even try to "place its argument into one of the narrowly circumscribed avenues for a successful Rule 59(a) motion," the court said. Moreover, whatever the prong the trustee wants to choose, its "eleventh-hour statutory argument" fails, the court said.

It noted that the trustee's argument would fail even if it were timely. Specifically, one of the ERISA provisions under which the DOL brought suit, 29 U.S.C. § 1132(a)(2), says the secretary or a plan participant, beneficiary, or fiduciary may file a civil action "for appropriate relief under section 1109 of this title." Section 1109 in turn provides that a fiduciary who breaches fiduciary duties is "liable to make good to such plan any losses to the plan resulting from each such breach." Further, the fiduciary must "restore to such plan any profits of such

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fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary."

According to the court: "A clearer authorization for the Secretary to pursue damages would be difficult to find." The language of the provisions contemplates the legal action and relief for the recovery of losses suffered "by the exact manner of breach proven in this case," the court said.

The court also pointed to "[n]eighboring provisions" that support this "plain interpretation." It emphasized that, under 29 U.S.C. § 1132(l), where there was a breach of fiduciary duties, "*the Secretary* shall assess a civil penalty against such fiduciary or other person in an amount equal to *20 percent of the applicable recovery amount.*" The "applicable recovery amount" is defined as "any amount … ordered by a court to be paid by such fiduciary … in a judicial proceeding instituted by the Secretary under subsection (a)(2) or (a)(5)." These were the provisions on which the DOL's suit was based.

"The Court need not look any further than the plain language of the statute to reject Evolve's argument," the court said.

It added that decisions from the U.S. Supreme Court, the 4th Circuit (the circuit in which this case arose), and other circuits "have all without fail either affirmed or acknowledged the ability of the Secretary to obtain monetary relief on behalf of employee benefit plans." No court seems to have ever questioned the Secretary's authority ("statutory standing") to pursue damages under section 1132, the court added.

The court also dismissed a claim by the trustee that the wording of the court's judgment did not make it binding on the defendants to pay the ESOP or that the DOL had to pass the award on to the ESOP. The court pointed to a letter from the DOL following entry of the final judgment that asked for evidence that the determined overpayment was restored to the ESOP. If the trustee "had any confusion as to whom to tender the $6,502,500.00 following the Court's Final Judgment," that letter should have cleared it up, the court said.

The trustee failed to show it was entitled to a new trial, the court concluded.

Editor's note: On Feb. 27, 2020, the defendants, Evolve and Mr. Vinoskey, gave notice that they appealed the trial court's judgments and all rulings with the 4th Circuit. Stay tuned for further developments in this case.

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Valuation Underpinning Contested Stock Sale Reflects Fair Value, Court of Chancery Says

***Coster v. UIP Companies, Inc.*, 2020 Del. Ch. LEXIS 36; 2020 WL 429906 (Jan. 28, 2020)**

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In a breach of fiduciary duty action arising out of a controversial stock sale, the Delaware Court of Chancery dismissed the plaintiff's attacks on the underlying valuation, noting the appraiser was "exceptionally knowledgeable about the industry" and held "informed beliefs" as to the company's specific structure. His methodology generated a reliable indicator of the company's value, the court said.

Highest level of scrutiny: The case centered on a real estate investment services company that the plaintiff's late husband had formed with two other partners. One partner eventually left the company. The remaining partner was a defendant in this suit, as were two board members. The company comprised three subsidiaries that specialized in property management, general contracting, and asset management. The main customers were high-risk, high-reward special purpose entities (SPEs) in which the company's principals had invested their own money besides capital from third-party investors. The record showed that the principals did not expect the operating companies to generate their own value—they were designed to manage the risk associated with the SPEs.

The plaintiff inherited the husband's 50% interest after his death. Eventually, relations between the plaintiff and the defendants deteriorated to the point where she felt compelled to sue for the appointment of a custodian, ostensibly to resolve a shareholder impasse between the parties. The plaintiff's action prompted the remaining principal to arrange for the sale of one-third of the company's stock to one of the co-defendants based on a valuation that was done just prior to the sale. The defendants essentially argued the stock sale resolved the deadlock and obviated the need for an outside custodian. The plaintiff then filed a second lawsuit, alleging the stock sale represented a breach of fiduciary duties. The court consolidated the actions.

The court applied the highest level of scrutiny—entire fairness review—in assessing the validity of the stock sale. Overall, the court found, the process was fair. The court explained that the fair price aspect of the entire fairness inquiry required a valuation analysis equivalent to the fair value determination in an appraisal. Here, the plaintiff, among other things, claimed the valuation was compromised because the valuator, shortly after corresponding with the defendant, expressed to a third party the belief that "there is no value" to the operating companies. The court said a cynical view would be that the valuation that followed was "results-driven window dressing on an uninformed gut reaction." But this conclusion was not justified here, the court said, noting the valuator held a senior position as well as professional licenses, including accreditation as a business valuator and also had extensive experience valuing real estate entities.

The court found the appraiser explained why he chose an income approach to value the company and, in performing a capitalized cash flow analysis, looked closely at facts specific to the company. In contrast, the plaintiff's rebuttal expert, by his own admission, approached the analysis more like an "academic exercise" and, in attacking the valuation, at times, engaged in "a theoretical dart throwing exercise that seemed untethered to any real world considerations," the court said.

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It found the valuation produced a fair price and the stock sale "must stand." "Fairness and justice do not compel the appointment of a custodian" over the company, the court said.

* * *

DOL's Valuation-Related Claims Against Individual Actors Survive Motion to Dismiss

***Pizzella v. Reliance Trust Co.*, 2020 U.S. Dist. LEXIS 26975, 2020 WL 805527 (Feb. 18, 2020)**

This developing ESOP case presents familiar themes and also shows the increasing strength of suits by the Department of Labor to withstand challenges from the defendants in the early stages of litigation as well as at trial. In addition, the instant case reflects the efforts by various defendants to separate themselves from other defendants to avoid liability and monetary exposure. The gist of the DOL's complaint to date was that the defendants—individuals with control over the company and the ESOP trustee— breached their fiduciary duties to the plan and caused it to overpay for company stock.

Background. The instant ruling on the individual defendants' motion to dismiss provides the most pertinent facts only. The DOL's lawsuit revolves around a 2014 transaction in which the individual defendants sold their shares in a company, RVR Inc., that, according to its website, "ranks as the nation's largest RV rental firm with 132 locations and about 300 employees at peak season in the U.S. and Canada." The individual defendants were the founders' two sons and another top executive as well as related trusts. Reliance Trust Co., which served as independent trustee for the disputed ESOP transaction, was named as a co-defendant. There was an independent ESOP appraiser (not a party to this litigation).

According to the suit, the individual defendants, as principal officers, sole shareholders, and sole directors, "controlled every aspect" of the transaction. They engaged a business valuation firm to provide advice regarding the contemplated ESOP transaction, including providing an estimate for the company's value and representing the interests of the individual defendants (sellers) in negotiations with the independent trustee. The three individual defendants also hired the independent trustee, the DOL alleged. At a "kick-off" meeting, the individual defendants gave an overview of the company's operations and performance outlook to the trustee and ESOP appraiser. The DOL's complaint alleged that the defendants set a timeline for when the transaction needed to be completed and caused the process to be "intentionally rushed." Ultimately, the plan overpaid by "tens of millions of dollars" for the then-outstanding company stock, the complaint said. Importantly, the defendants maintained their positions as controllers of the company, even though the plan paid a control premium for the acquired stock.

Claims specific to individual defendants. The DOL claimed that the individual defendants breached their fiduciary duties to the plan in three ways: (1) they failed to monitor the ESOP trustee; (2) they were liable for the trustee's breaches as co-fiduciaries; and (3) regardless of the fiduciary status of the individual defendants, they were liable for the ESOP trustee's breaches by knowingly participating in the trustee's breaches.

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The individual defendants argued for dismissal of the claims, arguing the DOL failed to allege sufficient facts to support its legal claims.

The court noted that the parties argued over what knowledge standard applied to an ERISA section 404(a) violation. According to the individual defendants, the DOL had to prove they had "actual knowledge" that the ESOP trustee breached its fiduciary duty and the transaction violated ERISA. The DOL claimed the standard was less stringent, i.e., the defendants "knew or should have known" of the breaches.

The court said it agreed with the DOL that the standard was "knew or should have known" but that "this determination is immaterial" here because the plaintiff provided sufficient facts in its complaint that the individual defendants had actual knowledge of the ESOP trustee's alleged breaches.

The court noted the complaint alleged the individual defendants controlled the company and communicated directly with the ESOP trustee and ESOP appraiser. They therefore knew of the information the ESOP trustee and appraiser received to value the company and assess the fairness of the stock price for the plan. The individual defendants knew what information was used and what price their shares would ultimately fetch or at least knew the company's approximate value. The court said it could infer from facts stated that the transaction was rushed based on the individual defendants' "dictated timeline" and that there was not enough time for the trustee and "its agent appraiser" to review and scrutinize the transaction.

The allegations sufficed to state a claim that the individual defendants breached their duty to monitor, the court concluded. However, this ruling did not answer the question of whether there was sufficient evidence to support allegations and inferences at later stages in the trial, the court noted. That was "a wholly different question."

The court also found the DOL provided sufficient facts, "which, when taken as true," provided support for the claim that the individual defendants breached their duty as co-fiduciary and participated knowingly in the trustee's breaches as fiduciary or nonfiduciary.

Contested indemnification provisions. The DOL's complaint contested the validity of certain provisions in the plan that would require the company or the plan to indemnify the individual defendants for losses and costs related to the litigation.

The court specifically noted that, at this stage, there remains the possibility that the individual defendants may be found liable for breaches of fiduciary duties. Given this possibility, the court would have to evaluate "in equity" at some later stage in the litigation whether those provisions would be void under ERISA sections 409(a) and 410(a), which allow for avoidance of indemnification for breaches of fiduciary duties.

Editor's note: To readers familiar with the Brundle *and* Vinoskey *ESOP litigations, certain facts alleged in this case will resonate, including the DOL's claim that the transaction was "rushed" and that the plan, despite paying a premium for control, ultimately did not acquire*

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control of the company. Rather, control stayed with the sellers, the allegations state. Digests of the various Brundle *and* Vinoskey *court decisions and the courts' opinions for those two key cases are available at* BVLaw.

* * *

Synergy Deduction Purely Academic in New Delaware Appraisal Ruling

***In re Panera Bread Company,* 2020 Del. Ch. 42, 2020 WL 506684 (Jan. 31, 2020)**

In a statutory appraisal case that involved the sale of a publicly traded company to a privately held entity, the Delaware Court of Chancery recently decided the deal price was a reliable indicator of fair value and a downward adjustment for synergies was justified but not practicable. But, because the company prepaid the unadjusted deal price to some of the dissenting shareholders and the court lacked a mechanism to order a refund, some dissenting shareholders received more than fair value.

Sufficiently reliable sale process: The target company was Panera Bread Co. (Panera), a successful bakery-café chain and franchise operation with a presence in the United States and Canada. The buyer was JAB Holdings B.V. (JAB), a private limited liability company that, in recent years, made a number of high-profile acquisitions, including Keurig, Krispy Kreme, Einstein Bros., and Peet's Coffee. The merger closed on July 18, 2017, and the unadjusted deal price was $315 per share.

The court's analysis was guided by Delaware Supreme Court key cases that encourage reliance on market evidence where there is a reliable sale process. The heart of this decision, as it was in other recent rulings from the Court of Chancery (e.g., *Columbia Pipeline* and *Stillwater Mining*), is an in-depth assessment of the facts surrounding the sale process against the facts of the controlling cases to determine whether the sale process here was "sufficiently reliable" to make the deal price a meaningful fair value indicator.

None of the traditional valuation methods (discounted cash flow method, comparable companies analysis, and precedent transactions analysis) the petitioners' expert used for his value determination yielded a reliable result, the court concluded.

The court found the sale process showed "objective indicia of fairness." The transaction was arm's length. The buyer, for its value assessment, was able to draw on extensive publicly available information about the target (Panera had a reputation for being exceptionally transparent) as well as confidential information. Panera's board and its founder/CEO, who was the main negotiator, extracted two price increases from a sophisticated buyer that had a reputation as "serial acquirer." Panera's board went into the negotiations with a deep understanding of the company's financials and projections and "empowered" the CEO to press for price increases and consider Panera's internal value determinations, the court said. Deal protections did not prevent any interested buyer from making an offer. None of the "big three" potential bidders, i.e., Starbucks, Chipotle, and Restaurant Brands International (RBI), showed an interest in bidding for the company, the court observed.

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The court found the deal price included synergistic value related to anticipated cost savings and tax-related savings that needed to be extracted. Crediting the company's expert, the court concluded that the deal price had to be reduced by $11.56 per share. But the synergies analysis ultimately had no practical importance because the company and dissenting shareholders had not agreed to a clawback provision in case of overpayment, and the appraisal statute did not mandate a refund, the court found. Therefore, the overpayment was not recoverable, the court concluded.

* * *

Tax Court Spurns IRS' Gift Tax Valuation Theory and Methodology

***Grieve v. Commissioner*, T.C. Memo 2020-28 (March 2, 2020)**

In a gift tax dispute, the U.S. Tax Court recently found for the taxpayer when it rejected the unusual reasoning and methodology the Internal Revenue Service's trial expert proposed to keep low the discounts applicable to the nonvoting membership units in two limited liability companies (LLCs).

Nonmarketable, noncontrolling interest: In late 2013, as part of his estate plan, the taxpayer transferred his 99.8% interest in an LLC called Rabbit to a grantor retained annuity trust (GRAT) and his 99.8% interest in another LLC, Angus, into an irrevocable trust. The GRAT transfer was structured to avoid gift tax liability. The taxpayer's 99.8% interest in both LLCs represented class B nonvoting units. A management entity that belonged to the taxpayer's daughter solely owned the remainder 0.2% interest. This interest represented class A voting units. Both LLCs held securities, investments, and promissory notes. Neither of the two entities' class B membership units were ever offered for sale or sold since the transfers.

The taxpayer filed a Form 709 gift tax return with valuations an appraisal firm had performed. In January 2018, the Internal Revenue Service (IRS) issued a deficiency notice, finding the taxpayer had understated the FMV of both companies' class B units.

The taxpayer petitioned the Tax Court for review. The court was presented with three valuations, including those attached to the tax returns, valuations from the petitioner's trial expert, and valuations from the IRS' trial expert.

To account for the noncontrolling, nonmarketable aspects of the class B units, the firm preparing the original appraisal applied discounts for lack of control (DLOC) of 13.4% and 12.7% and a 25% discount for lack of marketability (DLOM) for both companies. The taxpayer's trial expert prepared his own valuations and applied slightly higher DLOCs.

The IRS' expert proposed a theory of what the hypothetical buyer and hypothetical seller would do under the facts, which aimed to minimize the applicable discounts. Per the expert, a reasonable buyer of the 99.8% interest made up of class B units would try to maximize

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the buyer's economic interest by acquiring the remainder 0.2% interest consisting of class A units. Doing so would consolidate control of the respective company and further increase the value of the class B units by decreasing the discount a hypothetical buyer would pursue. To buy the class A units, the hypothetical buyer would have to pay a "reasonable" premium, which the expert determined to be 5%. Basically, he subtracted the premium amount from the undiscounted net asset value of the LLCs. The result was a significantly higher valuation for each company than those the taxpayer's appraisers offered.

The Tax Court, citing *Estate of Giustina*, in which the very court had cautioned against "imaginary scenarios as to who a purchaser might be," found the IRS expert's approach was not supported by facts, case law, or among peers. "We are looking at the value of class B units on the date of the gifts and not the value of the class B units on the basis of subsequent events that, while within the realm of possibilities, are not reasonably probable, nor the value of the class A units," the Tax Court said.

For Rabbit, the court adopted the NAV to which the parties stipulated. For Angus, it adopted the NAV the original appraiser calculated.

* * *

Plaintiff's Overbroad Damages Calculation Prompts Court Not to Grant Award for Proven Wrongdoing

***Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLP*, 2020 Del. Ch. LEXIS 76; 2020 WL 948513 (Feb. 27, 2020)**

The Delaware Court of Chancery recently decided damages in a case in which the buyer sued in tort and contract after the subject company lost in value post-acquisition. In a tactical misstep, the plaintiff submitted an expert damages calculation at the liability phase and adhered to it even though the court ended up substantially limiting the scope of liability. The expert's theory and calculation were not sufficiently tailored to the wrongdoing the plaintiff was able to prove, the court found. Vice Chancellor Glasscock said, "[H]arm is in itself insufficient for a damages award if I have no basis to make a 'reasonable estimate' of damages." The court therefore declined to award any damages for certain established misrepresentations. This case shows that it is not cost-effective for a litigant not to submit an updated, on-point expert report.

Backstory. The case arose over the acquisition of a company, Plimus, that functioned as a "reseller" between small online retailers and consumers. Its success depended on having good working relationships with payment processors. Two of them were critical for Plimus: PayPal and Paymentech. Typically, Plimus would "acquire" products from the retailer and receive payment for that retailer from the payment processor. The payment processor in turn had relationships with credit card companies and their banks.

Problems in the process would arise whenever the retailer's product was not satisfactory to the consumer and credit card companies had to cancel debt the consumer incurred for

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fraudulent or mispresented products known as “chargebacks.” In the event of a chargeback, the credit card company imposed a fine on the payment processor, which, in turn, contacted the reseller (e.g., Plimus). In sum, retailers whose products resulted in excessive chargebacks put a strain on the reseller and the payment processor.

The plaintiff (related private equity firms) acquired Plimus by way of merger in 2011. The sale price was based on due diligence, management projections, and representations in the parties’ merger agreement. The merger closed on Sept. 29, 2011. The merger price was $115 million. Shortly after the merger, PayPal terminated its business relationship with Plimus, placing Plimus on the “MasterCard Alert to Control High-Risk Merchant” list (MATCH list). Plimus then entered into an agreement with another payment processor. But, in January 2012, the new partner also terminated Plimus.

In its annual report ending Dec. 31, 2011, the buyer/plaintiff stated that “Plimus was the only portfolio company to experience decline in valuation, as the company removed a number of high-risk clients from its payment platform, resulting in a negative short-term impact.” Plimus’ removal of high-risk customers, its purging of some 500 higher-risk merchants in early 2012, and its giving more scrutiny to new vendors meant a decline in processing volume relative to expectations. The buyer said it therefore expected a lower sale volume into 2012. In August 2012, the buyer fired the CEO of Plimus. The buyer also made what it claimed were many millions in additional investments in Plimus. In 2014, Plimus changed its business model and began to operate as a payment facilitator. This role required it to show more transparency as to its vendors and as such was preferable to model processors and acquiring banks.

The buyer eventually sued the principals, including the CEO, and stockholders of Plimus in the Delaware Court of Chancery, claiming breaches related to the representations and warranties the defendants made in the merger agreement as well as various acts of fraud and fraudulent inducement related to the merger.

The court, in the instant opinion, noted that the litigation was “large,” as concerns the scope of allegations, the cast of defendants, and the damages claims. The court decided to bifurcate the proceedings into a liability phase and a damages phase. In the liability phase, the court rejected most of the plaintiff’s claims.

The damages findings are the subject of the court’s instant decision.

Surviving claims. Based on the liability proceedings, the court found the plaintiff was able to prove two instances of fraudulent misrepresentation, one involving Plimus’ former CEO, as well as several breaches of contractual representations by other defendants.

As for the fraud claims, before the merger closed, Plimus was put on notice by PayPal that it had to terminate one vendor in particular, GoClickCash. This vendor was involved in a “get rich quick” scheme that resulted in high chargebacks. Once Plimus had notice from PayPal, it terminated the account and performed an internal review that resulted in terminating

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another 16 potentially compromising vendors. About a week before the merger closed, Plimus received notice that PayPal would impose a $200,000 fine related to GoClickCash.

The court found, prior to closing, the buyer had organized a “bring down call” with Plimus’ management to discuss changes in the business that might require amending the disclosure schedule accompanying the initial merger agreement. Internally, Plimus’ CEO noted the fine was a business issue, but he chose not to disclose it to the buyer at that call or before the closing of the merger.

Further, the court found that, in early August 2011 and numerous times after that, PayPal informed Plimus that the latter had incurred excessive chargebacks and that PayPal might issue a 30-day termination notice and end its relationship with Plimus. On the date of closing, PayPal had not yet decided whether or not to terminate Plimus.

The court found that, while the CEO likely disclosed to the buyer that Plimus had some dispute with PayPal, he *did not disclose* the extent of the problem or the threat of PayPal’s terminating the relationship. Nondisclosure of PayPal’s threats and the GoClickCash fine were false representations, the court found, where Plimus principals stated that the company followed credit card network rules and that no suppliers of goods or services had threatened termination.

The court specifically noted that Plimus’ CEO “intended” for the buyer to rely on these false representations to induce the buyer to go ahead with the merger, recognizing that the PayPal problems could negatively affect the merger. Plimus knew that the loss of PayPal would mean a major disruption of its business, the court noted. In contrast, the buyer relied on representations by Plimus, and its reliance was reasonable where due diligence related to the merger was completed before PayPal made termination threats and Plimus had a contractual obligation to disclose the information. The court noted Plimus’ CEO later testified that he did not believe PayPal would go through with its threats to terminate. Although the court believed the testimony was truthful, it found problematic the CEO’s awareness of the threats and said he “fraudulently concealed them” from the buyer.

As for liability related to contractual breaches, the court noted Plimus had stated in the merger agreement that it followed the rules of the card systems, payment card industry standard, the National Automated Clearing House Association, regulations applicable to the credit card industry, and its member banks. At the same time, Plimus had received numerous violation notices from its two major payment processors, Paymentech and PayPal. The defendants conceded a number of breaches related to excessive chargeback issues.

Further, the defendants’ vouching in the merger agreement that there were no suppliers of products or services that had notified Plimus of an intent to terminate their business relationship with the company was misrepresentation.

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Damages calculation submitted. All told, the court "greatly circumscribed" liability for Plimus in the first phase of the proceedings. It found that "the bulk of [the plaintiff's] wide-ranging allegation were unproved" and could not support damages.

The court noted that, regardless of the limited scope of liability, the plaintiff entities "were content" to rely on a damages report and testimony that they had presented at trial based on their "generously-proportioned allegations."

In post-trial damages oral argument, the plaintiff said it did not think additional damages evidence was necessary (i.e., a revised expert report) considering the court's findings that there was fraud regarding PayPal. According to the plaintiff, all of its fraud claims ultimately "built to the PayPal fraud," which "was always the main issue. It's also where we tracked the damages from. And when that was the fraud that was found, we thought we could move forward on that basis." The court found the plaintiff's argument problematic.

The plaintiff's overriding damages theory was that the alleged breaches and wrongdoing by the various defendants lead to the diminution in the fair value of the plaintiff's equity interest in Plimus.

The plaintiff's damages expert found damages consisted of: (a) the difference between the $115 million sale price and the value of Plimus as determined by him on the merger date (the difference being about $90.3 million); (b) $31.5 million representing the additional investments the plaintiff had made in Plimus post-merger; and (c) about $212,300 in preclosing fines.

The expert noted the plaintiff had arrived at its $115 million sale price based on multiples of 2011 actual Q2 run rate EBITDA and 2011 estimated Q4 and yearly EBITDA. The expert thought it was appropriate to adhere to the same methodology. He used the 2011 Q4 EBITDA multiple of 10.1x, which, he said, was the valuation metric the plaintiff used for its valuation of Plimus.

The expert first calculated the 2011 Q4 EBITDA using Plimus' actual 2011 Q4 EBITDA. He then significantly downward adjusted the actual Q4 EBITDA to arrive at what he considered "the full extent of the harm." The projected Q4 EBITDA was about $11.4 million, which, based on a multiple of 10.1x, resulted in the $115 million merger price. In contrast, the actual Q4 EBITDA was about $5.1 million, which would have resulted in a fair value of about $51.3 million. Importantly, however, the plaintiff's expert did not use the difference between those two figures as his damages figure.

Rather, he adjusted the actual Q4 2011 EBITDA by eliminating revenues from "transactions attributable to the lost volume to Plimus' decision to terminate the relationship of customers with chargebacks in excess levels allowed by the payment processors or other risk concern." He justified this adjustment by noting "the full effects of the fraud were not felt until 2012 and beyond … [t]hat is, the actual EBITDA results still included the benefit of profits from clients that were shortly lost or terminated as the fallout from the fraud continued."

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In essence, he backed out from the company's actual Q4 2011 EBITDA revenue from *any* client (court's emphasis) whom Plimus terminated a few days after the closing of the merger, in October 2011, and throughout June 2012. The expert maintained that making this adjustment resulted in a "conservative estimate of the harm" the plaintiff incurred. By the expert's calculation, Plimus' adjusted 2011 Q4 EBITDA was only $2.45 million. Applying the 10.1x multiple, the expert arrived at a fair value determination of about $24.7 million (rather than $51.3 million based on actual Q4 EBITDA). The difference between the price the buyer paid and the $24.7 million was the diminution in business value, the expert found.

He then added to this amount the $31.5 million he said the buyer had invested in Plimus in fall 2012 and December 2014 and the fines.

Limited scope of damages. The court found certain defendants were liable for certain chargeback fines, and Plimus' CEO was liable for the $200,000 in fraud damages for the PayPal GoClickCash fine.

The more important issue was what damages were available to the plaintiff related to Plimus' nondisclosure of PayPal's termination threats where PayPal did terminate its relationship with Plimus immediately after the merger.

Damages could be based on tort or contract, but the damages resulting from this liability were identical, the court explained. "Both contract and tort law thus conceive of damages as the pecuniary consequences of the breach or tort. This requires an identification of the conduct for which a defendant is liable and an isolation of the harm occurring therefrom."

The task here was to "separate the non-disclosure of PayPal's termination threats—and the harm occurring therefrom—from all other fraud and breach allegations," the court explained. It observed that damages must "represent the difference between what the Plaintiffs expected—Plimus with PayPal as a processor—and what they got—Plimus *sans* PayPal."

Specifically, the plaintiff had a right to damages "consequent to the loss of the PayPal relationship which meant the inability to use PayPal's services, and the resulting reputational damage." At the same time, the court cautioned that the plaintiff was not entitled to damages going back to the underlying reasons as to why PayPal terminated its relationship with Plimus, such as Plimus' excessive chargebacks, lack of risk monitoring, and illegitimate vendors. The record showed the buyer knew of these problems at the time of the merger, the court explained.

The plaintiff had to prove damages related to the PayPal termination with "reasonable certainty," the court noted.

The court found the plaintiff's expert offered a damages calculation that was not sufficiently linked to the harm to the plaintiff from the nondisclosure of PayPal's termination threats. Rather, the calculation managed to "throw everything in the hopper: *all* amounts by which Plimus missed [the plaintiff's] projections for Q4 2011 EBIDA, *all* revenue and volume from

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vendors terminated in the 9 month period after the Merger, and *all* amounts [the plaintiff] invested in Plimus in the years after the Merger."

In his testimony, the expert himself said his calculations failed to filter out damages from the wrongdoing the plaintiff was able to prove at trial, which, the court noted, "are a rather small subset of its allegation." Notwithstanding the court's liability findings, the plaintiff "elected to stand" on its expert report, submitted before the court's liability findings were made, the court noted.

It said the plaintiff's expert offered no mechanism to segregate out the decrease in Q4 2011 EBITDA attributable to the loss of PayPal. Also, in terms of the claimed post-merger investment, the plaintiff failed to segregate what portion of the investment was necessary because of the loss of PayPal. Further, the plaintiff did not show how the latter damages were not already covered in the plaintiff's fair value estimate, the court noted.

Based on the record, the court said it was unable to assign damages caused by the loss of PayPal as a payment processor. Doing so would be "mere speculation or conjecture because the Plaintiffs failed to tie *any* portion of their damages estimate to the loss of the PayPal as a processing service provider."

Accordingly, even though the court found the plaintiff suffered harm from the loss of the PayPal relationship, the court declared itself unable to award fraud or contract damages related to the misrepresentations regarding the PayPal termination threats. The plaintiff was entitled to recover about $212,300 related to fines only.

* * *

New DOL Process Agreement Confronts Control Issue in ESOP Valuations

***Scalia v. Farmers National Bank of Danville & Weddle Bros. Const. Co.*, 2020 U.S. Dist. LEXIS 40443 (Feb. 28, 2020)**

The Department of Labor recently settled ESOP litigation with the trustee Farmers National Bank of Danville (FNB). The settlement incorporates a process agreement that contains noteworthy directives instructing the trustee on handling controlling interest acquisitions and indemnification matters.

This is the sixth such process agreement the DOL has made with defendant trustees. Ostensibly the agreements only bind the parties to it, here FNB. At the same time, the agreements have come to serve as guideposts to the ESOP community as a whole regarding the issues the DOL prioritizes in scrutinizing ESOP transactions and the positions the DOL takes on the issues. The crux long has been that the DOL has failed to issue final regulations that provide legal guidance and certainty to actors in ESOP transactions.

Control provision: The control provision in the FNB agreement applies only "when the ESOP intends to buy a controlling interest in the company whose stock it intends to acquire."

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It speaks to the question whether the ESOP, in purchasing 100% of the stock of a company, has acquired actual control over the company such that it is appropriate to include a control premium in the valuation underlying the transaction. This issue was heavily litigated in the two key cases arising in the 4th Circuit, *Brundle* and *Vinoskey.* In both cases, the courts sided with the DOL in finding the ESOP did not in fact acquire control of the company and a control premium was not justifiable.

The FNB agreement obliges FNB, when acting as trustee in an ESOP transaction, only to approve a transaction in which the ESOP pays for a control premium if FNB ensures the ESOP acquires a host of specific rights that, in the DOL's view, reflect true control over the company. "Control," under the agreement, means having "all of the unencumbered rights" a controlling shareholder normally would have as well as the rights normally vested in the company's board of directors and top executives. ESOP practitioners have chafed at this expansive definition of control.

Moreover, if the transaction imposes restrictions on the ESOP's ability to control the company or the ESOP does not acquire "the degree of control of the company commensurate with the ownership interest it is acquiring," FNB as trustee must ensure the purchase price reflects the ESOP's lack of control. In these circumstances, FNB has to ensure that the valuation does not only include a control premium but includes "an appropriate lack of control discount [DLOC], to the extent that the ESOP's rights of control are diminished."

Open questions are whether the list of rights the DOL provides here is now applicable in all ESOP transactions to show the ESOP has acquired actual control, whether a transfer of rights short of those on the list requires an adjustment in the form of a DLOC, and how one calculates the "appropriate" lack of control discount.

Indemnification provision: Also important is a provision that says FNB cannot request indemnification by an ESOP or "ESOP-owned company (irrespective of whether the ESOP owns some or all of the company's stock)" for liability and losses from breach of fiduciary duty claims or other ERISA violations. FNB, as defendant, also cannot ask for the advancement of legal fees "unless an entirely independent third-party determines that there has been no breach of fiduciary duty." Even then, there has to be "a prudent arrangement" that guarantees a refund of advanced fees or costs if a court later determines there was a fiduciary breach.

As legal exposure particularly for ESOP trustees has increased, who bears the cost of defending against DOL action has become a critical issue. This provision suggests an effort by the DOL to tighten restrictions on the defense-related assistance available to ESOP trustees.

Hat tip to James F. Joyner (Integra Valuation Consulting LLC) for alerting us to this case.

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Lack of Valuation Credentials Does Not Disqualify Expert, but Failure to Perform Valuation Does, Court Finds

***Eurochem North America Corp. v. Ganske*, 2020 U.S. Dist. LEXIS 26539; 2020 WL 747008 (Feb. 14, 2020)**

This tangled business dispute included a *Daubert* challenge to an expert who had no business valuation credentials but was retained to value the plaintiff's company for purposes of a before-and-after damages calculation. The court found that the expert was qualified based on decades of experience. But the expert's testimony was inadmissible under the unreliability and relevance prongs. Since the expert had not actually performed the value determination, he could not credibly vouch for the reliability of the decisions and data that went into the calculations. The testimony was irrelevant where the plaintiff's damages model failed to account for other factors contributing to the claimed losses. The expert's testimony was part of the plaintiff's flawed methodology and would not assist the jury, the court found.

Background. EuroChem (plaintiff and counterdefendant) sued a couple (Kent and Julie Ganske) and their company over more than $14 million in unpaid invoices for delivered goods. The Ganskes and their company disputed the debt and also filed a third-party complaint against EuroChem, alleging various business torts. An arbitrator found for EuroChem on the debt dispute, and the federal court confirmed the arbitration award. The court also rejected the Ganskes' claim that their personal guarantees to pay their company's debt were unenforceable because of fraud and lack of consideration

The Ganskes' third-party claim was headed for trial. In essence, they claimed that EuroChem, through trickery, managed to obtain confidential business information, which it used to contact the Ganskes' customers and vendors to lure them away with cheaper products and by defaming the Ganskes and their company. In terms of remedy, the Ganskes tried to introduce into evidence an expert report and testimony to show "business devaluation" damages of approximately $24 million.

EuroChem attacked the admissibility of the Ganskes' expert testimony under Federal Rule of Evidence 702 and *Daubert* and its progeny.

Applicable legal principles. Rule 702 provides that a witness may be qualified as an expert by "knowledge, skill, experience, training, or education." An expert may testify whether his or her knowledge will help the trier of fact (jury or judge) to understand the evidence or a disputed fact; whether the expert testimony is based on sufficient facts or data; whether the testimony is the product of reliable principles and methods; and whether the principles or methods have been reliably applied to the facts of the case.

The U.S. Supreme Court's *Daubert* decision requires the federal district court to act as gatekeeper to ensure expert testimony is based on a reliable foundation and is relevant to the proceedings.

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Put differently, the court must assess the expert's qualifications, the reliability of his or her methods, and the relevance of the expert's testimony. In assessing admissibility, courts are not concerned with "the ultimate correctness of the expert's conclusions." Under the controlling case law, courts have "great latitude in determining not only how to measure the reliability of the proposed expert testimony but also whether the testimony is, in fact, reliable."

Here, EuroChem challenged the admissibility of the Ganskes' expert under all three prongs.

The expert was retained to provide a valuation for the Ganskes' before-and-after damages model. Specifically, the expert, a business broker who typically worked with sellers to market their businesses to prospective buyers, offered a valuation of the business before the alleged misconduct by EuroChem took place. For this purpose, the Ganskes sought to introduce a 25-page business report the expert's company had prepared in late 2016 or early 2017, which valued the company at $36 million, as well as the expert's testimony. The Ganskes themselves claimed the "after" value of their company was about $11 million. The litigation strategy was to persuade the jury to attribute the loss in value solely to EuroChem's alleged conduct.

Qualifications challenge. EuroChem first argued the expert was not qualified under Rule 702 because he lacked business valuation experience and credentials. He was not familiar with the standards governing business valuations, EuroChem claimed. It noted the expert had only taken two one-day classes to become a "Certified Business Intermediary" from the International Business Brokers Association.

The court found qualification was not a problem for admissibility purposes. It observed that the expert had been a business broker for more than 40 years and, throughout his career, had valued and sold many businesses and performed more than 1,000 business valuations. He was qualified by experience.

Reliability challenge. However, the court found the testimony did not meet *Daubert*'s reliability requirement.

Under the applicable 7th Circuit case law, courts testing for reliability may consider a nonexhaustive list of factors that ask whether the proffered theory can be tested or has been tested, whether it has been peer-reviewed, whether it has been accepted in a given scientific community, whether the testimony flows "naturally and directly" from research that the expert conducted independent of the litigation or whether it was litigation-driven, and whether the expert adequately accounted for "obvious alternative explanations." See *Gopalratnam v. Hewlett-Packard Co.*, 877 F.3d 771 (7th Cir. 2017).

The court found significant problems with the methodology underlying the expert's valuation. For one, the expert did not actually prepare the report, the court noted. Rather, the report was prepared by an employee, who, the expert said in deposition, "does all of our valuations in-house." He said he typically reviewed valuation reports when they were completed, and he also reviewed the underlying information when it came into the office, including tax

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returns. At the same time, he admitted that he had not supervised the production of the contested report.

The court found the expert's testimony on the methodology his firm had used to create the report was inadmissible hearsay. There was no way to properly cross-examine him regarding its preparation, the court said.

Further, the expert admitted that the Ganskes did not retain him to prepare an independent determination of the company's value. He, or his firm, used the data the Ganskes provided for the express purpose of coming up with a valuation that would maximize the value of the business to prospective buyers.

Moreover, the expert said his firm did not prepare a valuation but "an estimate of value for marketing purpose."

Most importantly, there was no showing that the actual methods used to arrive at an estimate of value were reliable, the court found. The expert's firm used three income approaches (multiple of seller's discretionary income, multiple of EBITDA, and multiple of gross revenue). The multiple of gross revenue approach yielded a result that was about 20 times greater than the result achieved with the other two methods, the court noted. The expert conceded it was appropriate to disregard an outlier, and he could not explain why, in this case, the very high result was given equal weight in the final estimate of value. Not having prepared the calculation, he did not know what sources were used to produce various multiples that were used for the estimate. The court noted the expert "simply presumed the figure was reliable."

The Ganskes failed to show the methodology their expert used was sound and reliable, the court noted. It also said that, in a "post-hoc affidavit," the expert asserted that his firm had relied on sources "that I know to be reliable and the information that we gathered is of a type reasonably relied upon by experts in my field." The court declined to consider the affidavit but noted that, even if it did, this statement would not show reliability because it was nothing but the expert's "say-so."

Relevance challenge. The court said it had "serious concerns" that the testimony was even relevant. It was fair that the Ganskes wanted to introduce the expert report and testimony to support the "before" part of their before-and-after damages model, the court said. But the model as such was flawed because the Ganskes failed to account for other factors that might have led to business losses, such as changes in market conditions, i.e., factors unrelated to the alleged disparagement by EuroChem.

"[A] valid damages model in a case alleging unfair business competition must account for factors *not* attributable to the defendants' misconduct that might have caused the plaintiff's financial losses," the court noted. Under the applicable 7th Circuit case law, "a simple before-and-after theory is too imprecise," the court noted. The Ganskes' contention that *the entire decline* in the value of their business was attributable to EuroChem's smear campaign was "untenable" under common sense and the facts of the case, the court noted with emphasis.

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The record showed that *before* the alleged defamation campaign, the Ganskes had $23 million in customer liabilities and owned EuroChem millions more, the court emphasized. The expert failed to account for this debt in his estimate of value.

Insofar as the expert's testimony was to be the starting point of the Ganskes' flawed method, it was not helpful to the jury, the court said.

The court concluded the expert report and testimony were inadmissible under Rule 702 and *Daubert*.

* * *

Court Finds Delayed Disclosure of Expert's Complete Report 'Substantially Justified'

***Wright v. Old Gringo, Inc.*, 2020 U.S. Dist. LEXIS30476; 2020 WL 874033 (Feb. 21, 2020)**

In this discovery dispute, the defendants sought to exclude the plaintiff expert's valuation report, arguing it was untimely and the late disclosure would hurt the defendants. In rejecting the defense motion, the court noted any delay was largely caused by the defendants' discovery tactics to thwart production of vital financial information to the plaintiff. This case shows how a court may side with the party whose access to nonprotected valuation information is thwarted by the opposing side as long as the party and its expert timely and diligently alert the court to the problem.

Backstory. The plaintiff used to be a designer for the defendant entities, a Western wear manufacturer and distributor and its Mexican sister company. The plaintiff claimed, for years, several individual defendants promised her an ownership interest in the companies. This ownership interest was to be separate from her salary and bonus compensation. The promise was never put into writing. By the time the plaintiff left the defendant companies, she had no ownership interest and concluded it did not exist.

The plaintiff sued the entities and individuals, alleging various business torts and breach of contract. The defendants filed a host of motions to dismiss certain claims or resolve them through summary judgment. Further, the inclusion of international defendants and related motions as to which court had jurisdiction over them resulted in substantial discovery delays.

In June 2018, the plaintiff first asked the defendants in a written discovery request for financial information necessary to value the companies as of the valuation date and calculate damages. A dispute followed as to the sufficiency of the defendants' responses. In September 2018, the plaintiff submitted to the defendants the report of her valuation expert. The expert explained he lacked financial information for one entity and had insufficient documents about the other entity. Therefore, he was unable to perform a complete and proper valuation.

About a month later, the defendants submitted a rebuttal report from their expert that stated he "had not yet received any report by the Plaintiff's expert[] quantifying the Plaintiff's alleged

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economic damages." The rebuttal expert said that, if the plaintiff's expert were allowed to supplement the initial expert report, the rebuttal expert would prepare a rebuttal report.

About six months later, the plaintiff submitted a document that she called "Supplemental and Corrected Expert Report." The plaintiff's expert, a CPA and certified valuation analysist, again noted the information from the defendants was "incomplete and insufficient" for the purpose of valuing the contested company.

In late December 2019, the plaintiff served her expert's "Supplemental Report in Accordance with FRCP 26(e) Fair Market Analysis As of November 29, 2019." A few weeks later, in January 2020, the defendants provided their rebuttal report.

Rule 37 sanctions motion fails. Three days later, the defendants filed a motion to exclude the plaintiff's expert testimony and report citing Federal Rule of Civil Procedure 37, which provides a mechanism for punishing violations of the discovery requirements under Federal Rule of Civil Procedure 26. In essence, Rule 37 forbids the use at trial of any information that was not properly disclosed under Rule 26. Rule 37(c)(1) says that, if a party fails to make the required disclosure(s), it "is not allowed to use that information or witness to supply evidence … at a trial, unless the failure was substantially justified or harmless." The district court has broad latitude on ordering sanctions under Rule 37.

The defendants claimed the plaintiff's late disclosure of her valuation expert's report was unjustified and would harm the defendants.

The court found the plaintiff repeatedly argued that her expert was unable to provide a complete report because of the defendants' failure to produce necessary financial documents. Under these circumstances, the expert's December 2019 report was untimely. The question was whether the delay was "substantially justified or harmless."

The delay was excusable, the court found, noting the complicated procedural history, especially the defendants' successive pretrial motions, and the defendants' multiple efforts to prevent the discovery of the information the plaintiff's expert needed. The defendants asserted trade secret privilege over much of its financial information, and, even when ordered by the court to produce portions of those documents, defense counsel "engaged in semantic acrobatics to avoid producing its balance sheets," the court noted.

It said the plaintiff was transparent about her need for the documents, and her expert's earlier reports set forth what the plaintiff had asked him to do, his qualifications, other testimony he had provided during the required period, the documents he had reviewed and what other information he would need to issue an opinion on the value of the defendant entities for purposes of calculating damages. Counsel for the plaintiff openly communicated the plaintiff's intention as to the valuation expert, the court said. Therefore, there was no bad faith or willfulness to cause delay.

Moreover, all along, the defendants knew the plaintiff would supplement the expert's report and knew what information the plaintiff believed the expert needed to prepare a

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supplemental report. The court observed that the defense rebuttal expert submitted an initial and a supplemental report that addressed in detail the plaintiff's expert opinion.

Given these circumstances, it was no surprise to the defendants that the plaintiff's expert would be permitted to supplement his report, the court found. The delayed disclosure of the expert's complete report was "substantially justified," the court concluded, as it denied the defendants' motion to exclude.

* * *

Court Rejects Parties' Expert Valuations of Unique Sailing Vessel as Unreliable

***In re Manhattan By Sail, Inc.*, 2020 U.S. Dist. LEXIS 16978; 2020 WL 526107 (Jan. 31, 2020)**

This unusual damages case involving a unique sailing vessel includes some lessons applicable to expert testimony in general. In this case, both experts were qualified and testified to a number of data points that could be relevant, the court found. However, "neither was particularly credible or persuasive in explaining how he arrived at specific values," the court said. The experts' failure to provide reliable testimony left it to the court to take the various data points and perform its own analysis. Because the court itself served as fact-finder, it denied each party's motion to exclude the opposing expert's testimony under Rule 702 for unreliability, notwithstanding the court's own observations to this effect.

The incident. This is a negligence case in which a customer aboard a sailing vessel was hurt in April 2011 and sued the owner entities for damages. Under the applicable Limitations of Liability Act, "the owner can be liable on the covered claims only up to the total value of his vessel and its pending freight." Under case law, where there is no active market for a ship to determine fair market value, courts must consider other evidence. "It is not a matter of formulas, but there must be a reasonable judgment having its basis in a proper consideration of all relevant facts." *See Standard Oil Co. v. Southern Pacific Co.,* 268 U.S. 146 (1925). Under applicable case law, the term "pending freight" means "the total earnings for the voyage, both prepaid and uncollected."

The owners petitioned the court to determine maximum liability. Doing so required a valuation of the ship and its pending freight. The injured customer was the respondent.

Both parties offered expert valuation testimony, and both sides tried to exclude the opposing expert under Federal Rule of Civil Procedure 702 and applicable case law.

The ship. The petitioners acquired the ship in 2001 for $525,000. The vessel was built in 1929 and was unique. Both parties agreed there was no active market for it.

The petitioners changed the ship's use from catering exclusively to private events to offering harbor cruises for tourists. In 2001, the ship's annual revenue was about $250,000.

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Ultimately, the court found this data point was not meaningful to a 2011 valuation in part because the vessel under the petitioners' ownership came to serve a different market.

In 2002 or 2003, the vessel was severely damaged and had to be substantially rebuilt over the following three or four years. Reconstruction amounted to about $700,000, including legal and other costs. By 2006, the vessel generated revenue again. The rebuilding extended the useful life of the vessel.

A 2009 valuation of the vessel for financing purposes stated its value as $300,000. At the time, the owners/petitioners believed this value was too low.

In 2011, gross revenue was about $635,000 and net income about $125,000. Tax returns (2006 Federal Depreciation Schedule) valued the vessel at $525,000. The court observed that the generally accepted method to calculate depreciation is to reduce the value of the vessel by 10% of its original value for the first five years of its useful life. Then the base value becomes 50% of the original value and annual depreciation continues at a 10% rate.

The petitioners' expert opinion. The petitioners' expert had more than 30 years of experience working as an engineer at a marine consulting firm that appraised marine vessels. He had performed the 2009 valuation and, for purposes of this litigation, adhered to the $300,000 value determination, finding there was no meaningful change between 2009 and 2011.

He and the opposing expert agreed there were three generally accepted valuation methods: (1) the comparable sales approach; (2) the income approach; and (3) the cost-minus-depreciation approach.

Under the comparable sales approach, the petitioners' expert pointed to only one other vessel that was slightly more capable and was purchased and made ready for sea for $400,000.

The court found this was not a useful data point or methodology. There was only one comparable sale. Because it was not clear when that sale took place (sometime between 2006 and 2010), the expert was unable to compare market conditions. Also, the expert failed to prepare a comparison between the two vessels. The court found this failure on the expert's part "particularly glaring in light of [the expert's] admission that the [subject vessel] is a unique vessel, and that no other vessel like it is likely to be on the market."

The expert's income-based analysis was "completely unreliable," the court noted. The petitioners' expert claimed the total value of the vessel was $300,000 because it generated $250,000 in annual revenue. He said this calculation assumed there would be 50 trips a year for 50 people at $50 per person. The court noted the math showed the total revenue would be $125,000, not $250,000. What's more, the expert had no knowledge of actual revenue and the claimed $250,000 revenue figure was only half of what was stated in the company's federal income tax returns. The court called the income-based valuation "entirely baseless."

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The respondent's expert opinion. The customer's expert also had extensive experience, working as a marine surveyor and appraiser. He had been in business for nearly three decades.

He claimed the vessel was worth between $750,000 and $850,000. This expert used the 2001 purchase price ($525,000) as a starting point and added to it $700,000 invested in repairs. He then subtracted depreciation.

The court noted the expert inflated the amount spent on repair. It was only between $500,000 and $600,000, and a substantial amount went toward restoring the vessel to its preaccident baseline condition. While the new parts extended the life of the vessel, the repairs did not generate a dollar-for-dollar increase in the vessel's value, the court found. There was no evidence that allowed the court to quantify the length and value of the extension, the court noted. Also, at the evidentiary hearing, the expert asserted the increase in value was $0.50 for every dollar invested. But the court noted the expert did not explain how he calculated the 50% discount. The expert suggested he based this figure on "experience," but the court said there was "almost no data" to which the expert could apply his experience.

The respondent's expert also referenced the insured value, which was $800,000. However, the court noted there was testimony this was a value the petitioners agreed upon with the broker and underwriter. "While the 'agreed-upon' value could track the vessel's market value, it does not have to." The petitioners testified that the vessel was overinsured to provide for replacement and crew costs in case of a major business interruption.

In dismissing each expert's value propositions, the court noted that "[e]xplanations of rationales and calculations were consistently inadequate."

The court's approach. In performing its own value determination, the court used certain data points both experts presented but then drew its own conclusions.

The court found that the comparable sales approach here did not provide a reliable estimate of the vessel's value in 2011 for the reasons stated earlier: there was no active market for comparable vessels from which to obtain reliable sales data.

However, the 2001 purchase price was a "useful reference point" for determining the ship's subsequent value, the court found.

The income approach also was not a useful method here, the court found. A comparison of revenue from 2001 and 2011 was difficult. There was no record of profits from 2001 and the previous owner used the vessel for an entirely different purpose. It was not possible to use revenue figures from 2001 to extrapolate the ship's value in 2011, the court said.

Applying the cost-depreciation approach beginning with year 2006 (after the ship was substantially rebuilt) was "an appropriate alternative," the court found. It noted that the

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accident happened about a year after the petitioners acquired the ship for $525,000. Therefore, the preaccident value was $472,500. Repairs to the ship were completed in 2006 and extended the useful life of the vessel, the court noted. The repair cost was between $500,000 and $600,000, of which the insurance company reimbursed the petitioners for $225,000. The remainder were "value-adds" to the vessel, the court noted. It found the value in 2006 was $797,500. Applying the depreciation formula, the value in 2011 was about $400,000 under this approach, the court found.

It noted the evidence showed the insured value, $800,000, was too high and, based on this data point, put the actual value in 2011 at $550,000.

Ultimately, the court arrived at a value of $450,000 on the valuation date (i.e., the respondent's injury and voyage). It also found the record showed the pending freight on that date was about $2,400.

Motions to exclude denied. In denying both parties' motions to exclude expert testimony, the court explained that, under the applicable case law, expert testimony should be admitted where the court serves as fact-finder. There is a presumption that the judge will know what weight to give the testimony and separate helpful conclusions from those that are not grounded in a reliable methodology. There is no need for the court to be the gatekeeper of expert testimony.

The respondent also tried to exclude the petitioners' testimony under Federal Rule of Civil Procedure 37(c)(1) for failure to abide by the discovery rule (Fed. R. Civ. P. 26). Specifically, the petitioners' expert did not disclose the methodology he used to value the vessel prior to the evidentiary hearing.

Rule 37(c)(1) is a mechanism to sanction a party if it "fails to provide information or identify a witness as required by Rule 26(a) or (e)." Under this rule, the party may not use that information or witness in court proceedings "unless the failure was substantially justified."

The court found the respondent was only "minimally prejudiced, if at all" by the extra-report testimony at the hearing. It noted the petitioners' expert decided not to use the cost-minus-depreciation approach, and the court rejected the expert's testimony as to the comparable sales method. The petitioners' failure to make a timely disclosure was harmless, the court found.

Conclusion. Based on its own value analysis, the court concluded the total value of the ship and its pending freight was $452,400. This was the maximum liability for the petitioners.

* * *

Plaintiff Fails *Panduit* Test Where Lost Profits Analysis Includes 'Far More' Than Value of Patents

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***Sunoco Partnership Mktg. & Terminals L.P. v. U.S. Venture, Inc.*, 2020 U.S. Dist. LEXIS 14994; 2020 WL 469383 (Jan. 29, 2020)**

In this patent infringement case, which featured a protected system for blending butane and gasoline, the plaintiff claimed over $30 million in lost profit damages resulting from the defendant's misconduct. The court rejected the claim, noting the plaintiff failed to satisfy the four-factor *Panduit* test, and instead awarded a significantly lesser amount in reasonable royalty. The court found the plaintiff expert's damages analysis was flawed in that it did not capture the value of the patented invention only. The court also observed that the same expert earlier had been excluded under *Daubert* in a different suit involving the same plaintiff for offering a similarly problematic analysis. One takeaway for experts is that courts and the opposing party keep track of an expert's testifying history, including *Daubert* exclusions.

Backstory. The plaintiff owned five patents related to an automated system for blending butane into gasoline at the last point of distribution, i.e., before tanker trucks move the gas to retail gas stations. Butane is more volatile than gasoline and blending it into gasoline allows cars to start up consistently in colder weather. Because butane is lower in price than gasoline, commercial sellers have an incentive to blend as much of it into gas as possible. However, gas with higher volatility contributes to smog, causing the Environmental Protection Agency (EPA) to impose limits on the level of volatility allowed in gasoline. The plaintiff's patented system was able to blend to the permitted degree by way of an automated system that did not require human involvement.

The inventors first assigned the patents to a company called Texon in early 2000. In 2010, the plaintiff in this suit, Sunoco Partnership Marketing & Terminals LP (Sunoco), bought Texon's butane blending business for $140 million.

The defendant owned gasoline terminals in various states that stored and shipped gasoline and diesel. In 2008, the defendant began research on the development of an automated blending process. When it learned of the Texon system, the defendant negotiated with Texon to provide blending services to one of the defendant's facilities. However, the parties were not able to reach a deal. The defendant then continued to explore alternatives and recruited a different company, Technics (no longer a party to the litigation), to design and install a blending system. By the defendant's own admission, the goal always was to develop an automated way of blending butane into gasoline. Automation was a key feature in the plaintiff's patented system.

During the infringement period (April 2012 to April 2017), the defendant used its infringing system in seven of its terminals. Notably, in 2015, after the plaintiff filed suit in federal court alleging infringements of four patents related to the blending system, the defendant extended the use of its automated blending system from three facilities to seven. The plaintiff later successfully argued to the court that the defendant's conduct showed the infringement was willful and that the plaintiff was entitled to treble damages.

In April 2017, the defendant modified its system in a way that required a human operator to assist with the blending. The merit of the modified system in relation to the plaintiff's

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protected system also was an issue in the litigation, especially regarding the calculation of damages.

Much of the trial centered on the validity of certain patent claims, the question of whether there was infringement, and the extent and nature of damages available to the plaintiff.

Lost profits. The plaintiff sought lost profit damages based on expert testimony that professed to calculate the profit the plaintiff would have made had the defendant not infringed its patents. The expert claimed the total amount of lost profits was about $31.6 million.

This figure was based on the premise that the plaintiff would have signed a butane supply agreement with the defendant and the two sides would have split the profits made from the sale of gas blended with butane. The expert explained that the profit margin was the difference between the price of the extra gasoline that could be sold because it was blended with butane and the cost related to buying, transporting, and blending the butane.

The defendant's expert criticized the plaintiff's analysis, noting that the plaintiff's butane supply agreements did not reflect the value of the patent.

Applicable law. Under the applicable law, a plaintiff seeking lost profit damages must satisfy the four-factor *Panduit* test. Specifically, the plaintiff must show: (1) demand for the patented product; (2) an "absence of acceptable noninfringing alternatives"; (3) "manufacturing and marketing capability to exploit the demand"; and (4) "the amount of profit it would have made." *See Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152 (6th Cir. 1978).

The Federal Circuit has noted that it is difficult to prove damages under *Panduit* and that the second factor "often proves the most difficult for patent holders." *See Mentor Graphics v. EVE-USA, Inc.,*851 F.3d 1275 (Fed. Cir. 2017).

In this case, the parties' disagreement in fact centered on Factor 2, specifically on the issue of whether the defendant's modified blending system (requiring a human operator) represented a noninfringing alternative to the plaintiff's automated system. The defendant argued it did, but the court found this argument "not a compelling one." The court noted that automation was a critical aspect of the plaintiff's protected system and a feature the defendant had, for years, tried to replicate in its own infringing system. The court noted that the defendant's own damages expert stated the modified system cost the defendant 10% more than the automated system; moreover, the modified system required human intervention, which increased the risk of error related to blending. There was testimony that the defendant's human operators asked the company to "scrap[]" the modified system for the automated one.

The court found automation was the "particular feature[] available only from the patented product," which meant the modified system was not "acceptable." Accordingly, the plaintiff was able to show that there was no acceptable noninfringing alternative to its patented system.

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However, the court noted the plaintiff was not able to meet Factor 4 of the *Panduit* test, i.e., establish the amount of profit it would have made but for the infringement. The court agreed with the defendant's expert that the plaintiff expert's calculation based on butane supply agreements failed to separate out the value of the patented system. "But the problem with this analysis is that neither butane nor blended gasoline is the patented invention," the court said. It also noted that neither butane nor blended gasoline constituted a "functional unit," such that the plaintiff would be entitled to the entire market value of the patented and unpatented parts. And the court noted that, under the agreements Sunoco made, it did not require blending partners to use the butane Sunoco provided.

The $31.6 million figure, which the plaintiff said represented lost profits, included much more than just the damage to the plaintiff from the defendant's infringement, the court noted.

It went on to say that "[t]his court is not the first to identify such problems with [the plaintiff expert's] analysis." According to the court, a magistrate judge presiding over another suit Sunoco brought and featuring testimony by the same damages expert granted the defendant's *Daubert* motion to exclude the same expert's testimony for failure "to apportion the value of the patented system in comparison to the value of the butane supply agreements."

The court in the instant case concluded the plaintiff was not entitled to lost profits because it did not meet all the requirements under *Panduit*.

Reasonable royalty. Under the applicable statute and case law, if a plaintiff proves infringement, it is entitled to no less than a reasonable royalty. *See* 35 U.S.C. § 284; *Panduit*.

The court here looked to the common method for determining a reasonable royalty, which is premised on a "hypothetical negotiation" between the parties prior to infringement to achieve an agreed-upon royalty. This approach looks to the *Georgia-Pacific* factors for calculating the reasonable royalty.

The plaintiff's expert determined a reasonable royalty was between $17.1 million and $25.7 million. He estimated that, at the time of infringement, the defendant could expect to make a profit of between $0.40 to $0.60 per gallon of blended butane. Because the plaintiff typically negotiated a 50-50 profit share agreement, these numbers would be half, the expert assumed. He multiplied them by the 85.7 million gallons of butane the defendant blended during the five years in which it infringed to arrive at the proposed total numbers.

In contrast, the defendant's expert proposed royalty damages in the amount of $2 million only. He came to this figure by finding that, using the modified system, the defendant would blend about 10% less butane than if it used the plaintiff's protected system. Moreover, the modified system required a human operator to whom the expert assigned a $200,000 annual salary. During the five-year infringement period, the defendant would have lost about $4.6 million and would have had to pay a total salary of about $1 million to the extra operator, the defense expert calculated. He proposed that $5.6 million was the highest amount the

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defendant would pay to use the plaintiff's patented system. According to the expert, the parties would have agreed to a $2 million license for the plaintiff's system.

The plaintiff countered that this figure was too low considering the plaintiff bought the patented system for $140 million in 2010, two years before the infringement began.

The court rejected the plaintiff's reasonable royalty for a number of reasons. It said the expert's calculation was based on the same flawed analysis as the expert's lost profits analysis—relying on the plaintiff's butane supply agreements, where these agreements covered much more than the value of the patents. Similarly, the court found the $140 million price the plaintiff paid for the butane blending business, included the patents and the existing butane blending contracts, according to testimony from one of the inventors of the patented system.

Because the butane supply contracts included "far more than just patent licenses," the court said it was "difficult to identify how much of that $140 million actually concerned the patents as opposed to Texon's profit sharing agreements."

Finally, the court noted that, when the plaintiff acquired the patents and the rest of Texon's blending business, Texon retained a contract with one terminal. The plaintiff then granted Texon a license for the "Blending Patents" for use in Texon's ongoing relationship with the terminal. Texon paid the plaintiff $0.02 per gallon of each gallon it blended for the terminal. Using the $0.02-per-gallon amount with the 87.5 million gallons of butane the defendant blended during the infringement period results in $1.7 million, the court noted. It suggested this figure was close to the reasonable royalty the defense expert proposed.

The court said it was more persuaded by the defense expert's analysis and awarded the plaintiff $2 million in reasonable royalty.

Enhanced damages appropriate. In addition, the court found enhanced damages were justified because there was sufficient evidence that the defendant willfully infringed the plaintiff's patented system. Under the applicable statute, if a court finds there was infringement, it "may increase the damages up to three times the amount found or assessed." Accordingly, here, the plaintiff was entitled to $6 million plus prejudgment interest, the court said.

* * *

Court Decides *Daubert* Exclusion of Expert Testimony for Failure to Apportion Is Premature

***Pawelko v. Hasbro, Inc.*, 2020 U.S. Dist. LEXIS 738; 2020 WL 42451 (Jan. 3, 2020)**

An inventor of a Play-Doh-like substance brought suit against Hasbro, the toy company, for misappropriation of a trade secret and breach of contract. The company unsuccessfully sought to exclude both of the plaintiff's damages experts under *Daubert*. Two observations

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by the court stand out. The court found an expert's reasonable royalty was not fatally flawed simply because the expert did not analyze every *Georgia-Pacific* factor, where the expert used an accepted industry standard royalty. Further, the court found a damages determination was not automatically inadmissible where the expert did not apportion. Rather, the court said, it was for the jury to hear all the evidence and damages theories and then determine the experts' credibility as to the reasonable royalty in this case.

Backstory. The plaintiff created "Liquid Mosaic," an "arts and craft play system … that made it easy and fun for children to create art projects and decorate by using a unique craft gun. " She signed a nondisclosure agreement with the defendant, Hasbro, a multinational conglomerate that owned toy, board games, and media assets, and made a presentation to generate interest for her product. Hasbro was not interested in a deal but later came out with two product lines, Play-Doh Plus and DohVinci, which, the plaintiff claimed, incorporated components of her "Liquid Mosaic."

The plaintiff claimed Hasbro misappropriated the plaintiff's confidential information and breached the nondisclosure agreement. Hasbro countered that there was no legally protectable trade secret and sought summary judgment on this issue. The court rejected Hasbro's summary judgment motion, finding these were fact-intensive issues that had to be presented to the trier of fact. In other words, the issue should go to trial.

In pretrial motions, including a motion under Federal Rule of Civil Procedure 720 and *Daubert*, the defendant argued that the plaintiff's two damages experts should be precluded from testifying.

Court looks to industry standard. The plaintiff's Expert 1 presented two opinions. In one opinion, she essentially testified that the plaintiff's invention qualified as a trade secret even if elements were already known to the public (and Hasbro) before the plaintiff's meeting with Hasbro if those components in a new form gave the final product a competitive advantage.

In determining the applicable royalty rate, Expert 1 said the general industry standard royalty rate in the toy industry is 5%. That rate drops to 3% for co-branded products. Initially, in her report, the expert said the applicable rate was 5% for Play-Doh Plus. But, at her deposition, the expert changed the rate to 3% after finding out this product was a co-branded product.

Hasbro claimed this testimony was inadmissible because it was not based on an acceptable methodology and was speculative in that the expert did not follow the *Georgia-Pacific* 15-factor framework.

The court disagreed. It explained that, under Rule 702, an expert may testify if his or her "scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue."

Under *Daubert*, a court must determine whether the testimony represents specialized knowledge and whether this knowledge is relevant such that it will help the jury make factual determinations. *Daubert* also provides a list of factors to determine the reliability and

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relevance of the expert's specialized knowledge, including whether the expert's theory can be tested, has been subject to peer review, and has been generally accepted within the relevant community.

In the instant case, the court found the expert based her opinions as to the applicable royalty rate on standards that were generally acceptable in the toy industry. Therefore, the opinions "pass muster under Rule 702."

Hasbro further argued the testimony was unreliable because the expert did not "expound on every *Georgia-Pacific* factor in her report." The court said this failure did not "doom" the expert's opinion. "Because there is an established toy industry standard royalty rate, the Court finds that the fact that [Expert 1] did not focus specifically on *Georgia-Pacific* factors to render her opinions does not make those opinions inadmissible." The court added that cross-examination by Hasbro and the presentation of opposing evidence were the traditional methods for attacking "shaky but admissible evidence."

The plaintiff also offered testimony from a second damages expert (Expert 2) who said the royalty base here was made up of the total net sales of all of Hasbro's products in the DohVinci subbrand and the total net sales of all products sold with the Play-Doh compound. According to this expert, net sales were the gross earnings Hasbro made from the sale of each product line minus returns or discounts. Expert 2 calculated damages to the plaintiff of about $255 million. This calculation included profits from some 25 products that Hasbro sold with Play-Doh as well as all products sold under the DohVinci subbrand earned or to be earned from 2014 through 2023.

The products included elements that Hasbro, not the plaintiff, had invented. According to Hasbro's damages expert, damages to the plaintiff were at most $261,000.

Entire market value claim. Hasbro also contended that the failure by both of the opposing experts to apportion to the invented product made the testimony inadmissible.

The plaintiff argued that both of Hasbro's offending product lines derived from the plaintiff's invention. The invention was the basis for customer demand. Therefore, under the applicable law, the entire market rule exception to apportionment applied. "For the entire market value rule to apply, the patentee must prove that 'the patent-related feature is the basis for the customer demand.'" *See Lucent Techs. v. Gateway, Inc.*, 580 F.3d 1301 (Fed. Cir. 2009).

The court noted that "apportionment in trade misrepresentation cases is a potentially important tool that the parties can give the jury if the jury finds liability and determines that the plaintiff suffered damages." Citing to *Ericsson, Inc. v. D-Link Sys., Inc.*, the court acknowledged that "the ultimate reasonable royalty award must be based on the incremental value that the patented invention adds to the end product." *See* 773 F.3d 1201 (Fed. Cir. 2014) (available at *BVLaw*).

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But the court went on to say that “this is a determination that a jury must make after hearing all the documentary and testimonial evidence.” The court said it could not, at this early stage in the litigation, determine that the decision of the plaintiff’s experts not to apportion was fatal for admissibility of their testimony. There was an assumption that the jury would hear evidence to support the plaintiff’s claim that the entire market value rule exception applied, the court said. Also, the experts might explain how they selected their royalty rate and royalty base to support their damages opinions, the court said. The parties must “equip the jury with reliable and tangible evidence to decide which numbers are more consistent with that evidence and which experts are more credible,” the court said.

The court rejected the defendant’s motion to exclude the plaintiff’s damages experts under *Daubert* and Rule 702.

* * *

Court Affirms Plaintiff’s Showing of Loss of Income Pursuant to Business Interruption Policy

***Binghamton Precast & Supply Corp. v Liberty Mutual Fire Insurance Co.*, 2020 NY Slip Op 02214 (April 9, 2020)**

Filing a business interruption claim has become one of the first remedies businesses suffering from the economic consequences of COVID-19 look to in an attempt to mitigate the damage to their operations. But the process is hardly trouble free, as this pre-COVID-19 case illustrates. Insurers often deny claims, and the case winds up in court, often going to appeal, as happened here. The instant case is helpful in explaining the applicable legal principles underlying the theory of business interruption and making it clear that the success of a claim depends entirely on the individual policy. The issue in litigation often becomes how to interpret the policy. Here, the business owner was able to show a loss of income pursuant to the terms of the policy, the court found.

Backstory. The plaintiff made precast concrete products for the construction industry. Sales were based on custom orders for specific products, not from inventory. Once orders came in, the plaintiff manufactured them based on a tight production schedule subject to contractual deadlines and limited capacity.

The plaintiff had a policy with the defendant insurance company for equipment breakdown. In June 2015, one of the plaintiff’s concrete mixers broke down and caused an interruption in production until the mixer was repaired and was able to resume operation two days later.

In the event of an equipment breakdown, the plaintiff’s policy provided coverage for “actual loss of Business Income during the Period of Restoration” and extra expenses incurred by operating the business during the restoration period. The parties agreed that the restoration period began with the breakdown of the concrete mixer and ended 30 days after repairs were complete.

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The policy also provided that the insurer would “consider the experience of your business before the ‘Breakdown’ and the probable experience you would have had without the ‘Breakdown’ in determining the amount of our payment.” According to the policy, “business income” meant “Net income (Net Profit or Loss before income taxes) that would have been earned or incurred” and normal operating expenses.

The plaintiff filed a claim with the defendant insurer for lost profits resulting from the two days of lost production. The plaintiff explained that, because construction work was seasonal, the plaintiff had to operate its plant close to full capacity in summer. Having the breakdown occur in June meant the plaintiff lost two days of production that it could not make up in summer, resulting in lost profits.

The plaintiff provided the insurer with evidence of the lost production and an explanation of how it calculated lost profits.

The insurer denied the claim, arguing the plaintiff failed to show specific lost sales resulting from the breakdown during the short period following the breakdown.

The plaintiff sued in the New York Supreme Court (trial court) for breach of contract. Both parties then filed summary judgment motions. The court granted the plaintiff’s motion, finding the plaintiff established actual loss of business within the meaning of the policy.

‘Reasonable expectation of the parties.’ The insurance company appealed the ruling to the New York Supreme Court’s appellate division, reviving its argument about the need to show specific sales lost as a consequence of the concrete mixer’s breakdown.

The court’s appellate division disagreed with this interpretation of the policy at issue. Under case law, “[a]n insurance policy must be interpreted to give clear and unambiguous provisions their plain and ordinary meaning.” The appellate division found the policy expressly included profits and losses in its broad definition of business income. However, said the court, neither term (“profits” or “losses”) referred to specific sales or showed an intent to limit coverage under the policy in the way the insurance company argued. The court added that the policy also did not refer to specific sales in setting out the methodology for determining the amount of the insurance holder’s lost business income.

The court noted that, in calculating lost profits, the plaintiff followed the methodology the policy prescribed, i.e., demonstrating production before, during, and after the equipment breakdown and applying its profit margin during the relevant period to the lost production.

In addition, the court noted that, under New York law, the touchstone in interpreting a business interruption policy is the “reasonable expectation of the parties.” The court found the policy “cannot reasonably be interpreted as the defendant argues.”

> To impose a requirement that an insured cannot recover for lost business income under defendant’s policy unless it can demonstrate that an equipment breakdown caused a loss of specific sales during the relatively brief restoration period

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> immediately after the breakdown would, in effect, prevent recovery under the policy by an insured whose business—like plaintiff's—consists of fulfilling contracts after they have been made, rather than upon sales following production.

The court also rejected the defendant's late objection that the plaintiff's claim was not covered under a policy exclusion, noting the defendant had not ever advised the plaintiff this exclusion affected coverage or made this argument in front of the trial court. Rather, the record showed the defendant never argued denial of coverage but, instead, argued the plaintiff had failed to show actual loss of business income.

Moreover, the court dismissed the defendant's argument that the plaintiff suffered no loss of profits because it was able to reschedule any lost production in the next few working days. The court noted the plaintiff showed that rescheduling work meant displacing work the plaintiff would otherwise have performed on those days and having to fit that work into a schedule that was tight due to contractual deadlines, limited capacity, and the short duration of the summer season.

However, the court found the trial court erred in granting summary judgment to the plaintiff on the issue of the amount of damages. Whether the plaintiff mitigated its losses as required in the policy was an issue for trial, the court found. It added that mitigation requirements in business interruption policies also were controlled by and enforceable under the terms of the individual policy.

* * *

Defendants' Force Majeure Defense Related to Hurricane Devastation Does Not Excuse Breach of Contract

***Bayou Place Limited Partnership v. Alleppo's Grill, Inc.*, 2020 U.S. Dist. LEXIS 43960 (March 13, 2020)**

The doctrine of force majeure (aka "act of God" doctrine) has received a lot of attention during the current COVID-19 crisis, which has harmed great swaths of the national and global economy owing to mandatory closures of businesses, breaks in the supply chain, and the diminution of consumer demand. Typically, defendants invoke force majeure to excuse a breach of contract. In the instant case, the defendant restaurant owners sought to invoke force majeure as an affirmative defense to excuse their failure to make timely rent payments pursuant to the controlling lease. The unforeseeable superior force was Hurricane Harvey, the defendants argued. The court found the defendants' argument crumbled under the facts of the case.

Failure to pay rent. The plaintiff was a limited partnership that owned property in Texas that the defendants leased for the operation of a restaurant in Houston. The lease began in August 2012 and was for a term of 10 years. Under the agreement, the defendants had to maintain business interruption insurance to cover 12 months of rent. The contract was subject to Texas law.

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On July 1, 2017, the defendants failed to make payments under the lease. A month later, in August 2017, Hurricane Harvey made landfall in Houston. Businesses closed, and the storm caused damages of over $146,000 to the restaurant. Its basement, which harbored furniture, equipment, electrical systems, and liquor supplies, was completely flooded. Also, the area surrounding the restaurant was temporarily closed, and some of it has continued to be under construction.

The defendants were not able to reopen the restaurant until late September 2018. The business interruption insurance company rejected their claim related to losses resulting from the storm.

The plaintiff filed suit for breach of the lease, arguing the tenants were liable for missed rent payments and late fees totaling nearly $543,000. The defendants admitted they had not made all of the payments but argued that several legal defenses excused their breach, including force majeure. In essence, they claimed Hurricane Harvey was an act of God that caused substantial damage and interfered with their use of the leased property. The defendants asked the court to issue a declaratory judgment that "they be excused from certain obligations to pay rent due to Acts of God."

In response, the plaintiff filed a motion for summary judgment, which the court granted. The court first decided the plaintiff had provided sufficient evidence to establish a breach of contract claim.

As for the defendants' force majeure defense, the court explained that force majeure was a French law term meaning "a superior force." The court noted that Texas courts had recognized that Hurricane Harvey was an act of God and that an act of God event has been described as "caused directly and exclusively by the violence of nature, without human intervention or cause, and [that] could not have been prevented with reasonable foresight or care."

Contractual provision required. The court noted that, under Texas law, claiming there was an act of God is not a legally sufficient argument unless a force majeure or act of God provision is included in a contract binding the parties. "If the contract does not contain a *force majeure* clause, Act of God is not a legal excuse for failure to perform," the court said (citing *Metrocon Const. Co. v. Gregory Const. Co.*, 663 S.W.2d 460 (Tex. App. 1983.))

Here, the court noted, the defendants "directly acknowledge" that the lease at issue did not contain a force majeure clause. Moreover, the court observed the defendants failed to make lease payments almost two months before the storm hit Texas and have continually failed to make payments for the following years and during the litigation. Therefore, Hurricane Harvey was not a valid legal excuse for the defendants' failure to perform under the lease. The force majeure or act of God defense was inapplicable as a matter of law, the court concluded.

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Business Interruption Claim Raises Triable Issue as to Viability of New Business, Court Finds

***Optical Works & Logistics, LLC v. Sentinel Ins. Co.*, 2020 U.S. Dist. LEXIS 53987 (March 26, 2020)**

As the impact of the COVID-19 crisis on business activity has come into relief, business owners struggling to keep companies operating have turned to business interruption insurance to stay afloat. The instant pre-COVID-19 case shows what happens when the insurer denies the claim and the case proceeds to court. This case also points to opportunities business interruption disputes present for damages and valuation professionals, particularly on the plaintiff's side. Ideally, financial experts become involved in the early stages of a case, where they can provide analysis in support of a damages claim and increase the chance of keeping the claim alive.

Claim denied. The plaintiff was a fledgling Rhode Island optical media company that made replicas of DVDs and CDs for the education and healthcare markets. The company had invested in expensive, specialized machinery and ultrasensitive equipment by setting up a special room ("clean room") in a building the company rented. There were unpaid construction bills and rent payments as the company tried to make a go of it. The company had an all-risk property and business interruption policy with the defendant insurer.

The company began operations in July 2011 and August 2011. One month later, Hurricane Irene as well as Tropical Storm Lee hit the area, resulting in roof damage and water leakage into the company's clean room. The water damaged equipment and documents. The company tried to mitigate the damage and hired a company to fix the roof. Ultimately, the business owners decided they had to move the equipment off-site. In the end, the company concluded it could not stay in the building and moved operations.

The plaintiff claimed it had notified the business interruption insurer almost immediately, but the insurer disputed this, arguing it received late notice. The insurer only sent an adjuster in October 2011 who informed the company by letter that the insurer was investigating various coverage issues, including the cause of the water damage and whether conditions were sufficiently bad for the company to leave the property. The insurer sent three consultants to determine the cause of the loss to the building, the clean room, the equipment, and documents. Ultimately, the insurer denied the claim.

The plaintiff filed suit for breach of contract and bad faith on the insurer's part. The defendant filed for summary judgment. The plaintiff contended that, while losses could have been limited to between $50,000 and $75,000 had the insurance company provided prompt coverage, damages rose to over $4 million and ultimately resulted in the company's insolvency.

The insurer in essence claimed there was no breach of contract because the company did not suffer the kind of damage covered under its business interruption policy. The insurer

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also argued the company did not make a proper claim as required under the terms of the policy.

Question as to normal operating expenses. The court found summary judgment in favor of the defendant was inappropriate because the case raised too many issues of material fact that "are better left for a trier-of-fact to decide."

"The purpose of business interruption coverage is to ensure that a business has the financial support necessary to sustain its business operation in the event disaster occurred," the court said, citing case law. (internal citation omitted)

The court then looked at the plaintiff's individual policy to determine the coverage the company had. Coverage included "continuing normal operating expenses incurred" after and because of the event causing the loss; physical damage to the property; extra business expenses incurred as a result of the loss; and damage to valuable papers, computers, and media.

The court noted the policy provided coverage during the restoration period, i.e., from the date of the direct physical loss or physical damage until the date when the property should be repaired or replaced with reasonable speed and similar quality or when business was resumed at a new permanent location.

The court said there was a factual dispute between the parties as to whether the post-storm investigation the insurance company performed was proper.

As to the continuing normal operating expenses the company claimed, the court noted the insurer made various assertions that the company was new and was not a viable business even before the storm. There was no evidence of expenses incurred before the storm, the insurer said, and, therefore, the company was not entitled to coverage of continuing operating expenses.

In contrast, the plaintiff maintained its consulting expert projected what expenses it would have incurred had the insurer paid the benefit under the policy and the company been able to successfully continue its operations. Because the insurer denied the claim, the company had to shut down its business, the plaintiff claimed.

According to the court, determining when and whether the company could have resumed normal business operations raised "the type of murky factual question" that was best resolved by a trier of fact.

There were other disputed issues, the court said, including some related to expert witnesses. For example, there were questions as to what operating expenses such as rent and utilities and what extra expenses the plaintiff had incurred. The court noted the plaintiff had submitted financial evidence from its expert as to how much money it would need to replace business property, equipment and machinery, and documents.

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The court concluded that cross-examination was the best way to vet the disputed facts and opinions and that the trier of fact should decide which testimony was most credible and supported by facts. “The Court is sufficiently convinced that a trier-of-fact should decide the outcome of this case.”

* * *

IRS Private Letter Ruling on Whether to Consider Pending Merger in Gift Tax Valuation

Office of Chief Counsel Internal Revenue Service Memorandum, POSTF-111979-17, Number 201939002, Release Date 9/27/2019

Valuation experts working on gift and other tax-related matters will want to be familiar with a recent private letter ruling by the Internal Revenue Service on the issue of when a fair market value determination would consider a pending merger for gift tax purposes. Even though private letter rulings are not precedent, they can provide guidance to financial experts and attorneys on how the agency analyzes issues and what positions it may be expected to take in an audit or litigation setting.

Facts provided. The memo does not provide a lot of facts. Here is what we know.

The donor of the gifted property was a co-founder and chairman of the board of a publicly traded company (Corporation A).

On Date 1, he transferred shares to a grantor retained annuity trust (GRAT) for a certain number of years. (The memo does not state the number of years.) After that period, the remainder of the trust would be distributed to his children.

Following Date 1, on Date 2, the donor’s company announced a merger with another company (Corporation B).

Before Date 1, i.e., the transfer of shares, Corporation A had engaged in negotiations with multiple parties.

Also, before the transfer of shares, Corporation A had held exclusive negotiations with Corporation B. These negotiations eventually culminated in the merger.

After the merger was announced (the IRS memo does not state how many days later), the value of Corporation A stock “increased substantially, though less than the agreed merger price.” The memo does not state when exactly the merger closed.

Issue presented. The memo answered the question of whether, under these facts, a hypothetical buyer and a hypothetical seller of shares in a publicly traded company would consider the pending merger in determining the value of the shares for gift tax purposes.

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In other words, given these circumstances, should a fair market value determination for gift tax purposes account for the pending merger?

Short answer. Chief counsel said yes.

Applicable legal principles. If a gift is made in property, the value of the property on the date of the gift represents the amount of the gift. In other words, the valuation date is the date of transfer (date of gifting).

The value of the transferred property is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the facts."

In other words, the applicable standard of value is fair market value (FMV).

Under the FMV, the willing buyer and the willing seller are hypothetical, meaning they are not the specific donor and donee.

Further, the FMV assumes that the aim of both the hypothetical willing buyer and the hypothetical willing seller is to maximize their economic advantage.

Also, there is a presumption that the hypothetical willing buyer and willing seller ready to engage in a transaction have "reasonable knowledge of relevant facts" as to the property at issue. This presumption applies "even if the relevant facts at issue were unknown to the actual owner of the property."

There is a presumption that both the hypothetical buyer and hypothetical seller made reasonable efforts to investigate the relevant facts.

Besides looking to publicly available facts, this principle assumes reasonable knowledge of "those facts that a reasonable buyer or seller would uncover during the course of negotiations over the purchase price of the property."

There is a presumption that a reasonable buyer would have asked the reasonable seller about information that is not publicly available. In other words, the reasonable buyer would act in a prudent manner.

If a stock or bond is publicly traded, "the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond."

If it is found that the value based on the bid and asked price does not represent fair market value, there may be "some reasonable modification" of the trading price. Alternatively, "other relevant facts and elements of value shall be considered in determining fair market value."

Valuation is a question of fact. In practice, this principle means the trier of fact (e.g., the U.S. Tax Court) has broad discretion and is accorded great deference by the appeals court.

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Law on subsequent events. As a general rule, the valuation hinges on the valuation date (date of gifting) "without regard to events happening after that date."

But, to the extent subsequent events are "relevant to the question of value," they may be considered.

Further, a subsequent event may be considered "if the event was reasonably foreseeable as of the valuation date."

Chief counsel's memo goes on to say that "even if unforeseeable as of the valuation date," an event occurring after the valuation date may be "probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date." (citing *Estate of Gilford v. Commissioner*, 88 T.C. 38 (1987))

To support an argument in favor of accounting for the post-valuation date merger, the chief counsel cites a 1974 Tax Court case, *Silverman v. Commissioner.* According to the memo, in *Silverman,* the Tax Court rejected the taxpayer expert's testimony because it "failed to take into account the circumstances of the future public sale."

Editor's note: More precisely, in Silverman*, the taxpayers, who were controlling shareholders in a corporation, reorganized the company with a view toward a stock sale in a public offering. The first step was to create two classes of stock, nonvoting and voting stock. The taxpayers then gifted nonvoting stock to trusts benefitting their children. Afterward, they reorganized the corporation a second time to create a single class of voting stock. This resulted in one share of voting stock receiving seven shares of a new common stock and one share of nonvoting stock receiving 6.5 shares of a new common stock. The Tax Court found the 65-70 ratio provided a "yardstick with which to measure the value" of the gifted nonvoting stock. In doing so, the court found for the IRS in determining the value of the gifted nonvoting stock. The 2nd Circuit Court of Appeals affirmed, finding the Tax Court's valuation was conclusive and not clearly erroneous.* See Silverman v. Commissioner*, T.C. Memo. 1974-285, aff'd 538 F.2d 927 (2d Cir. 1976).*

In the IRS memo, chief counsel also cites a 9th Circuit case, *Ferguson v. Commissioner*, in which the Court of Appeals affirmed a Tax Court ruling in favor of the IRS that taxpayers were liable for gain in appreciated stock that later was transferred to various charitable organizations. However, this case centered on the anticipatory assignment of income doctrine. The court found the taxpayers had not completed the contributions of appreciated stock before it had ripened from an interest in a viable corporation to a fixed right to receive cash via an ongoing tender offer or pending merger agreement. *See Ferguson v. Commissioner*, 174 F.3d 997.

Application to instant case. Chief counsel's memo maintains that the instant case had "many factual similarities with *Ferguson*" and that, even though *Ferguson* dealt "exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and

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circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through."

Chief counsel's memo notes that, here, the board made a targeted search for merger candidates, there were exclusive negotiations with Corporation B before the final agreement, and an agreement was "practically certain" to go through. A hypothetical willing buyer and willing seller would have knowledge of all relevant facts, including the pending merger, the memo says. "Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation."

* * *

Court Agrees Market Approach Generates Most Accurate Value of Plaintiff's Interest

***Edelson v. Cheung*, 2020 U.S. Dist. LEXIS 56823 (March 24, 2020)**

The issue in this ugly business dispute was how to value the plaintiff's interest in a Chinese entity for which he had an option contract. The plaintiff's expert was an experienced accredited business appraiser and forensic accountant who explained to the court why the market approach was the only viable method under the circumstances. The court found the valuation and methodology entirely credible. On the other hand, the plaintiff's claim for lost profits resulting from the defendant's misconduct went nowhere. The plaintiff's bookkeeper offered a damages calculation the court found insufficiently nuanced even by the relatively relaxed standard that asked for a reasonable estimate of lost sales and lost profits. The court declined to do its own analysis and did not award lost profits. It's not clear why the plaintiff's valuation expert did not also perform the damages analysis.

Backstory. For about 40 years, the plaintiff owned a New Jersey business (Westchester Lace) that made lace that it sold to garment manufacturers. In 2003, for cost reasons, the plaintiff went into business with the defendant to set up a company in China (Eastchester Lace & Textiles, aka EL-China) to produce lace there. EL-China was to manufacture lace for Westchester Lace.

The plaintiff owned a 50% interest in EL-China; the defendant and two others each owned 16.67%. None of the three had experience manufacturing lace. Rather, the plaintiff provided EL-China with expertise as well as Westchester's contracts, methods, name and designs, knitting machines, and a lot of yarn. In addition, the plaintiff organized for the transfer of an expert in the lace and textile industry to EL-China and paid this expert to set up operations at EL-China. After the initial work, this industry expert remained a consultant and regularly returned to EL-China.

In 2005, the plaintiff and the two other owners transferred their interests in EL-China to the defendant. The transfer did not affect the business relationship between Westchester Lace and EL-China. After the transaction, the defendant sold a 10% interest in EL-China without notifying the plaintiff of the transfer.

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In 2006, the plaintiff and the defendant made an agreement under which the plaintiff had the option of once again acquiring a 50% interest in EL-China. The option contract said the plaintiff “may exercise this option at any time.” Meanwhile, Westchester Lace continued to buy EL-China’s lace and provided the latter with a stream of revenue.

Around 2012, the defendant and a former employee of the plaintiff’s Westchester Lace company developed a plan to start their own business in the U.S. Contemporaneous emails showed the aim was “to put [the plaintiff] out of business” and “grab all business from [Westchester Lace].” As part of the plan, on June 3, 2013 (the valuation date), the defendant sold EL-China to a third party while keeping the plaintiff in the dark and thus preventing the plaintiff from exercising his option to buy back his interest in EL-China.

Moreover, the defendant and the former Westchester Lace employee set up a business in New York (EL-NY) that competed directly with Westchester Lace. The plaintiff only learned of this development in August 2013, after he had emailed the defendant that the employee had resigned from Westchester Lace and was working for another company. At the same time, the defendant took steps to undermine Westchester Lace by accelerating the dates payments to EL-China were due and contacting customers of Westchester Lace to ask them to order directly from EL-China as EL-China “would no longer accept orders through Westchester Lace.”

Even after becoming “aware of this betrayal,” the plaintiff continued to pay for the consultant, who in turn was still working for the defendant and EL-China.

In 2013, the plaintiff sued the defendant asserting a host of claims. Only the claims for breach of the covenant of good faith and fair dealing and the fraud survived.

The basis for the breach of the covenant of good faith and fair dealing claim was the sale of EL-China and the formation of EL-NY with the express purpose of putting the plaintiff out of business. The plaintiff asked for the value of his 50% interest in EL-China. In addition, he asked for damages to Westchester Lace (lost sales and lost profits) resulting from the defendant’s breach and fraudulent conduct.

Liability. In a bench trial, the court found the defendant liable as to both claims. The case was subject to New Jersey law.

Regarding the breach of the covenant of good faith and fair dealing claim, the court noted that the option agreement was a legal contract. Under New Jersey law, a party to a contract was bound by a duty of good faith and fair dealing as to performing and enforcing the contract. A party claiming a breach of the covenant has to prove, by a preponderance of the evidence, that the opposing party acted in bad faith in that it “engaged in some conduct that denied the benefit of the bargain originally intended by the parties.”

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The court found the plaintiff met the burden. The facts showed the defendant acted in bad faith "and engaged in conduct that denied [the plaintiff] the benefit of the bargain originally intended by the parties under the Option Agreement," the court said.

As for the fraud claim, New Jersey law requires a showing of: (1) a material misrepresentation of fact; (2) the defendant had knowledge of the falsity; (3) the defendant intended for the other party to rely on the misrepresentation; (4) there was reasonable reliance; and (5) the other party suffered damages.

The court found there was proof of multiple misrepresentations as to the sale of EL-China. One day before the transaction, the defendant in an email wrote to the plaintiff that the company was in bad financial shape and "has no hope at all." A day later, the defendant sold the company and planned to make it the supplier for EL-NY, which he had set up to directly compete with Westchester Lace. When the defendant sold EL-China a day later, the plaintiff lost his 50% ownership option, the court noted. It found the plaintiff proved his fraud claim by clear and convincing evidence.

The court found the plaintiff was entitled to the value of his ownership interest.

Value indicators as to EL-China. There were several indicators as to the value of the 50% interest in EL-China.

One was a valuation the industry expert who served as a consultant to EL-China for a number of years had prepared at the request of the plaintiff. Using the date of sale (June 3, 2013) as the valuation date, this expert testified that he had valued the factory's equipment and parts at about $1.2 million. He said this was a conservative estimate.

The court found the witness's valuation testimony was credible. He "gave good reasons for his valuation and also credibly explained when he erred on the side of providing a conservative amount."

The defendant testified he sold the company for $100,000. The court noted there was no evidentiary support for this testimony. Further, Westchester Lace's bookkeeper testified "credibly" that Westchester Lace owed EL-China almost $348,000. The court said the defendant did not explain why he would sell the company for $100,000 while it was owed $348,000.

Further, the court noted, the defendant only produced one record speaking to the financial situation of the company. It included a statement by the defendant that factory sales for 2012-2013 totaled over $5 million. Also, the court said, "[T]he fact that [the defendant] established EL-NY in reliance on EL-China's manufacturing before selling EL-China renders [his] claim as to EL-China's financial status incredible."

The court found valuation testimony from the plaintiff's expert, a CPA with extensive experience in business valuation and forensic accounting, to be the most reliable and credited his value determination.

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The expert found the fair value of the plaintiff's interest was about $2.3 million. He stated there were three valuation approaches—income, asset, and market approach—and explained why he determined the market approach generated the most accurate result.

The expert explained that he was unable to use the income approach because he was not provided with financial statements or tax returns. He also said the asset approach was "essentially the floor value of the company." Relying on the consultant's $1.2 million valuation of the equipment EL-China owned on the valuation date, the expert said this was the amount shareholders would get if the company were liquidated, its asset were sold, and its liabilities were paid off. The expert explained that there are other, intangible assets such as customer lists and supply chains that "help drive cash flow that results in a value that's higher than a net asset value." The asset approach did not capture that value.

The expert found the market approach was a more appropriate methodology. He used the Capital IQ database to identify 19 publicly traded and privately held companies that were active in the same or a similar line of business as EL-China, i.e., manufacturing and textile companies. He identified various market multiples (not specified in the court's opinion) that he applied to data about EL-China.

Regarding information on EL-China, the expert reviewed deposition testimony from the parties and the consultant, the consultant's 2013 asset-based appraisal, general ledgers from Westchester Lace (including data on purchases Westchester Lace made from EL-China), knitting machine efficiency reports EL-China had provided to Westchester Lace, a questionnaire including the defendant's responses to a U.S. underwear company, and industry reports.

Based on all of this information, the expert arrived at a business enterprise value for EL-China of $4.6 million. The plaintiff's 50% share, therefore, was worth $2.3 million. The court adopted this valuation.

Unsuccessful lost profits claim. The plaintiff also sought future lost profits for sales lost as a result of the defendant's breach and fraudulent conduct. (The court's opinion is not clear whether the period was 2013 through 2018 or 2014 through 2019; both periods are mentioned.)

Under the applicable law, the plaintiff only had to prove damages "with such certainty as the nature of the case may permit, laying a foundation which will enable the trier of facts to make a fair and reasonable estimate." The court found the plaintiff had proven compensatory damages on both the breach and the fraud claims. As to both claims, the loss by the plaintiff of the opportunity to exercise the option agreement was a "reasonably certain consequence" of the defendant's misconduct.

The court noted the plaintiff took an all-or-nothing position by attributing all losses to the defendant's misconduct. In calculating lost profits, Westchester Lace's bookkeeper used

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2013 as a "baseline" for sales and subtracted sales in the following years. She calculated a profit margin of 25.9% and applied it to the lost sales figure.

The court said it had concerns as to the bookkeeper's methodology. Regarding the base year, the bookkeeper did not account for the wide fluctuations in Westchester Lace's sales in the years leading up to 2013. However, it was necessary to do so, the court said.

As for the claimed lost profits, the bookkeeper did not consider other reasons for the loss of sales, including market conditions, the court noted. At a minimum, she needed to explain why other factors did not cause the losses to Westchester Lace. The court noted the bookkeeper claimed one client stopped doing business with Westchester Lace "entirely as a result" of the defendant's actions. But, said the court, the plaintiff failed to show how much profit the company lost as a result of the loss of this particular client. Also, there was evidence from the defendant that EL-NY was in business for a short time. Even if the court viewed this evidence "with a jaundiced eye," it noted the plaintiff did not present contrary evidence.

In sum, the plaintiff was required to offer a reasonable estimate of lost sales and lost profits. Such an estimate would have accounted for market conditions and other factors, the court said. It also would have included a breakdown of lost sales by some category, "such as by customer or by year," the court said. The court added that it was not in a position "to attempt such a task" and awarded no damages related to lost sales or lost profits.

The court also noted that the $2.3 million award was compensation either for the breach claim or the fraud claim. The plaintiff would not be able to have a double recovery, the court noted.

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ECONOMIC UPDATE AT A GLANCE

The U.S. economy—as indicated by GDP—contracted at an annual rate of 4.8% in the first quarter of 2020, with economist's comparing the economic damage caused by the spread of the coronavirus to that of the Great Depression. The report noted that the second estimate for the first quarter 2020 data, which will be based on more comprehensive economic data on the impact from the coronavirus, will be released later in May. In 2019, GDP grew at an annual rate of 2.3%.

Total government spending grew 0.7% in the first quarter, which is slower than the rate in the prior quarter, when it grew 2.5%. Private fixed investment, which includes residential and business spending, decreased 2.6%, faster than the decline of 0.6% in the fourth quarter of 2019. The trade deficit increased in March, coming in at $44.4 billion, up from the $39.8 billion reported in February but less than the $48.6 billion reported in the fourth quarter of 2019. The March increase in the goods and services deficit reflected an increase in the goods deficit of $4.6 billion, to $65.6 billion, and a decrease in the services surplus of $0.1 billion, to $21.2 billion. Over the past 12 months, the goods and services deficit decreased $28.1 billion, or 17.8%, and exports decreased $21.7 billion, or 3.5%. Imports decreased $49.7 billion, or 6.4%.

The Leading Economic Index decreased 6.7% in March, to 104.2 points, the largest monthly decline in the 60-year history of the index. As a result, the index for the six-month period ending in March decreased 6.6%, which is equivalent to a 12.8% annual rate. In addition, the weaknesses among the leading indicators have become very widespread. The report suggests that the declines in stock prices, consumers' outlook on economic conditions, manufacturing new orders, average workweek in manufacturing, and rising unemployment claims will begin to negatively impact the economy.

The employment situation summary in March reported losses of 701,000 jobs from the economy, with figures depicting only the beginning of the labor crisis caused by the coronavirus. The March report was the first monthly decline since September 2010. Furthermore, revisions for the prior two months showed 57,000 less jobs than originally reported.

In a separate report, the Labor Department said initial claims for state unemployment benefits were at 6,648,000 for the week ending March 28. The figures for the last week of March established a new record high for unemployment claims, which had been established only the week prior.

The unemployment rate increased 0.9 percentage point in March, to 4.4%, which is its highest rate since August 2017. The jump in the March rate was caused by employers beginning to cut payroll due to the coronavirus pandemic. For perspective on the economic damages the virus caused, the unemployment rate in the month prior was the lowest rate in 50 years. The U6 unemployment rate increased 1.7 percentage points, to 8.7%, its highest rate since March 2017.

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Wages increased 11 cents in March, to $28.62. Real average hourly earnings, seasonally adjusted from March 2019 to March 2020, increased 0.86 cents, or 3.1%.

In the first quarter, the Federal Open Market Committee (FOMC) met three times, as the spread of the coronavirus allotted for two unscheduled meetings. In the first meeting, which was regularly scheduled, it was announced that the FOMC would maintain the federal funds rate at between 1.50% and 1.75%. In determining to maintain the existing level, the committee noted that, although job gains were solid, the unemployment rate remained low, and household spending continued to rise at a moderate pace, business fixed investment and exports remained weak. The meeting notes also referenced that, since inflationary pressures remained below the 2.0% objective, the current monetary policy is appropriate to support sustained expansion of economic activity.

During the second meeting of the quarter, which was unscheduled and came about as the spread of the coronavirus threatened the U.S. economy, the FOMC voted to lower the federal funds rate 0.50 percentage point, to between 1.00% and 1.25%. The committee noted the evolving risks caused by the coronavirus and the need to support and achieve maximum employment and price stability as the reason for lowering the target range for the federal funds rate.

The FOMC called the third meeting, also unscheduled, as the spread of the coronavirus across the U.S. worsened, causing extensive economic damages, notably to small businesses, the labor force, and global energy markets. At this meeting, the committee voted to further lower the target range of the federal funds rate to between 0.0% and 0.25%. The committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.

The Consumer Confidence Index fell sharply in March, as the economic impact of the coronavirus deteriorated the short-term outlook of the U.S. economy. The March score fell 12.6 points, to 120.0, but managed to report higher than forecasts of 110.0 points, according to a poll by the Dow Jones. The report did, however, note that the decline in March is more in line with a severe contraction rather than a temporary shock and further declines are likely to follow. Consumers' assessment of current conditions decreased modestly, by 1.6 points, to 167.7 points, but the expectations component plummeted by 19.9 points, to 88.2. The Consumer Sentiment Index decreased 11.9 points in March, to 89.1 points. Survey respondents noted that the score in March was the lowest monthly score since October 2016 and was the fourth largest monthly decline in 50 years. At the time of the survey, 8% of those surveyed mentioned the coronavirus as a concern to the current economic expansion. However, by the end of the month, that percentage increased to 20%, due to the steep declines in the stock market indexes as well as the warning by the CDC. At its peak, consumer sentiment levels averaged 105.3 from 1997 to 2000.

The Wells Fargo/Gallup Small Business Report published its first-quarter survey, which highlighted a softening in optimism in the first quarter, although the overall score suggests that small-business owners remain confident in their businesses and the U.S. economy. The

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survey fell 10.0 points from the record high of 142 set in the fourth quarter, to 132.0. The key drivers for this quarter's index include:

- *Attracting new business:* Eighty-two percent of small-business owners indicated attracting new business was their top challenge. The biggest challenges business owners face when trying to attract new business included the basics of finding and then retaining new customers, creating the right mix of advertising and marketing, dealing with competition for customers, keeping prices low, customer service and staffing, and having enough money to run the business effectively.

- *Technology:* Ten percent of owners said that technology was their highest challenge, ranking second in this quarter's survey. Small-business owners cited cybersecurity issues and keeping up with the latest technology and computer updates as concerns.

- *Taxes:* Ten percent of small-business owners indicated that tax matters remain a challenge in the current quarter.

Despite the decline, the latest survey findings suggest that small-business owners continue to feel confident about the economy and the future of their businesses. The Present Situation score of the report decreased 4.0 points for the quarter, to 63.0 points, and the Future Expectations score decreased 6.0 points from last quarter, to 69.0 points.

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 increased 4.7 points in the first quarter, as the RSM U.S. Middle Market Business Index came in at 132.0 points. The rise in the first quarter indicates that economic sentiment among middle-market businesses strongly improved. The index received a boost from improvements in gross revenues and net earnings. However, responses to the RSM US Middle Market Business Index survey were aggregated before the economic impact of the coronavirus. The survey lowered its forecast by 0.2%, to 0.3%, for GDP growth, which now is expected to increase 1.0% in the first quarter.

The manufacturing sector decreased 1.0 percentage point in March, to 49.1%, as measured by the Institute for Supply Management's manufacturing index. The decline to the index is attributed to the spread of the coronavirus with comments from those surveyed expressing a negative near-term outlook. The score in March ends the expansion in the manufacturing economy at two consecutive months. Despite the decline, the reading indicates the **overall economy** grew for the 131st consecutive month. A reading above 50% indicates that the

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manufacturing economy is generally expanding, while a reading below 50% indicates that it is generally contracting. Over the past 12 months, the PMI has averaged a reading of 50.0%.

The Federal Reserve reported that total industrial production fell 5.4% in March, as the spread of the coronavirus forced many factories to suspend their operations late in the month, resulting in most major industries posting declines. At 103.7% of its 2012 average, total industrial production in March was 5.5% lower than its level from one year ago. Capacity utilization for the industrial sector decreased 4.3% in March, to 72.7%, a rate that is 7.1 percentage points below its long-run (1972-to-2019) average.

As measured by the Institute for Supply Management's services index (NMI), the services sector decreased 4.8 percentage points in March, to 52.5%. Despite the decline, the March figure represents continued growth in the nonmanufacturing sector for the 122nd consecutive month and the overall economy for the 128th consecutive month. The index's decline in March is attributed to the economic damages caused by the spread of the coronavirus. Survey respondents cited the impact of the virus on daily operations, with staff shifting to telecommuting and customer concerns shifting from normal activities to preventative measures. 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. Over the past 12 months, the NMI index has averaged 55.0%.

Stocks endured their worst month in over a decade, which put an end to the bull market. Investors' concerns over the coronavirus outbreak led to the Dow Jones Industrial Average falling 13.6%, the S&P 500 Index falling 12.4%, the Nasdaq Composite falling 10.1%, the S&P MidCap 400 falling by 20.3%, and the Russell 2000 falling by 21.7%. Due to the spread of the coronavirus and uncertainty over the economic damages, volatility skyrocketed in March as the Chicago Board Options Exchange Volatility Index ranged between 24.9 and 85.5 and produced a monthly average of 57.9 that is higher than the 15.4 annual average in 2019.

During the first quarter, the yield on the benchmark 10-year U.S. Treasury bond fell sharply. At the start of the quarter, the 10-year Treasury yield was 1.88%; by the end of the quarter, the rate was 0.70%.

Housing starts decreased 22.3% in March but are 1.4% above the figures from one year ago. The decline in March came as the spread of the coronavirus and subsequent shutdown of nonessential businesses put housing construction projects on hold. The March figures were at 1.216 million units. Decreases were seen in two of the four regions, with the Northeast region falling 32.1%. Building permits authorized, which measures how much construction is in the pipeline, fell by 6.8% in March but is 5.0% above the level of a year ago. The adjusted annual rate was 1.353 million. Building permits fell 12.0% for single-family homes but increased 5.2% for multifamily homes.

Existing-home sales decreased 8.5% in March as the coronavirus kept potential buyers away. The decline in March ended the momentum created in February, when the monthly

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rise led to its highest level since February 2007. Distressed home sales were 3.0% of sales in March, which is up 1.0 percentage point from February and unchanged from one year ago. In March, the NAHB/Wells Fargo Housing Marking Index fell 2.0 points, to 72.0, but the index's score was calculated prior to the shutdown due to the coronavirus. All three HMI components decreased in March: The component measuring current sales conditions fell two points, to 79.0; the component gauging sales conditions over the next six months fell four points, to 75.0; and the component that measures buyer traffic fell one point, to 56.0.

The National Association of Realtors' Realtors Confidence Index for current conditions decreased 33.0 points for single-family homes, to 40.0 points, in March (strong = 100; moderate = 50; weak = 0). The RCI for the outlook for townhomes decreased 26.0 points, to 34.0, and the outlook for condos decreased 25.0 points, to 31.0. The RCI is a key indicator of housing market strength based on a monthly survey of over 50,000 real estate practitioners. Practitioners are asked about their expectations for home sales, prices, and market conditions.

The National Association of Realtors' most recent "Commercial Real Estate Trends and Outlook," which analyzed the small commercial real estate market in the first quarter of 2020, found that sales volume fell at a modest pace of 1.0% in the first quarter when compared to one year ago. Realtors and commercial affiliate members reported a modest dip of 1.5% in leasing volume.

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