Advocate's EDGE

January/February 2008

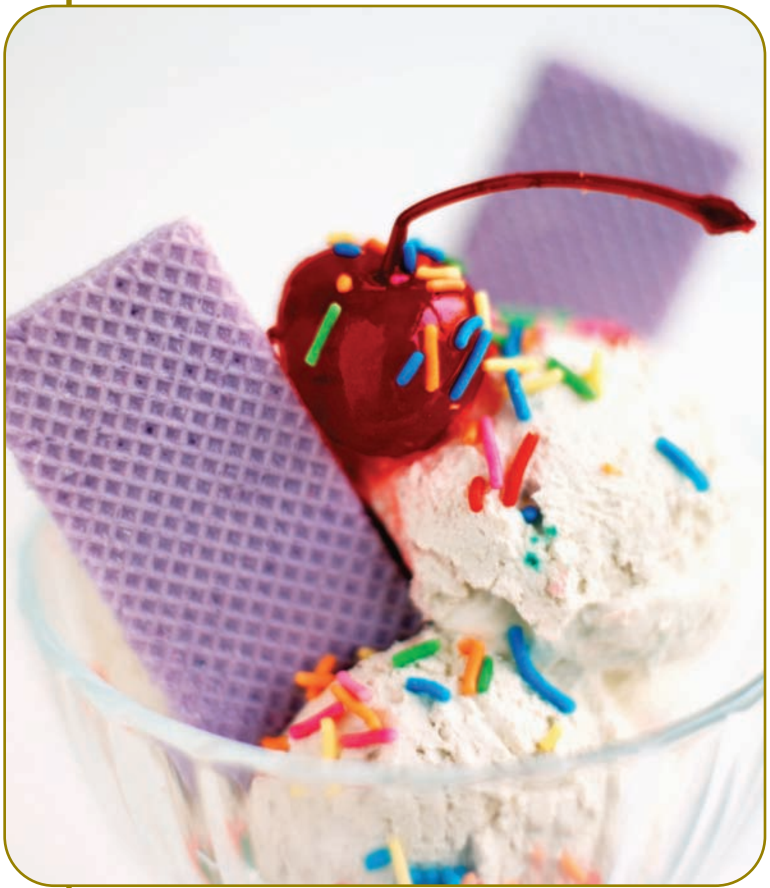
McGOVERN & GREENE LLP

CPA's & Forensic Accountants

A question of relevance

Calculating lost prospective profits

Establishing lost profits for businesses that were never actually operational can prove difficult. In *Parlour Enterprises Inc. v. The Kirin Group*, a California appellate court weighed in on the key factors to consider when calculating prospective profits in such cases. Among other points, the court's decision emphasizes the need to hire qualified valuators.



THE BIG CHILL

From 1963 to the mid-1980s, at various times, 55 to 140 Farrell's Ice Cream Parlours were in operation across the United States. Operations shut down in the mid-1980s, except for one location in San Diego. Then, in 1996, Herman Chan formed a corporation, Kirin, and purchased trademarks and trade names from Farrell's.

Kirin opened a Farrell's in Temecula, Calif., in January 1999, but closed the restaurant in early 2002 because it wasn't profitable. Before the closing, Kirin entered a series of agreements with Parlour Enterprises to develop Farrell's subfranchises in California. Under the agreements, Parlour would receive an upfront fee, as well as royalties based on a percentage of net sales.

The agreements also required Parlour to open a minimum number of restaurants within a certain time period. It opened only one restaurant — in Santa Clarita — in that time, but obtained an extension from December 2002 to December 2003. In October 2003, Kirin terminated the agreements for failure to pay certain attorneys' fees. Parlour sued for, *inter alia*, breach of contract.

BUILDING REASONABLE CERTAINTY

The California Court of Appeal evaluated the defendants' contention that the plaintiffs' expert testimony was too speculative to support the award of lost profits. The court began by noting that, when an established business's operation is interrupted, lost profits damages are generally recoverable. The occurrence and extent of such damages can be ascertained with reasonable certainty from the past volume of business and other provable data relevant to probable future sales.

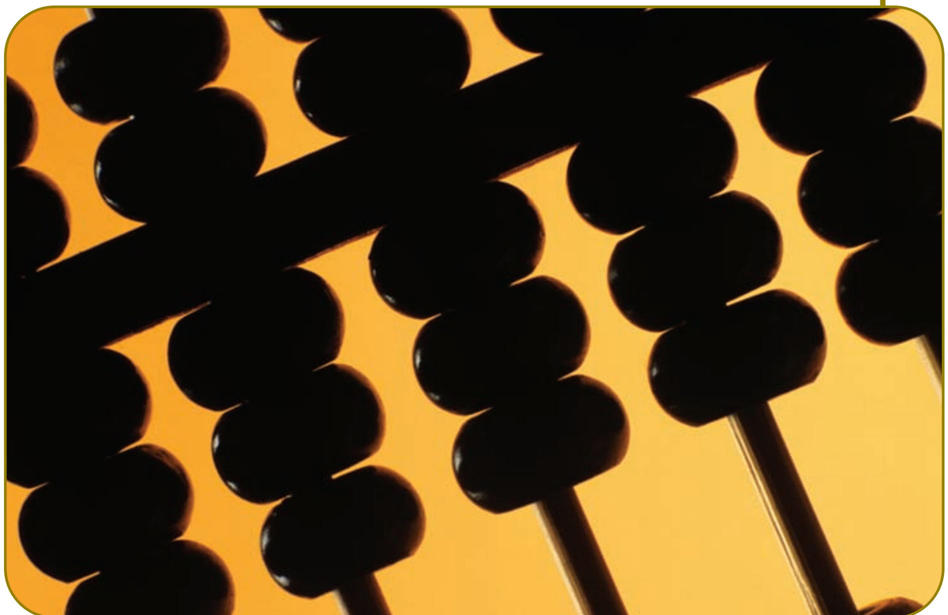
Lost profits damages for unestablished businesses generally aren't recoverable because their occurrence is uncertain, contingent and speculative. But they may be recovered, the court noted, "where the evidence makes reasonably certain their occurrence and extent. … Certainty as to the amount is not required."

The court explained that reasonable certainty as to damages can be built with:

- Expert testimony,
- Economic and financial data,
- Market surveys and analyses,
- Business records from similar businesses, and
- Prelitigation projections, particularly those prepared by the defendant.

The court added that whether the market is established is also relevant. The underlying requirement for each type of evidence cited is "a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed."

Notably, the court observed that expert testimony alone can provide sufficient basis for a lost profits award in a new business context — but only if the expert opinion is supported by tangible evidence with a substantial and sufficient factual basis. Mere speculation and hypothetical situations won't suffice. With these precepts in mind, the court turned to the evidence in question.



SHAKY PROJECTIONS

The plaintiffs' expert based his opinion in part on projections taken from an offering circular Parlour had prepared for potential investors. The circular figures weren't based on those from actual operations, but from Parlour's assumptions over five years. In fact, each of the figures included disclaimers that income and expense estimates might not reflect actual results.

The court acknowledged evidence that Parlour's COO had prepared the projections with the assistance of another officer of the company, and that both of them had extensive experience in the restaurant industry. Neither, however, testified about particular qualifications that permitted him to predict income, expenses or profits specifically for a Farrell's restaurant.

The COO did testify that he had consulted with defendant Chan when preparing the circular projections. Chan conceded this but added that he, the COO and a Parlour shareholder had "backed into [their] numbers" to appear economically viable.

Ultimately, the court rejected Parlour's expert's use of the offering projections. And it reiterated that projections must be based on facts substantially similar to the lost business opportunity to be relevant and admissible.

QUESTIONABLE USE OF MARKET DATA

The plaintiffs' expert also considered market data on Friendly's Ice Cream Corp., which he asserted was relatively similar to Farrell's because its restaurants offer both ice cream and food. The court countered that "many restaurants serve both ice cream and food; that alone does not make them sufficiently similar to Farrell's for purposes of proving lost prospective profits."

The court found that the expert's "cursory" description of Friendly's business model failed to establish that its profit and loss experience was sufficiently similar to Farrell's to be relevant. It reached the same conclusion regarding the market data for the dozen or so smaller ice cream parlors, which served only ice cream, considered by the expert.

Finally, the court assessed the expert's use of market data from existing Farrell's restaurants and other businesses. The expert didn't use actual numbers from the Santa Clarita location as a starting point for his estimates of lost profits for other locations. And, as to the data from the San Diego location, he presented no evidence on what those figures were or how they affected his calculations. Again, the expert didn't show the required substantial similarity with the locations at issue.

Lost profits damages for unestablished businesses generally aren't recoverable because their occurrence is uncertain, contingent and speculative.

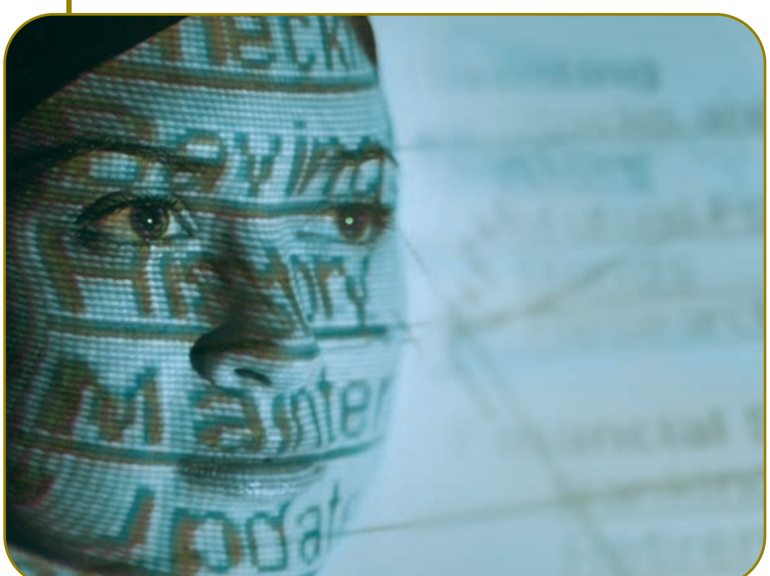
VALUATOR SELECTION MATTERS

After applying the factors it outlined, the court reduced the plaintiff's original award from about $6.6 million to $203,000. Don't make the same mistakes made here: Work with qualified valuators who can back up their calculations with solid, relevant and admissible data.

What to expect from the new business valuation standard

The American Institute of Certified Public Accountants (AICPA) has issued a new valuation standard that takes effect for engagements accepted on or after Jan. 1, 2008. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* applies to all AICPA members, including those who perform valuations for certain purposes — including transactions, financings and taxation. Attorneys, however, may be affected by the provisions related to valuation reports.

Aimed at improving the consistency and quality of practice among valuation analysts and promoting greater transparency, the long-awaited standard was released by the AICPA in June 2007. The standard provides CPAs with guidelines for best practices for performance and reporting. And the glossaries of valuation terminology are expected to facilitate more effective communication with clients and other parties who rely on valuation reports.



STANDARDS COVER TWO TYPES

The new standards cover two types of engagements to estimate the value of a business, business interest, security or intangible asset: 1) valuation, and 2) calculation. In a valuation engagement, the valuation analyst applies the approaches and methods he or she deems appropriate to reach a "conclusion of value."

In a calculation engagement, on the other hand, the valuator doesn't employ all of the procedures required for a valuation engagement. Rather, he or she performs the engagement according to the valuation approaches, methods and procedures agreed upon with the client. This results in a "calculated value."

The standard grants an exemption for engagements conducted exclusively to determine economic damages — unless that determination is used to estimate the value of a subject interest (for example, when valuing a company that is the plaintiff in pending litigation involving economic damages). If an expert performs an engagement to estimate value to determine the loss of value of a business or intangible, the standard is applicable.

In the case of a start-up business that has failed, lost profits and loss of value represent two common measures of damages. To determine whether the new standard should be followed, a valuation analyst, acting as an expert witness, will evaluate whether the particular damages calculation constitutes an engagement to estimate value or a lost profits calculation.

ENGAGEMENT REPORTS

Depending on the level of reporting details desired by the client, the standard permits two types of written reports to provide a conclusion of value for valuation engagements:

1. Detailed. This type of report is structured to provide sufficient information to allow the intended users to understand the data, reasoning behind the conclusion and underlying analyses. In addition to standard report elements such as an introduction, table of contents, appendix and exhibits, the report should include, as appropriate:

- A letter of transmittal,
- Sources of information,
- Analysis of the subject entity and related nonfinancial information,
- Financial statement and information analysis,
- Valuation approaches and methods considered and used, and any valuation adjustments made,

- Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets,
- Representation of the valuator, or a summary of the factors that guided his or her work,
- Reconciliation of estimates and conclusion of value, and
- Qualifications of the valuation analyst.

The sections should use language similar to that above, but may be positioned in the body of the report or elsewhere at the valuator's discretion.

2. Summary. This type of report is structured to provide an abridged version of the above information. Appendices or exhibits may be used for required information or information that supplements the summary report. And the assumptions, limiting conditions and expert's representation often are provided in appendices.

ENGAGEMENT LETTERS FORM THE FOUNDATION

Attorneys aren't the only professionals who rely on engagement letters. CPAs, too, use these documents — particularly with business valuation engagements.

To benefit all parties involved, the letter should be drafted before the work actually begins and expressly describe the parameters and limitations of the services to be rendered during the engagement. For a business valuation, the letter must list the name of the party retaining the accountant, the subject asset, the purpose of the valuation, any assumptions and conditions, timing requirements, and the fees and billing schedule. It also should specify the applicable professional standards and reporting format.

Finally, an engagement letter should state that all communications are incidental to the provision of legal services and intended to remain confidential. To maintain attorney-client privilege, the letter should prohibit disclosure of confidential information to third parties and note that all documents are the property of the attorney.

For calculation engagements, a so-called calculation report is the only acceptable format for conveying results. The report should identify itself as a calculation report and include the valuator's representation; describe any hypothetical conditions or specialists' contributions (such as input from a real estate appraiser) incorporated; and include a section summarizing the calculated value.

GOING FORWARD

The new standard recognizes an exemption from the reporting requirements for valuations performed for matters already before a court, arbitrator or mediator. It also exempts matters in governmental or administrative proceedings where the jurisdictional exception applies. Otherwise, begin preparing for the new standard. ◗

E-mail evidence: Handle with care

In many, if not most, businesses, e-mail is the preferred communication tool these days. As such, it has assumed a prominent evidentiary role in all types of litigation. Proper handling of e-mail evidence is critical — the consequences of improper handling can range from sanctions to adverse jury instructions to devastating damages awards.

PIVOTAL LITIGATION ROLE

E-mail has played a pivotal role in cases involving sexual harassment, racial discrimination, copyright infringement, trade secret infringement and privacy issues. It can be used to demonstrate intent, offers and acceptance, and security breaches. Further danger stems from e-mail's volume, ease of replication, searchability, hidden data, casual and unguarded nature, and difficulty of deletion.

In the normal course of business paper documents are routinely shredded. E-mail, however, lives on. A single e-mail message can generate multiple copies and land:

- In the sender's sent or deleted folder,
- In the recipient's inbox or deleted folder,

FORENSIC INTERVENTION

Clients who aren't knowledgeable about the location and accessibility of their e-mail can encounter significant hurdles when executing a litigation hold. These businesses, in particular, benefit from early intervention by a forensic expert. The expert can conduct a thorough review of the company's practices and procedures and develop an accounting of the business's reasonably accessible e-mail. This inventory plays an integral role in crafting an effective litigation hold and discovery response.

A forensic expert — keeping in mind legal requirements and implications — also can copy employees' hard drives, PDAs and cell phones that might harbor e-mail. The expert also might advise the company to halt its rotation of backup tapes to preclude copying over e-mail evidence.

- On the sender's and recipient's hard drives,
- On network backup systems, and
- On backup tapes archived for those systems.

If the message is sent or received by webmail, copies may reside on the service provider's servers, and on the hard drives of any computers used to access the webmail. If a PDA was involved in the communication, a copy probably exists there, as well.

PRESERVE AND PROTECT

As an ongoing precaution, your clients need to keep their e-mail secure. Backup tapes are especially vulnerable to tampering, so advise your clients to consider adopting real-time archiving. It makes their e-mail more resistant to interference and enables compliance officers to quickly identify policy violations. Real-time archiving also may eliminate the need for e-mail recovery services later on.

Once litigation arises, minimize the risk of discovery violations, such as the loss or alteration of e-mails. First, determine the scope of the discovery request, so you can identify the e-mails that must be preserved. Then promptly issue a litigation hold that immediately suspends the client's routine document retention and destruction policies and institutes measures to preserve e-mail in its original format.

Several methods may be used to collect data from preserved e-mail. Your forensic expert can provide recommendations based on the company's computer systems and volume of e-mail. The collection process must be documented in a legally defensible manner and avoid alteration of evidence. Forensic experts can analyze the e-mail using keywords, timelines, relationship diagrams and other mechanisms to help you determine the evidence's potential repercussions.

Danger stems from e-mail's volume, ease of replication, searchability, hidden data, casual and unguarded nature, and difficulty of deletion.

REDUCING THE RISK

E-mail evidence appears to be with us for the long haul. With the assistance of a forensic expert, you can anticipate the potential effects — negative and positive — of e-mail evidence and reduce the risk of sanctions, or worse.

All's fair?

Court rules on standard of value in shareholder dispute

Fair value vs. fair market value — the difference might sound semantic, but it's not. The recent decision in *Kim v. The Grover C. Coors Trust* demonstrates the dramatic consequences that the very different standards of value can create.

GENESIS OF THE DISPUTE

The plaintiff owned common stock in Graphic Packaging International Corporation (GPI). Before the transaction at issue in the case, the Coors family owned 47% of the GPI common stock and controlled the company.

GPI acquired the assets of another company in 1999, financing the acquisition with a credit agreement that required it to repay $525 million within one year. GPI planned to fund a large portion of its obligation with proceeds from the sale of a paperboard mill, but the sale fell through. Facing a substantial payment, GPI sold 1 million shares of convertible preferred stock to the Grover C. Coors Trust for $100 million. Jeffrey and William Coors were both trustees of the trust and directors of GPI.

The plaintiff filed suit, individually and on behalf of similarly situated shareholders. He alleged that the defendants — all associated with the Coors family — manipulated the sales transaction to dilute the value and voting rights of minority shareholders while increasing the ownership and value of their own shares.

THE VALUATION ISSUE

The plaintiff maintained that the defendants' expert improperly applied a discount to the value of GPI's controlling stock, thereby undervaluing the stock's value in his testimony. The plaintiff cited an earlier Colorado appellate court decision holding that it's improper to apply a minority discount in "dissenters' rights actions" under the state's version of the Model Business Corporation Act (MBCA) except in "extraordinary" circumstances.

The Colorado Court of Appeals noted here that the previous decision was based on amendments to the definition of fair value in the MBCA provisions governing dissenters' rights actions. The amendments do not allow the use of marketability or minority discounts.

The court held that the present case didn't qualify as a dissenters' rights action and didn't involve the question of the fair value of the dissenters' shares. Rather, "it involves the question of whether a transaction was fair." Fairness in this context is evaluated based on whether — under all of the circumstances — a transaction "carries the earmarks of an arm's length transaction," including whether the company received "full value." In other words, is the transaction based on fair market value?

Having found the MBCA provisions did not apply, the court allowed a discount of 15% to 20% to the value of the controlling stock based on lack of marketability. It concluded that "applying such a discount made the $100 million price fair."

LESSON LEARNED

If fair value had in fact been the appropriate standard of value in *Kim*, the sale price might not have been deemed fair, and the plaintiff may have prevailed. By illustrating the different methods required to determine fair value and fair market value, the case reinforces the notion that the parties to a valuation should clearly define the standard of value at the beginning of an engagement.