# Valuation & Litigation Briefing

MAY/JUNE 2019

*West Plains, LLC v. Retzlaff Grain Co.*

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The U.S. Court of Appeals for the Eighth Circuit recently upheld a $1.5 million damages award for tortious interference with business relationships and breach of the duty of loyalty to an employer. The court found that, though the plaintiff's business wasn't completely destroyed, its expert's calculation of damages based on a total loss of value supported the jury's verdict. Here are the details.

## Postsale misconduct

The owner of West Plains, an agricultural commodity trading business, sold the company to the plaintiff in March 2012. The seller declined the buyer's offer of employment.

One of the business units sold was a small freight brokerage operation, called CT Freight (CT). After the sale, most of CT's employees stayed with the company. Although the employees weren't required to sign noncompete agreements, the buyer had them sign an employee handbook that prohibited "conflicts of interest and disclosing confidential information to a competitor."

**A business may not recover both lost profits and the lost market value of the business.**

CT's top 20 customers generated 70% to 75% of its revenue. Shortly after the sale, the seller began working with CT's key employees to transfer CT's largest accounts to the seller's new company (RFG Logistics). The key employees secretly provided the seller with confidential information, including customer lists,


and recruited CT's employees. In February 2013, 10 of CT's employees submitted their resignations and went to work for RFG Logistics.

The plaintiff's expert testified that, in the months following the mass resignations, CT lost sales from its top 20 customers. Then RFG Logistics, "which previously hadn't had much sales, [had] sales from these same customers."

## Lost business value or profits

The plaintiff's expert testified that the loss of CT's top customers was "effectively a total loss." He valued CT before the mass resignations in February 2013 at $2,131,000, based on the value of "future profits." He also claimed that, by October 2013, CT had suffered $330,000 in "actual losses" in an attempt to "mitigate the damage and rebuild the business."

Before the trial, the defendants filed a motion in limine, seeking to exclude testimony on the expert's total loss theory. The defendants cited cases in other jurisdictions, which indicate that the proper measure of damages is the market value of the business if a business is completely destroyed. However, a plaintiff may be entitled to only lost profits if the business isn't completely destroyed.

## Should you obtain a separate business appraisal review?

The Uniform Standards of Professional Appraisal Practice (USPAP) establish specific standards for conducting appraisal reviews. And several appraisal organizations offer accreditation programs specific to reviews.

However, in practice, appraisal reviews tend to be more informal, and many don't comply with USPAP standards. It's common for a business valuation expert to prepare a written report and then critique the opposing expert's report.

In some cases, there may be significant advantages to retaining a *separate* expert to formally review the opposing expert's valuation, including to:

**Preserve credibility.** Using your primary appraisal expert to critique an opponent's expert may create a perception of advocacy. But an independent reviewer may have greater credibility, especially if he or she is accredited in appraisal review.

**Maintain focus.** Using a separate reviewer allows your primary expert to focus on his or her testimony without the distraction and time commitment involved with evaluating and rebutting the testimony of other experts.

**Minimize scrutiny.** Using one expert to value the business and perform a review gives opposing counsel a second opportunity to cross-examine your primary appraisal expert. This may be damaging to his or her direct testimony.

**Be prepared.** In addition to reviewing the opposing expert's report, an independent reviewer can review your expert's report. This can help you identify potential vulnerabilities and prepare possible explanations before deposition or trial.

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The district court noted that Nebraska law, which applied in this case, was silent on this issue. But it concluded that a plaintiff wasn't required "to show *complete* destruction as a [prerequisite] to recovery on a lost value theory." Instead, the critical inquiry was whether the jury could properly find a causal relationship between the defendants' alleged wrongdoing and the plaintiff's alleged loss in overall value as a going concern, and calculate those damages with reasonable certainty.

On appeal, the Eighth Circuit determined that the district court had committed no error in allowing the plaintiff to present this evidence. It upheld the $1.5 million damages award, concluding that it "was considerably less" than the expert's estimate of business value before the mass resignations, and "reflected an amount a reasonable jury could have believed would fairly compensate [CT]."

### No expert for the defense

In commercial tort claims, financial experts can make or break a case. In *West Plains*, it appears that the defendants offered no expert testimony. Instead, they relied on various legal arguments as to why their conduct wasn't unlawful. If the defendants had hired an independent financial expert, either to rebut conclusions made by the plaintiff's expert or to independently estimate economic damages, the outcome of the case might have been different. ■

# Close-up on goodwill in divorce cases

When divorcing spouses own a private business interest, it complicates the settlement process. A spouse who's active in the business may want to continue participating in day-to-day operations after the divorce is settled. So, it might not be an option to sell the business and split the proceeds. Instead, the business interest must be valued and included — either entirely or partially, depending on state law and legal precedent — in the marital estate.

Once a value has been assigned to the business interest, the parties need to work out an equitable distribution of the remaining marital estate. Often, that's easier said than done. Fortunately, a business valuation professional can help the parties sort through the issues.

## Two components of business value

The value of a business can be broken down into two pieces. First up are tangible (or hard) assets, which include such items as cash, receivables and equipment. These items are typically recorded on a company's balance sheet. The difference between the combined market values of tangible assets and liabilities (such as payables and bank debt) is called net tangible value.

The second component is intangible value. Most intangible assets aren't reported on financial statements because they're generated internally. Moreover, any book values of intangible assets that are reported on the balance sheet are typically from a former purchase. Sometimes estimates used to allocate the purchase price to intangibles vary from the assets' current fair market values, especially if the purchase occurred many years ago.

In general, intangible value equals the difference between the business's fair market value and its net tangible value. Often, divorce courts lump all intangible value into a catchall phrase called "goodwill." Sometimes, goodwill may include other identifiable intangible assets, such as patents, customer lists, brands, leases and proprietary software.

## Divvying up goodwill

How goodwill is treated in a divorce depends on case facts, state law and relevant legal precedent. Some judges may look to other jurisdictions for guidance. State laws and legal precedent vary, but courts generally have three choices when dividing goodwill:

**1. Exclude all goodwill from the marital estate.** Here, the expert separates business value into tangible and intangible components, and only the former is included in the marital estate.

**2. Include all business value in the marital estate.** The business valuation expert makes no distinction between personal (or professional) and enterprise (or business) goodwill.

**3. Differentiate between enterprise and personal goodwill.** Personal goodwill is specifically excluded from the marital estate, but enterprise goodwill is included.

A handful of states have yet to take sides on this issue, and others have made inconsistent rulings on goodwill. Although goodwill is generally associated with professional practices, some states have ruled that other types of businesses — including retailers, manufacturers and construction contractors — also may possess goodwill.

## Enterprise vs. personal goodwill

In more than half the states, goodwill is broken into two pieces: enterprise and personal goodwill. The former is linked to the business itself. Companies with established brand names, accessible locations and an assembled workforce likely possess enterprise goodwill.

Conversely, personal goodwill is inextricably linked to the business owner and can't easily be transferred to a buyer. Personal goodwill is a function of

an owner's reputation, skills and personal efforts. It's also important to consider the age, health and retirement plans of shareholders. Personal goodwill is limited if shareholders are expected to participate in operations only for a short remaining time.

The logic behind excluding personal goodwill from the marital estate is that it represents a spouse's future earnings capacity. Some courts have determined that it's unfair to credit a spouse who's not active in the business for a company's personal goodwill and also award maintenance payments based on the former spouse's future earnings.

## Need help?

There's little consensus across the United States on how courts should divvy up intangibles for divorce purposes. A clear understanding of relevant legal precedent and the theory underlying goodwill allocations can help divorcing spouses achieve equity. Contact a business valuation professional for more information. ■

# Valuing distressed companies

Struggling businesses face different financial challenges than healthy ones do. Business valuation experts must factor these differences into their estimations when valuing troubled companies.

## How do you assess distress?

Regardless of whether a business is healthy or distressed, experts must consider the following three general approaches to value it:

**1. The cost approach.** Under this technique, all assets and liabilities (including off-balance sheet, intangible and contingent) are adjusted to their fair market values.

**2. The market approach.** This approach encompasses methods that derive pricing multiples (such as price-to-revenue and price-to-pretax earnings) by comparing the subject business to similar businesses that have been sold within a reasonable time period.

**3. The income approach.** Value is estimated by converting anticipated economic benefits (earnings) into a present single amount, using a discount rate that's based on the risk of the investment.

When a business is under financial distress, it may be worth more "dead than alive." That is, the business isn't generating sufficient operating cash flow to justify keeping the business open in its current state of operations. It may need to reorganize or liquidate under the U.S. Bankruptcy Code. In these cases, the cost approach may serve as a "floor" for the company's value.

## How much is the business worth in liquidation?

Certain financial trends — such as recurring net losses, declining sales and severely reduced liquidity — may suggest that the business should be liquidated. There are two types of liquidation value: orderly and forced.

As the name suggests, in an orderly liquidation, assets are sold piecemeal over a reasonable period

of time to maximize proceeds. Conversely, forced liquidation value assumes assets will be sold as quickly as possible, possibly at an auction.

When estimating liquidation value, business valuation experts typically start with the balance sheet. The book values of recorded liabilities generally are accurate, but assets may require adjustments to estimate recoverability and current market values.

Experts also must consider the existence of *unrecorded* items. Examples include internally generated patents, trademarks and customer lists, along with warranty claims and pending lawsuits. An expert also must factor in liquidation expenses, such as severance pay and professional fees. An escrow account may be set up for these incidentals before the company distributes liquidation proceeds to creditors and investors.

## What about selling a distressed business?

Distressed businesses have a third alternative, beyond reorganization and liquidation. Some find a strategic buyer who'll pay more than the fair market value under the cost approach to acquire the business or its assets. Potential strategic buyers may include competitors looking to expand market share or supply chain partners who want to become more vertically integrated.

Strategic value is based on a specific buyer's investment requirements and expectations. For example, a buyer may be willing to pay a premium for a company that provides synergies or economies of scale.

## Beyond valuation

Distressed businesses often need more assistance than a simple valuation report. An experienced business valuation professional can help throughout the bankruptcy or reorganization process. For example, experts can help restructure debt, perform solvency analyses and work with court-appointed receivers.

**When estimating liquidation value, business valuation experts typically start with the balance sheet.**

They can also provide guidance to distressed business owners who would prefer to sell to a strategic buyer. Beyond setting an offer price, experts can help identify potential strategic buyers and structure deals to minimize adverse tax consequences. For a full range of valuation and consulting services, distressed business owners and their legal advisors should contact a business valuation professional. ■

# Beyond *Georgia-Pacific*

## How market data can be used to calculate reasonable royalty damages

In intellectual property infringement cases, business valuation experts often use the *Georgia-Pacific* model to determine reasonable royalty rates. But some experts are now embracing a market-based alternative.

## 15 factors

Under U.S. patent law, an infringed patent holder may recover its lost profits, but in no event less than a "reasonable royalty." This is the amount a

hypothetical willing buyer and willing seller would agree on when the infringement occurred.

Under *Georgia-Pacific*, the following 15 factors may be considered:

1. Existence of an established royalty,
2. Rate paid by the licensee for comparable patents,
3. Nature and scope of the license,
4. Licensing policy,
5. Business relationship of licensor and licensee,
6. Effect of selling the product to promote other products of a licensee,
7. Duration of the patent and term of the license,
8. Established profitability, commercial success and current popularity,
9. Utility and advantages of the product over older ones,
10. Nature and benefits of the patented invention,
11. Whether the licensee used the product and the value of that use,
12. The customary industry portion of the profit or selling price,
13. How much profit should be credited to the invention,
14. Hypothetical license negotiation when the infringement began, and
15. Testimony of qualified experts.

It's not always clear where to start the hypothetical negotiation. Possible starting points include 1) royalties received by the patentee for licensing the patent-in-suit, and 2) rates paid by the infringer for the use of other comparable patents.

If this data isn't available, some experts have used a bright-line 25% "rule-of-thumb" rate to start their

analysis. But the federal courts have rejected that approach as fundamentally flawed.

## Market approach

Recently, in *StoneEagle Services*, a federal district court allowed an expert to testify on his use of a market approach to determine a reasonable royalty rate. The expert collected transactions from multiple databases and identified seven licenses he deemed comparable to the license that would have been the subject of the hypothetical negotiation.

The court noted that the Federal Circuit doesn't require experts to apply the *Georgia-Pacific* factors, and "there may be more than one reliable method for estimating a reasonable royalty."

## No one-size-fits-all approach

Using market data can be an effective alternative method of calculating reasonable royalty rates. In 2012, Randall Rader, who was then the chief judge of the U.S. Court of Appeals for the Federal Circuit, commented that the *Georgia-Pacific* factors "were never meant to be a test or a formula for resolving damages issues." Rather, he said, the emphasis should be "analyzing the market occupied by the claimed invention… ." Contact a valuation professional to discuss which method is best for your next infringement case. ■