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Daubert and the Lost Profits Expert: Recent Cases

Can a lost profits analysis ever be too "simple" under the Daubert standard? The answer might be "it depends," as the following three recent court decisions demonstrate.

1. *Coyne's & Co., Inc. v. Enesco, LLC*, 2010 WL 3269977 (D. Minn.)(Aug. 16, 2010)

The plaintiff sued the defendant for tortiously interfering with the contract with its distributor. The defendant challenged the plaintiff's expert under Daubert. His lost profits calculations were "simply rudimentary math" that failed to account for alternative causes of the plaintiff's losses, the defendant argued, and he failed to corroborate sales data provided by the plaintiff, despite their "material difference" from the records the plaintiff produced in discovery.

The court agreed that the plaintiff's expert used a "simple" analysis that did not address "a number of apparently relevant factors." For instance, he did not consider incremental costs, the risk and uncertainly of realizing actual sales, competition, supply chain disruptions, and general economic conditions—including the recent recession. Nevertheless, the court found these weaknesses did not render the expert evidence "fundamentally unsound." Similarly, the differences in the sales data—which amounted to two pages of records—did not undermine his opinion. An expert is not generally required to independently verify all of the underlying records, the court held, and admitted his opinion, subject to cross-examination at trial.

2. *Truman Arnold Companies v. Hammond and Consultants Enterprises, Inc.*, 2010 WL 2982912 (Tex. App.)(July 30, 2010)(unpublished)

The plaintiff sued the defendant for breach of contract to pay commissions for customer referrals. Before trial, the defendant unsuccessfully challenged the plaintiff's expert under *Daubert*, and the jury ultimately awarded the plaintiff approximately $325,000 for actual lost commissions and nearly $500,000 for future losses. The defendant appealed the *Daubert* ruling as well as the damages, claiming the plaintiff's expert relied on flawed records of income and expenses.

The court disagreed, finding that the defendant had produced "unusual" records regarding its customer sales, which significantly understated profits. The plaintiff had made every effort to obtain more specific records, but its expert ended up having to rely on the defendant's documentation. Any resulting gap between the data and the expert's analysis did not render it unreliable, and the court sustained its admission under *Daubert*. It also found the jury's award of actual damages ($325,000) fell within the range of expert evidence presented at trial.

At the same time, plaintiff did not establish that any of its current referrals intended to buy from the defendant in the future. Moreover, the plaintiff's expert had specifically declined to offer an opinion on future damages. Instead, he simply extended the actual damages amount into the future, discounted back to present value, so the jury might use his figures if it determined future damages were warranted. As such, the court found the evidence insufficient to support lost profits damages and reduced the jury's award by $500,000.

3. *Gresh v. Waste Services of America*, 2010 WL 3475580 (E.D. KY.)(Sept. 1, 2010)

The plaintiff held stock options in a closely held company, which amounted to a 5% interest. He sued the majority owners for preventing him from exercising the options until after they sold the company and claimed over $500,000 in damages, including prejudgment interest. The defendants challenged the plaintiff's damages expert under *Daubert,* arguing that he'd merely calculated the plaintiff's 5% interest at the time the company was sold rather than value the entire company under "one of many accepted methods of business valuation," such as the net assets approach, the income approach, or the market approach.

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The court found the market approach would be inappropriate in this case, given the company's closely held status. Moreover, the fact that the plaintiff's expert could have valued his 5% interest in ways "other than a mere computation of his proportionate share" of the company did not make his damages opinion unreliable, the court held. The court struck the expert's prejudgment interest calculations, however, because applicable state law gave the trial court discretion to decide prejudgment interest for unliquidated damages.

Court Prefers Expert with BV Experience and Better Application of FV Law

***California DHI, Inc. v. Erasmus*, 2010 WL 3278224 (C.A. 10 (Colo.))(Aug. 20, 2010)(unpublished)**

In the early 1990s, a veterinarian formed a company to develop an animal food supplement with two partners, including the defendant. When the company discovered the defendant was creating a competitive supplement based on the same formula, it sued and won an $800,000 verdict. Six months later, the company merged with a California firm and the defendant invoked his statutory right to dissent and demanded purchase of his shares. Not surprisingly, the parties were unable to agree on the fair value of his 33% interest and found themselves back in court.

The parties' experts proposed widely divergent fair value appraisals. The company's expert was an experienced business appraiser who valued the enterprise at approximately $3.7 million. The defendant's expert, an investment banker with experience in the natural foods industry, valued the company at more than twice that amount—or $7.6 million. The federal district court ultimately adopted the lower value by the company's expert, finding it more reliable for several reasons, including her "significant appraisal experience; her application of the fair value standard as reflected in Colorado law; her reliance on [the company's] financial records; and the thoroughness with which she explained and duplicated her methodology." By contrast, the court noted several "gaps" in the methodology used by the defendant's expert, questioned his choice of comparable companies and products, and discredited his anticipated growth rate calculation.

The court accepted the defendant's assertion that the company's $800,000 judgment against him was too contingent on collectability to be included as an asset. However, the court declined to subordinate the company's debt to the defendant's share, and ultimately reached a going concern value of roughly $2.3 million—or just $800,000 for the defendant's 33% interest (ironically, just about the same amount as the defendant owed the company in the prior lawsuit).

After an unsuccessful request for reconsideration, the parties appealed to the U.S. Court of Appeals for the Tenth Circuit. On "careful" review of the record and the applicable state law, the 10th Circuit summarily dismissed all claims. The district court correctly determined the valuation date and the more credible valuation. It also correctly decided that the $800,000 judgment in favor of the company was too contingent to include in the fair value appraisal, but that all corporate debt should be included before an award of the defendant's proportionate share.

New Guidance from DE Chancery Court on DCF Inputs, Assumptions

Three recent decisions by the Delaware Chancery Court—in opinions authored by Vice Chancellor Leo E. Strine, Jr.—provide important insights into the application of the discounted cash flow (DCF) analysis in statutory fair value appraisal and related merger proceedings.

Focus on the discount rate, management projections

In *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.*, 2010 WL 1931084 (Del. Ch.)(May 13, 2010), the court enjoined a proposed merger because the proxy statements were misleading. In particular, V.C. Strine found the company misrepresented how its investment bankers selected the discount rate to use in its DCF and related fairness opinion. The prospectus said the advisors calculated a range of discount rates, 23% to 27%, based on the company's weighted average cost of capital (WACC) along with the WACC of the target company and market comparables. The court found, however, that the bankers had actually used a loose variation of the capital asset pricing model and a market analysis to generate discounts of approximately 22%, but disclosed the higher range to suggest a "far more attractive" deal.

Moreover, the court found the proxy statements "inexplicably" omitted the free cash flow estimates prepared by the target's management and provided to the investment bankers. "In my view, management's best estimate of the future cash flow of a corporation

that is . . . to be sold in a cash merger is clearly material information," the court held, and ordered a further supplement to shareholder disclosures before the merger vote could proceed.

Synergies not appropriate to assess merger value

In *In re Dollar Thrifty Shareholder Litigation*, 2010 WL 3503471 (Del. Ch.)(Aug. 27, 2010), the court declined to enjoin the proposed merger between Hertz Global Holdings Inc. and the Dollar Thrifty Group at $32.80 per share plus stock. The court saw no evidence of self-dealing by the Dollar Thrifty board and every indication that it had tried to maximize shareholder value.

In particular, during the negotiations leading up to the Hertz deal, the Dollar Thrifty board performed DCF analyses showing top value ranges hovering at about $43 per share. During litigation, the plaintiffs offered an expert's DCF that purported to value the company at $44.25 to $57.93 per share. However, the expert arrived at his DCF values by including synergies from the proposed merger. "That is, [the expert] did not present a sound DCF valuation," the court stated. After backing out the synergies, the plaintiffs conceded their expert's analysis was "not fundamentally different" from those performed by the board's investment bankers. "In other words, Dollar Thrifty had pressed Hertz to pay something very near the high end of its own view of its stand-alone value, and a price that would involve synergy sharing if the mid-level of the DCF range was used," the court said.

DCF does not apply to breach of contract damages.

Finally, in *WaveDivision Holdings, Inc. v. Millennium Digital Media Systems, LLC*, 2010 WL 3706624 (Del. Ch.)(Sept. 17, 2010), the court found that defendant had breached its agreement to sell two of its cable systems to the plaintiff for $157 million by conducting a separate, secret refinancing deal with its unsecured investment note holders (primarily private equity funds). The proper measure of damages was to put the plaintiff in the same position it would have occupied but for the breach, which equaled the value it expected to realize from the acquired systems minus any avoided costs (the contract price) and post-breach mitigation.

The plaintiff claimed the cable systems would have grown substantially under its stewardship. Its expert used a multiple of EBITDA analysis based on the plaintiff's recent acquisitions of similar companies to calculate damages in excess of $85 million. By contrast, the defendant's expert relied primarily on the forecasts the plaintiff provided to its lender to generate DCF values for the systems at the time of sale, between $122 million and $140 million. Because this range was less than the $157 million purchase price, no damages were due.

The court wasn't entirely convinced by either expert. A DCF-based, fair market value of the defendant's systems would deprive the plaintiff of all the expected benefit of the bargain. On the other hand, the plaintiff's expert extrapolated too much benefit from too small a pool of comparables without grounding his analysis in the systems' specifics. Instead, the court began with the projections that the plaintiff provided its lenders, which were credible and comparable to those the defendant had relied on in its separate deal with the note holders. The court could have used these projections in either a DCF or multiple of earnings approach, but found the latter was more common in the cable industry. After making certain adjustments for overhead and other costs, the court calculated the defendant owed damages of just over $14.8 million, plus pre-judgment interest.

Five Potential Problems in Today's Fairness Opinions

Corporate attorneys, boards of directors, and trustees frequently rely on fairness opinions from valuation specialists when evaluating merger and acquisition transactions. Changes in the economic and regulatory environment have altered the analytical landscape for fairness opinions. In particular, watch out for the following five pitfalls:

1. **Inadequate due diligence.** In providing a fairness opinion to a corporate board or special committee, the financial analyst should have performed a thorough due diligence and analyzed the company and the transaction from qualitative and quantitative perspectives. At any presentation, be sure to ask questions that plumb the analyst's depth of knowledge about the company, its business and operational procedures, and how these relate to the conclusions of value.
2. **Poor selection of guideline companies and transactions.** It's not enough to simply look at multiples of revenues or earnings from guideline companies and/or transactions. Given the cyclicality of asset prices and earnings over the last couple of years, make sure the valuation analysts have made a good match between the effect of the recession on the subject company

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and the guideline comparables. For example, more recent transactions are likely to be more relevant than older transactions, but they also may have been made under economic "duress." M& A transactions require closer evaluation these days, and analysts have to be far more careful when applying the data in the market approach.

3. **Mismatch of discount rates and projections.** One of the most common, recurring analytical errors is to mismatch the discount rate with the inherent risk in management's projections. Remember, the discount rate is a long-term measure, but in a discounted cash flow analysis (DCF), a substantial portion of the risk might end up in the terminal value. For example, the current market environment may justify a higher discount rate, but any DCF that uses the higher rate will be applying it in perpetuity, through the terminal value, rather than for the shorter period of the relevant projections.
4. **Omission of critical market data**. Given the current uncertainty in market pricing, make sure the analyst has carefully considered general economic factors as well as industry-specific data. An uptick in economic indicators or industry deals does not spell the end of stock market volatility. No analyst should ignore today's asset prices when conducting any valuation, particularly when evaluating the financial fairness of any proposed transaction.
5. **Inappropriate valuation discounts and premiums.** Most fairness opinions focus on valuing marketable interests, and the applicable fair value standards will specifically preclude the application of marketability and related discounts. But in today's financial markets, make sure the analyst has considered whether some factor at the entity level might restrict the company's sale or liquidity.

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