

# Zivetz, Schwartz & Saltsman CPAs

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## Roundup: Lost Profits Damages and Lessons Learned from *Daubert*

Three recent decisions illustrate the ways in which a pre-trial *Daubert* motion can make or break a plaintiff's case for lost profits damages, based solely on the reliability and relevance of its expert evidence.

***Victory Records, Inc. v. Virgin Records America, Inc.*, 2011 WL 382743 (N.D. Ill.)(Feb. 3, 2011)** In this first case, the plaintiff sought millions of dollars for the defendant's alleged interference with its multi-album recording contract with a rock 'n' roll band. Its expert, a music industry accountant, calculated damages based on a "before and after" approach, comparing what the plaintiff's sales would have been absent the alleged interference, as well as the "yardstick" analysis, which looks to profits produced by industry comparables. Both methods must rest on "adequate" assumptions and "cannot be the product of mere speculation," the federal district court observed.

However, the expert's "before and after" approach relied almost exclusively on the plaintiff's internal sales projections, without independently verifying whether they were accurate. When a party's internal projections rest on its "say-so" rather than statistical analysis, they are unreliable under *Daubert*, the court held. Similarly, the expert relied on the plaintiff to recommend a single rock band to use as a yardstick comparable. This "paltry foundation" failed to meet the reliability requirements of Rule 702 of the Federal Rules of Evidence, the court held, and excluded the expert's evidence.

***Insignia Systems, Inc. v. News America Marketing In-Store, Inc.*, 2011 WL 167259 (D. Minn.)(Jan. 14, 2011)** The plaintiff's expert in this case also used two approaches to estimate damages (ranging from \$121 million to \$214 million) for the defendant's antitrust violations. Under the first, he selected "a cohort" of comparable, publicly traded firms to serve as a proxy for the plaintiff's "but for" market performance and market capitalization. Under his second approach, the expert calculated separate categories of the plaintiff's lost profits based on management's "best estimates" of future performance.

The defendant challenged the evidence under *Daubert*, claiming that the expert's market approach used companies from different industries and failed to account for alternative causes of loss; and his projections came from "biased" and unverified sources. In response, the expert noted that in a market with so few players, it would make little sense to compare the plaintiff's performance against competitors that were unaffected by the defendant's antitrust violations. Nevertheless, he submitted a supplemental report, which recalculated damages by using a set of comparable companies in the plaintiff's same industry, resulting in a range of damages similar to his original calculations.

"The law is clear that comparable companies must be as similar as possible," the court held. However, in this case, his rebuttal evidence met the required standard. Further, even though the expert attributed the plaintiff's entire market loss to the defendant's misconduct (instead of its earnings drop), these determinations were better subject to cross-examination at trial than dismissal under *Daubert*, the court held. Likewise, the expert may have relied on "optimistic" management forecasts, but any alleged bias could be tested at trial, and the court admitted the expert's lost profits conclusions.

***The Citrilite Co. v. Cott Beverages, Inc.*, 2011 WL 284915 (E.D. Cal.)(Jan. 25, 2011)** In this last case, the federal district court confirmed that the expert's use of a statistical regression analysis to calculate losses for breach of a distributorship agreement was both relevant and reliable under *Daubert*. At the same time, the court rejected any calculations by the expert that were based on a term longer than the contract's 60-day termination provision. As a result, the expert's calculations were relevant only to the extent they projected lost goodwill value based on the plaintiff taking over the defendant's sales after the expiration of the contract. These calculations must be based on

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“sound” projections and include the plaintiff’s tangible costs, the court ruled, and ordered the parties to submit additional briefing on the merits of the expert’s “lost goodwill value” analysis.

## Professional BV Standards Sufficient to Safeguard Appraiser Neutrality

***In re South Canaan Cellular Investments*, 2011 WL 52558 (E. D. Pa.)(Jan. 6, 2011)**

To fund their plan of reorganization in this bankruptcy case, the debtors agreed to sell their limited partnership interests in a wireless communications provider by May 2011. If the debtors were unable to find a buyer, then the limited partners (LPs) could compel the debtors to purchase their interests.

To determine the price of the put, the partnership agreement required both parties to value the subject LP interests. If these valuations differed by more than 10%, then the parties would appoint a joint appraiser to determine the fair market value of the LP interests. If the parties couldn’t agree on an appraiser, then each would appoint its own appraiser, and within 20 days, these two would appoint a neutral third, who would make an additional determination of value. “The valuation proposed by the limited partner that is closest to the value opined by [the neutral third appraiser] then becomes the agreed upon value of the limited partnership,” the bankruptcy court explained, and the purchase price would be calculated.

**Parties couldn’t agree on anything.** The debtors couldn’t find a suitable buyer for the limited partnership, triggering the put provision. The parties exchanged their valuations of the LP interests—which differed by more than 10%. After each party chose an expert appraiser, it took another two months to select a neutral third, and even then, the debtors asked the court to preclude the neutral appraiser from learning of the prior valuations or communicating with the LP’s management.

The court held a hearing on the proposal, at which the debtors’ appraisers admitted that the professional standards of the AICPA and the American Society of Appraisers required valuation analysts to be objective, independent, and impartial. They also obligate the analyst to use “professional judgment” and to “obtain all relevant financial and non-financial information” when making a determination of value. After this testimony, the debtors withdrew all but one request,

asking the court to bar the independent appraiser from learning about the parties’ prior valuations. The parties’ agreement contemplated “an appraiser who is blind to the numbers put on the table by the parties,” the debtors argued. Further, keeping the appraiser “in the dark” would prevent any loss of objectivity or independence.

Neither party called the independent appraiser to testify regarding the information he might request to make his value determination. Nevertheless, the court assumed that after the protracted selection process, even the debtors believed that the third appraiser would be “competent, independent, objective, and fair in completing his valuation engagement.” Further, had the parties intended to restrict any review of their valuation provisions, they could have negotiated such a restraint in their agreement, the court ruled, and denied the debtors’ motion to keep the independent appraiser “in the dark.”

## DE Chancery Advocates ‘Triangular’ Approach to Business Valuation

***S. Muoio & Co., LLC v. Hallmark Entertainment Investments*, 2011 WL 863007 (Del. Ch.)(March 9, 2011)**

In its recent letter opinion, *In re Hanover Direct, Inc. Shareholders Litigation*, Consol. C.A. No. 1969-CC (2010), the Delaware Chancery court confirmed that “there is no single preferred or accepted valuation methodology . . . that establishes beyond question a company’s value.” At the same time, “there are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of its valuation,” the court said, in rejecting an expert’s opinion that relied solely on a discounted cash flow (DCF) analysis.

**Another company on the brink.** Like the troubled company in *Hanover*, Crown Media Holdings, Inc. (the owner of the Hallmark Channel) was foundering under declining revenues, and it couldn’t find a buyer to cover the \$1.1 billion debt to its controlling stockholder, Hallmark Cards. In 2010, a special committee approved recapitalizing the debt, based on an independent appraisal that said the company was worth only \$750 million and on the brink of bankruptcy. A single minority stockholder sued to rescind the deal, claiming that both the process and the price of recapitalization were unfair and drastically

undervalued the company—which was worth nearly \$3 billion, according to its expert’s DCF.

Under an entire fairness review, however, the Delaware Court of Chancery found that the special committee was independent and had negotiated the Hallmark recapitalization at arm’s length. Further, the plaintiff’s \$3 billion DCF valuation failed to explain why no other potential buyer came forward during the company’s bidding process to capture the alleged excess value. It also failed to recognize “the brute facts” of the company’s near-bankruptcy, the court held.

Finally, the plaintiff’s expert failed to incorporate any other valuation method into his conclusions. In fact, the expert had performed a comparable companies analysis (\$803 million) and a comparable transactions analysis (\$1.3 billion), but he rejected those approaches as “absurdly low.” Such an outlier valuation reinforced its lack of credibility, the court said, citing Hanover. A DCF approach is only reliable when it can be verified by “alternative methods” or “real world valuations,” particularly valuations by potential third-party buyers, the court explained:

Thus, it is preferable to take a more robust approach involving multiple techniques—such as a DCF analysis, a comparable transaction analysis . . . and a comparable companies analysis . . . to triangulate a value range, as all three methodologies individually have their own limitations.

The court also rejected the expert’s DCF for ignoring contemporaneous management projections in favor of his own, and dismissed the plaintiff’s suit.

## Financial Experts May Be Instrumental at Initial Stages of Securities Litigation

***Fulton Co. Employees’ Retirement System v. MGIC Investment Corp.*, 2010 WL 5095294 (E. D. Wis.) (Dec. 8, 2010)**

In the wake of the recent financial crisis, current securities fraud litigation focuses on whether shareholders can show that a company’s failure to write down impaired assets caused the loss of share value. Under tightening federal standards, however, the complaint may not survive a motion to dismiss if the plaintiffs fail to enlist a financial expert to help them evaluate and apply certain fair value accounting concepts and techniques in the initial allegations.

**Subprime venture collapses in 2007.** The plaintiffs in this case were institutional investors in the defendant, which in turn owned a 46% interest in a private venture that held \$8.8 billion of mortgage-backed securities (MBS). As the subprime crisis began to unfold in early 2007, the defendant engaged in a “fraudulent scheme” to inflate the value of its holdings by failing to report their impairment according to the then-applicable financial accounting standards (FAS 115 and 157), according to the plaintiffs. When the private venture collapsed in August 2007, the defendant wrote off its entire investment of \$516 million, leading to substantial loss of shareholder value.

The defendant filed a motion to dismiss the claims, arguing that the plaintiff failed to plead sufficient facts showing that the assets were not valued properly for financial accounting purposes. “This type of valuation is not an exact science,” the federal district court observed. “Rather, these principles tolerate a range of ‘reasonable’ treatments, leaving the choice among alternatives to management.” Accordingly:

It is important to recognize that there was no single value that could have been applied to [the MBS] portfolio and deemed the “true value” of the portfolio during the first half of 2007. Instead, there was a range of reasonable valuations, and statements that reported the value of the portfolio could have been false only if the reported value was not within the range.

Accordingly, the complaint must allege that the reported valuations were outside the reasonable range, in this case by 1) identifying the accounting principles that govern the valuation of the MBS portfolio; and 2) pleading facts that give rise to a reasonable belief that the defendants did not properly apply such principles. Moreover, because the valuation of the subprime portfolio fell on the “extremely difficult end of the [valuation] spectrum, due to the limited number of observable transactions involving such assets,” the complaint had to contain enough background information to enable the court to conclude that a fraudulent statement (or omission) regarding asset value had occurred. It is not enough merely to list the asset values and then simply assert that they were not reported at fair value, the court explained. Instead, the plaintiff “must take the pleaded facts, run them through the fair-value machinery, and show that one could not reasonably come up with the values that the defendants reported,” the court held.

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In this case, nothing in the allegations informed the court whether the reported values were justifiable, or what magnitude of write-offs should have been taken. The plaintiffs offered the statements of a confidential witness to show that the portfolio was overvalued—but they failed to indicate that the witness had any financial accounting expertise or was familiar with fair value determinations of subprime assets. The complaint also failed to allege that the witness had competently formed his opinion “or that his understanding of ‘value’ was in any way similar to the accounting concept of fair value,” the court held, in dismissing the entire suit.

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