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Valuation & Litigation

BRIEFING

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Struggling economy presents business valuation challenges

During an economic crisis, it's typical for many businesses to decline in value. But how does a struggling economy affect the business valuation process itself?

In one sense, the process doesn't change: Valuators continue to apply traditional valuation approaches and methods, and the results reflect current conditions. At the same time, however, valuations during tough economic times — particularly those involving distressed companies — present unique challenges.



Different approaches

Business valuations typically involve some combination of three general approaches:

Income. This involves various methods of converting anticipated economic benefits (such as earnings or cash flows) into a present value.

Market. This analyzes valuation multiples from acquisitions of similar businesses or from the stock prices of comparable publicly traded companies and adjusts for the subject company's particular characteristics.

Cost. Also known as the "asset" approach, this uses various methods to determine the replacement cost or market value of a company's assets, net of liabilities.

For healthy companies, the income and market approaches generally are the best indicators of fair market value. And, in theory at least, the two approaches should produce similar values. Why? Because ultimately a business's value is based on the market's perception of its ability to generate economic benefits.

If the market is "priced" correctly, the value of a business under the market approach should be comparable to the value of its expected future earnings or cash flows, converted to present value using an appropriate risk-adjusted discount rate.

A disconnect

In bad times, there may be a disconnect between the income and market approaches, creating a wide gap between valuations using the two approaches. The challenge for valuers becomes reconciling these differences.

In a recession, it's likely that both the market approach and the income approach — such as the discounted cash flow (DCF) method — will yield lower values. For the market approach, lower values could result because a potential investor would likely assign less value to a business during recessionary times. The income approach will result in lower values because revenues and earnings are generally down and a business's overall risk may be higher.

To arrive at an accurate valuation, the valuator must dig beneath the surface to reconcile the values

derived from the two approaches. If the market from which pricing multiples are derived is artificially depressed or has become inactive, DCF may be a more reliable indicator of value.

The profitable

Even when the subject company is profitable, the valuator should scrutinize cash-flow projections used in a DCF analysis, because the company's track record may no longer be an adequate guide to its future performance. Thus, it may be necessary to reflect this risk by adjusting cash-flow projections downward or by incorporating a higher risk premium in the discount rate.

That's not to say that a business can't continue to thrive in the current economy. But to support a valuation that's higher than other companies in the industry, a valuator should carefully evaluate the company's business plans and projections to be sure its cash-flow expectations are realistic.

The financially distressed

When the subject company is financially distressed, DCF may or may not be appropriate because its expected earnings may be insufficient to contribute to the business's value. The key is for the valuator to understand the reasons the company is troubled and its prospects for turning things around.

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If the company is highly leveraged, for example, it may be able to solve the problem with an infusion of cash from its owners or other investors. But if such an infusion is unlikely or demand for the company's products has dried up, the income approach may be less meaningful. (See "Bankruptcy court rejects DCF method" at right.)

Impact of a valuation's purpose

The purpose of a business valuation can have a big impact on the valuation methods that are used,

BANKRUPTCY COURT REJECTS DCF METHOD

As a recent bankruptcy case illustrates, the relevance of the discounted cash flow (DCF) method is highly dependent on the validity of the valuator's assumptions. In *In re DBSD North America, et al.*, the U.S. Bankruptcy Court for the Southern District of New York rejected the use of the DCF method to value the reorganized debtors. The debtors' expert projected cash flows using a business plan that required a \$1.5 billion capital investment, a premise the court found unrealistic, at least based on the record before it.

A creditor's expert also used the DCF method, applying it to a consistently *negative* cash-flow stream. The court rejected this valuation as well, finding it "extraordinarily unlikely ... that anyone would pay to secure a stream of uniformly negative cash flows...." If a buyer were interested in such a company, the court explained, it would be for some other reason, such as the value of its assets.

as well as on the ultimate value conclusion. Is the business being valued for sale? Then its value to a strategic buyer — who may be more interested in acquiring market share, technology or people than in the target company's earning potential — may exceed its fair market value.

Is the company being valued for liquidation, either in or out of bankruptcy? If so, an asset-based approach would likely be appropriate.

Is the company going through Chapter 11 reorganization? In that case, it may come out of bankruptcy looking very different — at least from a financial perspective — than it did going in. To value the business as a going concern, the valuator must carefully analyze the impact that bankruptcy would have on its future performance.

Due diligence required

The fundamentals of good business valuation remain the same in good times and bad. But tough times require valuation experts to exercise heightened due diligence to reconcile a company's internal characteristics with external economic forces. ♦

Lucent sheds light on patent infringement damages

Courts are generally loath to disturb a jury's verdict on damages. But in last year's decision in *Lucent Technologies, Inc. v. Gateway, Inc. et al.*, the U.S. Court of Appeals for the Federal Circuit threw out a \$350 million patent infringement award that wasn't supported by substantial evidence.

The court was particularly critical of Lucent's damages expert, who, among other things, had failed to explain to the jury how eight "real-world" license agreements were sufficiently comparable to support the lump-sum damages award.

A reasonable royalty?

The main dispute in this case was between Lucent and Microsoft over Lucent's patented "date-picker" technology, which allowed Microsoft Outlook® users to input a date by clicking on a calendar rather than using the keyboard. Microsoft sold approximately 110 million units incorporating this feature, with total sales of around \$8 billion.

U.S. patent law allows a patentee to recover its lost profits, but in no event can it recover less than a "reasonable royalty." In this case, both sides offered evidence of a reasonable royalty using the "hypothetical negotiation" approach, which is based on the royalty the parties would have agreed to had they successfully negotiated a license agreement just before infringement began.

The hypothetical negotiation was reconstructed based on the 15 *Georgia-Pacific* factors, which include considerations such as the nature of the patented invention, the infringer's use of the patented invention and rates paid by licensees for comparable patents.

Lucent asked for \$562 million in damages based on an 8% royalty rate applied to the full amount



of Microsoft's sales revenues from the infringing product. Microsoft countered that a lump-sum royalty payment of \$6.5 million would be appropriate.

Damages were speculative

The Federal Circuit found that the jury's award wasn't supported by substantial evidence, but was "based mainly on speculation or guesswork." For one thing, given the complexity of Outlook and the seemingly small role played by the infringing component, the court found it inconceivable, based on the record, that the date-picker constituted a substantial portion of Outlook's value.

In addition, although Lucent relied on eight license agreements to support its royalty claims, several of the agreements were "radically different" from the hypothetical agreement at issue. As to the others, Lucent's expert provided no explanation about the patents or subject matter they covered.

Role of expert testimony

Lucent illustrates the need for detailed expert testimony, which will establish credible evidentiary facts and conclusions and, thus, support a claim for patent infringement damages. It also reveals how some courts are willing to scrutinize jury awards and take a more active role in evaluating damages when such testimony is lacking. ♦

What's behind the veil?

Digging for the truth in alter-ego cases

In many cases, shareholders in a corporation can fully protect themselves against liability for corporate debts. After all, the protection of the corporate form isn't just for successful businesses and can't be discarded simply because poor management or unavoidable losses depleted the company's assets.

So when a plaintiff can't collect a judgment from a corporation and seeks to obtain it from the corporation's owners, it must convince the court to "pierce the corporate veil." To do so, the plaintiff must show that the shareholders abused the corporate structure in such a way that it would be unfair to let them hide behind it. Typically, this means showing that the corporation and its shareholders lack separate identities — that is, the corporation is the owners' alter ego.

Lack of separateness

Lack of separateness is a key factor in alter-ego cases. A court is more likely to disregard the corporate form if the shareholders themselves disregarded the corporation's separate existence. For example, if the shareholders neglected corporate

formalities — such as electing officers and directors and keeping minutes — the corporation might be an alter ego. In addition, commingling of funds and assets can blur the distinctions between a corporation and its shareholders.

Similarities between a parent and subsidiary can create confusion and support application of the alter-ego doctrine.

Lack of separateness also can be an issue when a parent corporation has one or more corporate subsidiaries. Plaintiffs who dealt with a subsidiary may have believed they were dealing with the parent. The corporations may have been so similar that it was difficult to tell them apart. Or the parent's actions or representations may have led the plaintiff to believe that the parent would stand behind the subsidiary's obligations.



Similarities between a parent and subsidiary can create confusion and support application of the alter-ego doctrine. Entities may not be separate, for example, when they share the same, or a similar, line of business, name or trademark. Moreover, if they share officers or directors, they might not be considered separate.

Lack of separateness also may be indicated by transactions between a corporation and its shareholders or parent that aren't conducted at arm's length. For example, the parent might sell or lease property for less than fair market value.

A financial expert can provide insight into whether such situations are ordinary and appropriate or indicate abuse.

Financial dependence

A common sign that a corporation has an alter-ego relationship is when it's financially dependent on its shareholders or parent. This relationship is often demonstrated when the corporation is undercapitalized, the shareholders or parent owns most of the assets used in the business and leases them to the corporation, or the shareholders or parent makes undocumented or below-market loans to the corporation or relieves the corporation from its payment obligations.

A financial expert can analyze the corporation's capital structure and compare key financial ratios and indicators to similar companies to determine whether it's undercapitalized. The expert also may review the corporation's operating history and analyze intercompany transactions and relationships to determine whether the corporation became undercapitalized as a result of operating losses or irregularities in its financing. In addition, the expert can analyze transactions to determine whether they were conducted on an arm's-length basis.

Undue influence

Nothing says "alter ego" like shareholders or a parent that exercises undue influence or dominates a corporation. In this case, the shareholders or parent may cause the corporation to favor it over third parties (by, for example, giving it a preferred status over other creditors).

In such cases, a financial expert can review the corporation's operations and transactions, examine accounting records and apply valuation techniques to determine whether the corporation's dealings with related parties are legitimate or involve undue control or domination by its owners.

Piercing the corporate veil

Because there's a lot at stake with alter-ego cases, make sure you work with an expert that fully understands not only how corporations work, but also how they sometimes hide certain assets and relationships through alter-ego entities. It's time to pierce that corporate veil. ♦

Guidance issued on valuation of partial interests

After a six-year development period, the American Society of Appraisers (ASA) recently added a new procedural guideline to its Business Valuation Standards: PG-2 — *Valuation of Partial Ownership Interests*.

Although not a binding standard, PG-2 offers valuable guidance to ASA members and other business valuers on this difficult and often controversial subject. Here are highlights of some of the issues it addresses:

Size. A partial interest can range in size from nearly total control (a 95% stock interest, for example) to almost complete lack of control (such as a small block of nonvoting stock).

Degree of ownership vs. degree of control. One doesn't necessarily correspond to the other. A 60% limited partner may have no control if removing the general partner requires a two-thirds vote of the limited partner interests. And a 2% owner may have limited control if the other two owners each own 49% and are at odds with each other.

Underlying entity's value. Valuation of a partial interest isn't necessarily a function of the underlying entity's value as a whole, particularly if the partial interest can cause the liquidation or sale of the entity.

Contracts, laws and regulations. Valuation of a partial interest may depend on contractual provisions — such as corporate bylaws, partnership agreements or shareholder agreements — or applicable laws and regulations.

Standard of value. The relevant standard of value is critical. The *fair* value of a minority shareholder's interest, for example, may be very different from its *fair market* value.

Valuation approaches. Valuers should use all three valuation approaches (asset-based, income and market) when valuing partial interests, and their reports should explain the reasons that any approaches are excluded.

Legal counsel. Valuers should seek legal counsel, if appropriate, to gain an understanding of legal or regulatory considerations, governing documents or agreements that influence or affect value.

Discounts and premiums. Valuers should explain discounts or premiums applied at the partial interest level. The level of ownership will have a direct bearing on whether discounts for control and marketability will be applied, and if so, will directly affect the amount of the discount(s).



Testing. Valuers should consider conducting tests to confirm the reasonableness of their valuation conclusions, such as calculating the implied internal rate of return for the subject interest.

PG-2 also includes an extensive list of factors to consider in valuing partial ownership interests and detailed guidance on applying certain approaches, methods and procedures, including development of assumptions under the income approach. It also discusses the use of restricted stock studies and pre-IPO studies to develop marketability discounts or discount rates.

Despite its nonbinding status, PG-2 will likely have much influence on valuers and perhaps on courts as well. So take some time to review the guidelines and discuss their implications with your valuation experts. ♦