

Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community July 2009

Redefining the use of qualified business valuation professionals

With bankruptcy and other forms of litigation becoming increasingly complex, recent cases demonstrate how professional business appraisers can work with attorneys to provide the highest level of service to their clients.

Valuation Expert Evidence Helps Support Trustee's Successful Claims

***Boyer v. Crown Stock Distribution, Inc.*, 2009 WL 418275 (N. D. Ind.)(Feb. 17, 2009)**

With annual net income of roughly \$1.3 million in 1999, at its peak, Crown Stock Distribution, Inc. was a profitable company. A buyer agreed to purchase the company for \$6 million, with \$3.1 million from bank financing and a \$2.9 million promissory note. He formed a holding company to acquire the assets and obtained appraisals of the company's real estate (\$1.5 million) and its equipment (\$406,000). He also agreed to assume its \$1.5 million debt.

Notably, however, the buyer's accountant warned that the price was too high, especially when there was not sufficient working capital to cover the liabilities. The company also failed to disclose a 1994 appraisal, which valued its assets at \$1.2 million, increasing by 20% annually—that would have made the company worth only \$2.5 million the year prior to sale.

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Redefining the use of qualified business valuation professionals (continued)

After the deal closed, the company failed to turn a profit or service its debt, including payments on the promissory note. It filed for bankruptcy in 2003. The trustee brought claims against the prior owners to recover the \$3.1 million down payment as a fraudulent transfer, claiming the debtor failed to receive “reasonably equivalent value” for the entire exchange when the company was either insolvent or on the brink of failure.

Exchange value fell short by nearly \$3 million. At trial before the bankruptcy court, the trustee’s valuation experts testified that the company’s assets were worth only \$3.25 million compared to the \$6 million purchase price. The defendants (former owners) argued that the court should deduct the \$2.9 million promissory note, because it was “essentially worthless,” the seller or former owners having received only two payments totaling \$200,000. That would have made the purchase price \$3.3 million, well within the range of the company’s value—but the court rejected this argument. The promissory note was not conditional; the debtor booked it on its balance sheet and honored the debt as long as it could. “The parties didn’t discount the promissory note at the time of the transaction and the court shouldn’t use hindsight to discount the note now.”

In the alternative, the defendants argued that even if the debtor failed to receive reasonably equivalent value, the company was not insolvent at the time of the sale, especially since it continued to operate for nearly three years. However, the court refused to find the length of its post-sale operations determinative. The debtor survived “through the financial equivalent of advanced life support,” the court said, and despite the new owner’s efforts, the company was “doomed to failure.”

In fact, the cause of the debtor’s financial distress was not what happened after the sale, but “the excessive purchase price paid to acquire the business” and its associated debt. Given the former primary shareholder’s access to the \$2.5 million appraisal and his knowledge that the buyer needed sizeable financing, the court found “no justification” for the \$6 million purchase price. Based on all the evidence, including the expert valuations, the court held that the debtor received less than reasonably equivalent value, and avoided the sale as fraudulent. On review, the federal district court (N.D. Indiana) affirmed the decision.

Financial Expert Ensures Proof of Reasonable Royalty In Unjust Enrichment Case

Mass. Eye and Ear Infirmary v. QLT Phototherapeutics, Inc., 2009 WL 78064 (C.A. 1 (Mass.)) (Jan. 12, 2009)

After a “spirited” trial on the merits, a jury found QLT Phototherapeutics (the defendant) liable for misusing the plaintiff’s confidential research and proprietary materials in the development of a “blockbuster” pharmaceutical to treat age-related macular degeneration. The jury awarded the plaintiff a running royalty rate of 3.01% of the defendant’s gross sales of the pharmaceutical, and the defendant appealed.

The U.S. Court of Appeals for the First Circuit initially reviewed the jury’s verdict in favor of unjust enrichment, and found that it met the standards under applicable (Massachusetts) law; i.e., the plaintiff conferred a benefit on the defendant (in this case the unauthorized use of confidential information), which the defendant knowingly accepted without paying for its value. Having lost on liability, the defendant agreed that the appropriate remedy for unjust enrichment would be some royalty rate based on its net sales of the pharmaceutical. “Unfortunately,” the court commented, “the parties agree on little else.”

A financial expert proves indispensable. Under Massachusetts law, the appropriate measure of damages was the “approximate” value of the benefit that the plaintiff’s confidential information conferred on the defendant, the court held, and not (when the parties had no agreement to the contrary) on the plaintiff’s lost profits. When a jury cannot estimate this value from “common knowledge,” the plaintiff must present evidence of its “reasonable” value of the benefit.

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Redefining the use of qualified business valuation professionals (continued)

With these standards in mind, the court reviewed the jury's damages award in relation to the record. At trial, the plaintiff's expert provided the jury with "important background evidence showing reasonable royalties in the pharmaceutical industry." He testified regarding general industry standards as well as particular licenses that the defendant negotiated with other parties, concluding that a reasonable royalty could be as high as 13.5%, or approximately 50% of the defendant's net profits from its sale of the infringed pharmaceutical.

The defendant also presented a damages expert, primarily to discredit the plaintiff's for his reliance on certain reasonable royalty surveys and his rejection of the 0.2% royalty that the defendant paid other parties. Moreover, because a co-inventor could sell the pharmaceutical independently, the expert claimed that the defendant did not have to pay any royalties at all, and thus the 0.5% that he presented to the jury "was not only fair, but munificent."

"From this competing evidence," the court said, "the jury had enough information to establish an approximate valuation of the benefit [plaintiff] conferred on [defendant]." Importantly, "the damages experts ensured that the jury engaged in an effort to determine a reasonable approximation of the value of the benefits [the plaintiff] conferred on [the defendant]."

The court was not concerned that at one point during his testimony, plaintiff's expert referred to the defendant's profits on the sale of the pharmaceutical. This testimony did not conflict with the requirement that a reasonable royalty rate must be based on defendant's sales. Moreover, the jury "grappled with highly complex, voluminous evidence to reach a reasonable conclusion," the court said. **While the jury ultimately rejected the plaintiff's "out-sized valuation of its own contributions" to developing the pharmaceutical and the defendant's "cramped" view, enough information had been provided by plaintiff's expert to give pause to the appeal. Therefore, the court found no reason to disturb the jury's findings, and upheld the damages award. •**

The valuation of a business can be an important issue in a myriad of legal matters. Companies and their attorneys who advise them should be aware of the many situations in which a business valuation is either required or advisable. Typical situations in which a valuation may be needed include:

- Allocation of the acquisition price of a business
- Buy-sell agreements
- Compensatory damages cases
- Mergers, acquisitions and spin-offs
- Determination of the adequacy of life insurance
- Divorce/property settlements
- Financing applications
- Gift and estate tax valuations of business interests
- Insurance claims
- Liquidation or reorganization of a business
- Public offerings of stock
- Valuation of minority shareholder interests

Many CPAs have valuation experience, but are not accredited business appraisers. Valuation opinions are typically provided by professionals that are accredited in business valuation. The American Society of Appraisers grants "Accredited Senior Appraiser"(ASA) credentials; The American Institute of Certified Public Accountants (AICPA) grants "Accredited in Business Valuation" (ABV) credentials; and the National Association of Certified Valuation Analysts grants the "Certified Valuation Analyst" (CVA) credential. Additionally, the "Chartered Financial Analyst" (CFA) credential is granted by the CFA Institute.

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