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# The Franchise Valuations Reporter

## Giving Thanks

Having survived Sandy, we give thanks for things like electricity and hot water. We wish you all a happy and safe Thanksgiving.

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## Our Expertise

Within the franchise, distribution and dealership context, we are experts in:

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We offer a free initial consultation. If any readers have questions, you are welcome to email or phone us and we will provide our best answer as quickly as possible.

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Our franchise law and computer forensics experts provide consulting

## Estate Planning and Exit Strategies for Baby Boomers in Franchising

***Tools and Strategies for Implementing a Graceful (and Profitable) Exit***

As we noted in our last two issues, there are about 40 million baby boomers in the US, many of whom are franchise owners approaching retirement age; and for many of them the most valuable asset(s) they own - indeed often far more than 50% of their net worth - is their franchise, dealership or distributorship.

At a minimum, those exiting baby boomers must consider, devise and implement: (i) a Succession Plan as discussed in part in our September newsletter, (ii) an Estate Plan with appropriate documents as discussed in part in our October newsletter, (iii) estate tax planning if needed, and, (iv) a Valuation to determine how much money the business is worth. The value is particularly important information whether a franchise owner is considering selling the business or leaving it by will or trust.

In light of the impending "fiscal cliff" and difficulties between the President and Congress, we think it imprudent to offer advice on the estate tax until we know what changes, if any, shall be wrought. Accordingly, in this issue we shall discuss the valuation of the franchise.

***Terminology***

The specialized vocabulary of appraisals and valuations is stultifying and filled with technical terms, many of which mean the same thing. Also some legal and accounting definitions tend to overlap the appraisers' usage while others do not. For example, in fixing the "value" of a business, a practitioner must deal with a whole host of confusing names and bizarre ratios such as discounted cash flows and modified discounted cash flows; price-to-earnings ratios and price-to-sales ratios; "cap" rates and growth rates; and disputes over whether one business is "comparable" to another.

There are three (and really only three) general methods that are acceptable for determining business value. These are-in legal terms-book value, capitalization of earnings, and comparable sales.

1. Book value is the net worth of a company determined by either its balance sheet assets or the replacement cost of its balance sheet assets-minus liabilities.

2. The capitalization of earnings method assumes either that the earnings of a business constitute an annual percentage return on the value of the business or, more accurately, that the present discounted value of all of the business's earnings into the future is the current business value.

   Once the discount rate and the earnings are determined, a value is computed. Thus, a 5% capitalization (also called discount) rate applied to $100,000 of earnings would yield a business value of two million dollars ($100,000 divided by .05 = $2,000,000). This is the same result as a 20:1 price/earnings ratio.

3. "Comparable" sales are recent sales of similarly situated

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businesses. Because those prices are not estimates but actualities, the comparable sales method is generally preferred as the most realistic proof of fair market value.

In accounting terms, these methods are known as (1) cost (book value), (2) income (capitalization of earnings), and (3) market (comparable sales), respectively. Calculations using other methods or comparisons should be treated with great caution. For a review of the entire area, including valuation premiums and discounts and valuations of intangible property, see the paper I recently presented on the issue of valuation for the Canadian Franchise Association with co-author Edward (Ned) Levitt.

## Valuing Covenants Not to Compete in the Franchise Context

***Most of the Research Considers Covenants Bought and Paid For as Part of a Business Sale***

Agreements not to compete are found in virtually every merger and acquisition agreement. The proper value to place on such covenants has been the subject of extensive litigation for decades with the main dispute centering on whether the payments for the covenant are ordinary income or capital gain for tax purposes and whether they are disguised stock payments. In this context it is practically always the seller who provides the covenant not to compete and the buyer who pays for it.

Some of the factors that courts have considered in tax cases include:

- The grantor having the business expertise to compete
- The grantor's intent to compete
- The grantor's economic resources
- The potential damage to the buyer posed by the grantor's competition
- The grantor's contacts and relationships with customers, suppliers and other business contacts
- The duration and geographic scope of the covenant not to compete
- The enforceability of the covenant not to compete under state law
- The age and health of the grantor
- Whether payments for the covenant not to compete are *pro rata* to the grantor's stock ownership in the company being sold
- Whether the payments under the covenant not to compete cease upon breach of the covenant or upon the death of the grantor
- The existence of active negotiations over the terms and value of the covenant not to compete

According to Robert W. Wood, "If an examination of these factors indicates economic reality in the covenant not to compete and the consideration given for it, then the courts have been likely to find likewise."[1]

Wood further advises, "Be realistic and reasonable in allocating between a covenant not to compete, salary and bonus. More importantly, be reasonable and realistic in allocating payments between a covenant not to compete and the purchase price for assets. If there is a dispute, use an expert, and have good documentation of how values were reached."

***Covenants in Franchising***

But what about franchising? In this context the buyer (rather than the seller) is always the one providing the covenant and there is no separate value put on it in the agreement. So how is it to be valued?

there is no answer of general application but here are some situations where the issue may arise in litigation:

- If the franchisee is alleging **fraud in the inducement** and the franchisor denies it and demands enforcement of the covenant, is injunctive relief enough or are there money damages for wrongful enforcement of the covenant?
- If the franchisee is alleging **violation of a registration statute** and the franchisor denies it and demands enforcement of the covenant, is injunctive relief enough or are there money damages for wrongful enforcement of the covenant?
- If the franchisee is alleging **encroachment** and the franchisor denies it and demands enforcement of the covenant, is injunctive relief enough or are there money damages for wrongful enforcement of the covenant?

[1] "A Primer on Covenants Not to Compete," CCH, The M&A Tax Report, October 2011. Wood is also the source of the list of factors. For further analysis of the process of valuing a covenant not to compete, see Gary Trugman, "Valuing Covenants Not-to-Compete: an 11-Factor Checklist," Business Valuation Update, February 2012.

## Expert Witnesses: When to Hire

***Early Retention May Help to Avoid Costly Errors***

One authority, Donald M. May, Ph.D.[1], advises the following:

"Expert guidance and testimony play a central role in the late stages of legal proceedings, when experts provide reports and serve as witnesses concerning the substance of the case and the appropriate damages. In the hope of minimizing fees, many [litigating parties] often wait until the late stages to engage them.

"But that's false economy. **Early retention of experts is critical** to helping [litigating parties] decide if a case is worth pursuing or disputing or if it makes more sense to settle, based on forensic evaluation of specific evidence and economic evaluation of likely damages. [Emphasis added.]

"If the case is worth pursing, these experts can increase the odds of winning by helping improve strategy, guiding discovery and depositions, and enhancing the quality of *Daubert* challenges, both to exclude the opposition's experts and to achieve summary judgments.

"The sooner [litigating parties] add this expert knowledge to the case preparation team, the greater the benefit they will be able to realize. The overall impact of early-stage expert contributions is an improvement in efficiency and win rate."

Another authority in the area, John Porter, Esq.[2], listed disasters he's seen in the area of valuation testimony:

- Prior opinions: If an expert's testimony in the case differs from prior testimony or published articles, be prepared to explain it. "In this day of larger valuation firms," Porter said, "you should also search out prior testimony or articles by anyone in the firm."

- Incomplete references. Porter recently reviewed an appraiser's report that excerpted an authority without providing its full context. "I was able to cross-examine him and say you 'cherry-picked' the companion guide, which caused you t overstate the discount," Porter said. So if you're going to cite authoritative materials, "make

sure nothing can come back to bite you."

- The uninformed testifier. If junior colleagues performed the "spade work," make sure the senior appraiser (who ultimately signs off on the repot), becomes "intimately familiar" with its content. Porter just attended a deposition in which the senior appraiser kept looking to his junior associate for help answering questions, "which made him look like he needed a lifeline."

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[1] "Factors to Consider When Hiring an Expert"
[2] Baker Botts LLP, Houston

*Franchise Valuations Ltd. provides consulting and testifying expertise for money damages and valuations. Readers are invited to contact us at (212) 689.0440 or Bruce@FranchiseValuations.com to see if our expertise can help in resolving your situation.*

## IP Daily: Trademark News

***Excerpts from CCH's New Daily Report, a Valuable Asset for Practitioners Dealing with Intellectual Property***

**INDUSTRY NEWS: USPTO Warns of Seemingly Official Solicitations from Unscrupulous Private Companies; Provides Links to Examples**

Members of the public should be aware that private companies that are not associated with the U.S. Patent and Trademark Office (USPTO) often use trademark application and registration information from the USPTO's databases to mail or e-mail trademark-related solicitations, the USPTO has warned. These solicitations are often deceptively worded or designed to resemble official USPTO communications. In order to better inform the public about non-USPTO solicitations, the USPTO has expanded its "solicitation warnings" web page to provide direct links to 13 examples about which the Office has received complaints within the past several months.

**TRADEMARK-SDCal: Drug-Testing Lab Could Proceed with Trade Dress Claim Against Competitor That Allegedly Copied Report Format for Lab Tests**

A specialty diagnostics laboratory (Millennium Laboratories, Inc.) could proceed with a trade dress infringement claim against a direct competitor (Ameritox Ltd.) in the market for urine- and saliva-based drug testing, the federal district court in San Diego has ruled (*Millennium Laboratories, Inc. v. Ameritox, Ltd.*, October 12, 2012, Anello, M.). Millennium alleged that it provided physicians with lab tests reports in a format that included a specific combination of graphs and charts that constituted protected trade dress. According to Millennium, Ameritox sold confusingly similar lab reports that copied that trade dress.

**Allegations of Trade Dress Infringement.** To state a claim for trade dress infringement, a plaintiff must allege that its trade dress: (1) was nonfunctional; (2) was either inherently distinctive or had acquired distinctiveness through secondary meaning; and (3) was likely to be confused with the defendant's products by the consuming public. In this case, the Millennium's complaint contained allegations of trade dress infringement that were sufficient to state a claim under federal notice pleading standards.

**Non-Functionality.** Millennium alleged sufficient facts to support a plausible inference that its claimed trade dress was nonfunctional. Trade dress protection was limited to non-functional product features, and the question

of functionality was a factual one that could not be resolved on a motion to dismiss. Although Millennium's test results design could ultimately prove to be purely functional, the opposite could be true as well. Construed liberally, Millennium's complaint alleged facts to show that Millennium's competitors would not need the features of Millennium's report in order to compete without disadvantage.

**TRADEMARK: Brooklyn Delicatessen's Use of "Rolex Deli" Diluted Famous ROLEX Watch Mark**

The federal district court in New York City has ordered the "Rolex Deli," a Brooklyn delicatessen restaurant, to cease using the term "Rolex" in order to prevent dilution of the famous ROLEX watch mark (*Rolex Watch U.S.A., Inc. v. Rolex Deli Corp.*, October 18, 2012, Jones, B.). The court entered a default judgment and permanent injunction against the Deli and its owner as to Rolex Watch U.S.A.'s dilution by blurring claim. The court, however, rejected the watchmaker's other Lanham Act claims and its request for attorney's fees.

Rolex Watch's products-watches, clocks, and their components and cases-were "a far cry from products sold in a delicatessen" and it was "highly unlikely" that either party would "bridge the gap" and offer competing products or services, in the court's view. Because Rolex failed to show a likelihood of confusion, it could not succeed on its Lanham Act claims for trademark infringement, unfair competition, false designation of origin, and false description.