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The Franchise Valuations Reporter

See You In New Orleans

International Franchise Association Annual Convention

On February 24, 2014, Michael Seid, Managing Director, MSA Worldwide, and I will be speaking on the topic of ***"Exit, Succession and Estate Planning for Baby Boomer Franchise Owners"***. The session will be moderated by Carlton Curtis, VP of Industry Affairs, The Coca Cola Company.

For more information on the program and to register, go the the IFA website here.

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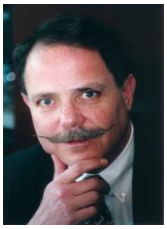
Our Expertise



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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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Valuations: Multiple of EBITDA Method

Commentary in a Canadian Case is Worthy of Note

As our readers know, I am not a big fan of the multiple of EBITDA method for valuing franchises, dealerships or distributorships. In keeping with that theme, a Canadian case has a quote worthy of consideration[1]:

> EBITDA is a formula used in the public market sector; it is a mathematical conversion that makes it easy for investors to determine profitability. **It is not a rigorous valuation technique and is not the primary way to carry out a valuation analysis because it has a number of shortcomings**. (emphasis added)

[1]*1115038 Alberta Ltd. v. 1163256 Alberta Ltd.and Asia Concepts Franchising Corporation*, 2012 ABQB 334 (Alberta Court of Queen's Bench, May 18, 2012)

Valuations: Michael Jackson's Estate v. IRS

Telling the Service to "Beat It" Doesn't Work

A case has been filed in Tax Court with the caption *Estate of Michael J. Jackson, Deceased, John G. Branca, Co-Executor and John McClain, Co-Executor, Petitioner(s) v. Commissioner of Internal Revenue, Respondent* and the fight is strictly over valuation. The conflict: According to *Forbes*, Jackson's estate was valued between $80 million and $500 million which is a tremendous spread. And that's the problem.

Valuations of LLCs for Gift and Estate Taxes: Formula Clauses and the *Wandry* Decision

Valuations Are an Essential Part of Any Attempted Gift of an LLC Interest - With or Without a Formula Bequest

In the much-noticed U.S. Tax Court case of *Wandry v. Commissioner*,[1] donors transferred gifts of specific dollar amounts of membership units in a limited liability company (LLC) to their children and grandchildren. The documents specified that the fair market value of the units was unknown at the time of the transfer, but the donors were transferring the number of units required to equal certain specified amounts and that if the IRS challenged the eventual valuation of the units, the number of units transferred would be adjusted so that they still equaled the specified amounts. This is referred to as a "formula clause" and *Wandry* upheld its use.

In a wonderful discourse on the law of Formula Clauses in Gift and Estate Taxation by a second year law student (which was published as a Note by Tax Lawyer the publication of the forum of the ABA Tax Section)[2] the history and rationale of the use of formula clauses to determine the value of assets such as interests in LLCs is discussed and explained. The article makes clear that with or without a formula clause a top flight valuation is essential to sustain a position in a tax dispute over value.

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Franchise Regulation and Damages, the only treatise that covers valuations of franchises, is updated 3 times a year.

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It also offers the wise warning to practitioners that the *Wandry* decision upholding formula clauses is hard to rely on because it overturns years of precedent going back to the 1944 *Proctor*[3] case and is merely a Tax Court memorandum decision by a single judge.[4]

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[1]TC Memo. 2012-88, 103 TCM 1472, March 26, 2011.
[2]"NOTE The Death of *Proctor* and the Rise of *Wandry*: A New Era of Formula Clauses in Estate Planning", Vol. 66 Tax Lawyer, No. 3, ascribed to Payson Lyman, Georgetown University Law Center, J.D. Candidate 2014
[3]*Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944)
[4]The Tax Court is currently composed of 17 Presidential Appointments, 12 Senior Judges and 5 Special Trial Judges.

Expert Testimony

Harsh Words for Underperforming Experts

The recent case of *In re Eastman Kodak Company*[1] is a cautionary tale for valuation experts who take on engagements for which they are not qualified or not willing to do the required research. Eastman Kodak filed for Chapter 11 bankruptcy in January 2012, and its June 2013 disclosure statement set the company's enterprise value at $498 million as of fall 2013 (the date of the reorganization plan). This valuation "was the result of hundreds of hours of work by recognized professionals," one of its financial experts testified. But a group of shareholders claimed Kodak had underestimated its value by over $2 billion. They offered expert reports that said there was significant undisclosed value in the company's patent portfolio and in its brand.

Kodak opposed the admission of the expert reports under *Daubert*. The first appraiser had graduated from law school less than five years previously and set up his own company to provide intellectual property (IP) services. He performed a discounted cash flow analysis and said, in a three-page letter to the shareholders in June 2013, that he believed "the intrinsic value of Kodak's U.S. patent portfolio to be $1.6 billion to $2.5 billion." But his data was all wrong. The most recent public financial statements projected 2013 IP revenue of only $35 million. The shareholders' expert had not even reviewed the most recent financial information.

The Court threw him and his report out saying, "Whatever the strength of his background, he spent only five hours and his firm spent a total of ten hours on valuing Kodak's patents," while admitting that his firm would need 5,000 hours to do a full analysis of the value of the patent portfolio. The Court concluded that based on his assumptions "that have no validity whatsoever," his testimony was not "useful or admissible" as to value.

The Eminent Judge Posner on the Requisite Qualifications for an Expert

In a recent engagement I came across an opinion[2] by Judge Posner, the Chief Judge of the US Court of Appeals for the Seventh Circuit (who has been receiving much press of late for his change of heart on voter identification laws and for his distaste for patent laws), on the admissibility of experts and found it very informative:

We move on to the issue of damages. [Plaintiff] presented its theory of damages by way of its accountant (a C.P.A.), and in the district court Suzuki argued that the accountant should not have been permitted to testify as an expert witness because he does not have a degree in economics or statistics or mathematics or some other "academic" field that might bear on the calculation of damages. The notion that *Daubert v. Merrell Dow Pharmaceuticals, Inc.* requires particular credentials for an expert witness is radically unsound. The Federal Rules of Evidence, which *Daubert* interprets rather than overrides, do not require that expert witnesses be academics or

PhDs, or that their testimony be "scientific" (natural scientific or social scientific) in character. Anyone with relevant expertise enabling him to offer responsible opinion testimony helpful to judge or jury may qualify as an expert witness. The principle of *Daubert* is merely that if an expert witness is to offer an opinion based on science, it must be real science, not junk science. [Plaintiff's] accountant did not purport to be doing science. He was doing accounting. From financial information furnished by [Plaintiff] and assumptions given him by counsel of the effect of the termination on [Plaintiff's] sales, the accountant calculated the discounted present value of the lost future earnings that [Plaintiff] would have had had it not been terminated. This was a calculation well within the competence of a C.P.A. [Citations omitted.]

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[1]2013 Bankr. LEXIS 3325 (Aug. 15, 2013)
[2] *Tuf Racing Products, Inc., v. American Suzuki Motor Corporation*, CCH Business Franchise Guide ¶11,904. (CA 7 July 24, 2000). Appeal from U.S. District Court, N.D. Illinois. 2000 U.S. App. Lexis 17728.

Estate Planning and Use of SCINs

Valuation At Issue In Pending Tax Court Case

Very little has been written about the valuation of self-canceling installment notes (SCINs), but they may be important in a pending Tax Court case, the *Estate of William M. Davidson,* in which the IRS has filed a petition for taxes due of up to $2 billion (yes, billion) because of undervaluations. Davidson was the late owner of the Detroit Pistons, Tampa Bay Lightning, and Guardian Industries (one of the country's largest private companies).

Of particular interest is the fact that in addition to the undervaluation allegation, the IRS is questioning the SCIN technique of selling assets to heirs based on a payment schedule that includes a provision that cancels the payments when the seller dies. The IRS says Davidson made errors in figuring his life expectancy, which caused the heirs to pay much less than fair market value.

Valuations: Discounted Cash Flow Method

Summary of Canadian Cases Available

In preparation for a Webinar to be offered to members of the Canadian Institute of Chartered Business Valuators on **"Why Valuing Franchised Businesses Is Different,"** my co-presenter, Edward (Ned) Levitt of Dickinson Wright LLP and his Student-at-Law Alexandra J. Schwarz, researched Canadian cases on discount rates. A summary of these cases may be obtained by contacting our office.

Cybersecurity

More Reasons To Harden Your Network Security

Adobe hack: At least 38 million accounts breached

Meet "badBIOS," [Basic Input/Output System] the mysterious Mac and PC malware that jumps airgaps