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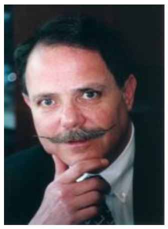
The Franchise Valuations Reporter

Franchise Technology Risk Management

Our Expertise



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

- Damages, Valuations & Expert Testimony
- Finance, Accounting and Tax
- Cyber Security and E-discovery of Electronically Stored Information

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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Franchise Technology Risk Management

Our franchise law and computer forensics experts provide consulting and implementation of all aspects of cyber security, ESI management and e-discovery for franchise systems - from preparation of cyber security and ESI-related policies and procedures manuals through collection, preservation, processing, production and presentation.

To inquire about our services, please e-mail Henry@FTRM.biz or call (212) 689-0400

Valuations: Discounts, Subsequent Events and CAPM

Fifth Circuit, Reversing Tax Court, Awards Full Discount

In *Est. of Elkins, Jr.*[1], the decedent's estate argued for a discount of 44.75 percent for fractional interests in works of art (a precedent that should be applicable in cases where family limited partnerships own franchises, too). The IRS countered with zero and the Tax Court applied a 10 percent discount. The Fifth Circuit held that the IRS had no viable basis for determining that no fractional-ownership discount was applicable. Accordingly, the circuit court agreed completely with the estate's expert, allowed a 44.75% discount and ruled there should be a refund of $14,359,508.21, plus statutory interest.

Estate Tax Valuation: Consideration of Post Death Events

In *Estate of Bernard Kessel v. Commissioner*,[2] the Tax Court addressed the issue of an estate seeking a refund for estate taxes paid on a Bernie Madoff account which was subsequently discovered to be worthless. The IRS moved for summary judgment asserting that after-death events cannot be considered. The Tax Court denied the motion finding there were fact issues and said,

> "Value in this context is defined as fair market value -- what a willing buyer would pay to a willing seller, both having reasonable knowledge of the relevant facts. Accordingly, later occurring events affecting the value of the property transferred are relevant to the determination of fair market value only if they were reasonably foreseeable at the time of transfer. [citation omitted]. But later occurring events not affecting value may be relevant to the determination of fair market value regardless of their foreseeability at the time of transfer. [citation omitted]."

CAPM Is An Absurd Valuation Model, Says Finance Professor

Here's one man's opinion:
"The CAPM [Capital Asset Pricing Model] is an absurd model because its assumptions and its predictions/conclusions have no basis in the real world. The use of CAPM is also a source of litigation: many professors, lawyers... get nice fees because many professionals use CAPM instead of common sense to calculate the required return to equity. Users of the CAPM make many illogical errors valuing companies, accepting/rejecting investment projects, evaluating fund performance, pricing goods and services in regulated markets, calculating value creation..."[3]

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[1]CA-5, September 15, 2014, 2014-2 USTC ¶60,683
[2]U.S. Tax Court, CCH Dec. 45,612(M), T.C. Memo. 59,915(M), (May 21, 2014).
[3] CAPM: an absurd model, Pablo Fernandez, Professor of Finance, IESE Business School, University of Navarra (October 6, 2014)

Nexus: Sales and Use Tax

South Carolina Tax Department Updates Nexus Guidance

We Write the Book

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

For more details, to see a Table of Contents or to place an order, go to the Wolters Kluwer Law & Business web page here.

DISCLAIMER

The information provided in this newsletter is for informational purposes only and should not be construed as legal or expert advice which can only be obtained from appropriate professionals. Franchise Valuations, Ltd. and Franchise Technology Risk Management provide such expert advice on the topics addressed herein.

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The South Carolina Department of Revenue has updated its sales and use tax guidance on nexus-creating activities. A release lists more than 40 types of business activities and relationships that will or will not create sales and use tax nexus with South Carolina. Two that may be of interest to franchisors are:

- the business **sells gift cards** in affiliated South Carolina stores; and
- the business sells tangible personal property to South Carolina residents from outside the state and is the single member in a **single member LLC** that is a disregarded entity operating in South Carolina.

The department also identified activities that do not create nexus on behalf of a business. For a complete list see Revenue Ruling 14-4, South Carolina Department of Revenue, September 10, 2014.

Texas: Out-of-State Retailer's Truck Deliveries to Texas Residents Established Nexus

A furniture retailer in Louisiana that did not have any locations in Texas, nonetheless established nexus in Texas by using its company trucks to deliver furniture to Texas resident purchasers and, therefore, was required to collect Texas use tax on items delivered into Texas. A retailer is engaged in business in Texas if it has a representative, agent, salesperson, canvasser, or solicitor operating in Texas for the purpose of selling or delivering or taking orders for a taxable item. Moreover, a tax rule requires an out-of-state retailer who is engaged in business in Texas to continue collecting Texas use tax on sales made into Texas for 12 months after the seller ceases to have nexus or ceases to be engaged in business in Texas. Decision, Hearing No. 107,751, Texas Comptroller of Public Accounts, July 23, 2014, released September 2014.

Sales Tax Nexus: Wisdom from Learned Counsel

In a recent issue of the ABA publication, *The Tax Lawyer*, there is an erudite piece on sales tax nexus by Rick Handel, formerly General Counsel for Policy for the South Carolina Department of Revenue.[1] He closes with a footnote worthy of consideration:

For my two cents, I would favor a compromise where the physical presence standard is abandoned and the Business Activity Tax Simplification Act (BATSA) bill is defeated. I think that using outdated standards that are not consistent with the way business is done, and encouraging entity manipulation to save taxes, will waste money and talent on nonproductive activities, favor those who are bright at using form over those who are bright at creating substance, and be detrimental to the national economy in the long run.

On the other hand, there needs to be an objective and generous *de minimis* standard. Businesses need to know what the rules are, and the country needs to encourage new and creative businesses by not overburdening them with tax compliance - not to mention that an "undue burden" would be unconstitutional. This *de minimis* standard would need to be based on the unitary business, to avoid rewarding gamesmanship and to allow new businesses to compete.

In addition, to avoid giving a competitive advantage to out-of-state businesses and encouraging inefficient business location to minimize taxes, the *de minimis* standard should be available to all taxpayers, in-state as well as out-of-state.

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[1]"A Conceptual Analysis of Nexus in State and Local Taxation," *The Tax*

Lawyer, Vol. 67 No. 4, Summer 2014.

Wrongful Termination: Good Cause?

Franchisee Granted Preliminary Injunction Against Termination

In *Romper Room Inc. v. Winmark Corporation*[1] the franchisee of a secondhand clothing franchise, Once Upon a Child, who had pled guilty to misdemeanor fraud in receiving state health insurance assistance, was granted a preliminary injunction against the franchisor's efforts to terminate his franchise based on the conviction.

In July 2014, the franchisee pleaded guilty to collecting more than $25,000 in benefits from BadgerCare -- a government-subsidized health insurance program for Wisconsin citizens who earned too much to qualify for Medicaid but not enough to buy insurance on their own without help. He collected the benefits over three years, despite earning more than $600,000 during that period. The result: a plea agreement to three counts of misdemeanor theft by fraud, a sentence of 30 days in jail and payment of $30,000 in fines.

On July 18, 2014, the story was reported in a newspaper carrying the headline "Once Upon a Child owner sentenced to jail for BadgerCare fraud." Three days later, franchisor Winmark notified the franchisee Gering that it intended to terminate the OUAC franchise pursuant to a provision in the franchise agreement allowing termination for a franchisee's pleading guilty to violating a law that adversely impacted the reputation of the business or materially impaired the goodwill associated with the "Once Upon a Child" name or marks. Winmark stated that termination would occur after 90 days, on October 22, 2014, and that it viewed the default as incurable.

Gering brought suit, contesting the termination on the basis of a lack of good cause for termination and a failure to provide 60 days for cure, under the Wisconsin Fair Dealership Law (WFDL). Gering moved for a preliminary injunction prohibiting Winmark from terminating the franchise agreements during the pendency of the litigation and the court agreed ruling the franchisee had no adequate remedy at law and that a balancing analysis showed that termination would impact the franchisee by the loss of employment to about 32 employees, possible insolvency, and the loss of ongoing business. Winmark, on the other hand, had already suffered whatever damage to its reputation that was likely to occur. Assuming the franchisee continued to make payments to the franchisor required under the agreement and complied with the remaining provisions of the agreement, the balancing of merits analysis weighed in favor of granting the preliminary injunction against the termination.

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[1]U.S. Dist. Court, Eastern Dist. of Wisconsin, Case No. 14-C-1217 (October 10, 2014, Griesbach, W.) This issue is covered extensively in Chapter 17 of Fox & Schaeffer, "Franchise Regulation and Damages" (CCH updated 3 times annually).

Cyber-Security

Standard Liability Policy Specifically Excludes Data Breach Coverage

As of May 1, 2014, Insurance Services Office, Inc. (ISO) requires a data breach liability exclusion endorsement to its standard commercial general liability (CGL) policy form. The endorsement is titled "EXCLUSION - ACCESS OR DISCLOSURE OF CONFIDENTIAL OR PERSONAL INFORMATION AND DATA-RELATED LIABILITY - WITH LIMITED BODILY INJURY EXCEPTION." Insurance regulators in virtually all U.S. states and territories have reportedly approved the endorsement.[1]

How many wake-up calls will it take? All franchise company executives should be evaluating the protection they have against this potentially crippling risk that can arise from organized hacking, laptop loss, or employee theft. [See Franchise Valuations Reporter, July 2014, "Cybersecurity: Quantifying Business Risk for Average Clean-up Costs.]

Regular liability insurance does not work; specific cyber insurance coverage is essential. Without it, not even the costs of litigation defense are covered. [See Franchise Valuations Reporter, April 2014, Cybersecurity: No Coverage for the Cost of Defense Under General Liability Policy.]

If your business has not yet suffered a cyber-loss consider yourself lucky but plan for the future - call us. If you have been breached you should call us also to get a cyber-review under attorney-client privilege.

Links to Recent Articles on Cyber-Crime

Cyber Security Business Doubles for London Insurer

Staples says probing possible payment card data breach

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[1] Under Coverage A - Bodily Injury and Property Damage Liability of the CGL policy form, exclusion "p" is revised to exclude damages arising from any "access to or disclosure of any person's or organization's confidential or personal information, including ... trade secrets, ... customer lists, ... credit card information, health information or any other type of nonpublic information...."

Under Coverage B - Personal and Advertising Injury Liability, coverage is removed for personal and advertising injury liability arising from any access to or disclosure of such non-public information. The exclusion applies to damages claimed for notification costs, credit monitoring expenses, public relations expenses, and other expenses that arise from any access to or disclosure of such non-public information. The exclusion retains a limited exception for damages that arise because of "bodily injury."