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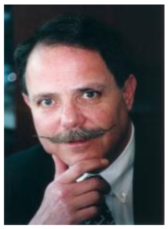
The Franchise Valuations Reporter

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

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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

Vicarious Liability for Venture Capital Funds Investing in Franchising?

First Circuit Holds Private Equity Fund Is a "Trade or Business" For Purposes of ERISA

As we noted briefly in last month's newsletter, the U.S. Court of Appeals for the First Circuit, in a decision with potentially far-reaching consequences for the private equity industry, has adopted an expansive view of what constitutes a "trade or business." The issue in the case was to determine whether a private equity fund can be held jointly liable for Employee Retirement Income Security Act (ERISA) multiemployer pension withdrawal liability incurred by the fund's portfolio companies. Although the case specifically deals with ERISA liability, a finding that a private equity fund constitutes a trade or business could also have wider tax implications for the fund, its managers and investors.

The case, *Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund et al*., No. 12-2312 (1st Cir. 2013) (Doc 2013-18003), involved a fairly typical private equity structure in which certain Sun Capital Funds funds (the "Sun Funds") together acquired 100 percent of a portfolio company, with no fund owning 80 percent or more on its own. The Sun Funds had no offices or employees nor did they make or sell goods, and they did not report income other than investment income. At some point after the Sun Funds made their investment, the portfolio company filed for bankruptcy and triggered the ERISA withdrawal liability event.

Carried Interest Tax Break Also At Risk of Being Undercut by Court

According to Bloomberg News, if the same logic is applied to the rest of the Internal Revenue Code, the changes could jeopardize the structure of the industry by altering some core benefits of private equity. "Carried interest," the profits share that fund managers receive as part of their compensation, is currently taxed as capital gains, because the purchase and sale of companies is treated like a stock transaction. But if the Sun Capital case is universally applied, it could affect the "entire legal infrastructure" of private-equity funds. "There's no extra leap that a court would have to take other than applying the same reasoning and interpretation," said Victor Fleischer, a law professor at the University of San Diego.

A three-judge panel of the First Circuit Court of Appeals ruled against the private-equity funds on July 24 and sent the case back to a lower court to address additional issues. On Aug. 23, the judges refused Sun Capital's request for a rehearing by the full appeals court. So far, the Treasury Department and the Internal Revenue Service have been cautious in reacting to the legal ruling, saying publicly only that they're looking at the issue carefully.

Valuations in Acquisitions

Purchase Price Allocations Shift Away from Goodwill

Recent data on the accounting treatment of acquisitions shows that more value is being allocated to identified intangible assets and less to unidentified goodwill, according to a report from Houlihan Lokey on purchase price allocation. The analysis examined 511 transactions in which the acquiring systems - from preparation of cyber security and ESI-related policies and procedures manuals through collection, preservation, processing, production and presentation.

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company was based in the United States and publicly held.

According to the report, the percentage of the purchase consideration allocated to intangible assets increased to 32% on average in 2012, up from 26% in 2011 while the percentage of purchase consideration allocated to goodwill dropped to 31% compared with 38% in 2011.

Categories of intangible assets acquirers most frequently identified were customer-related intangibles (cited in 53% of deals), trademarks and trade names (41%), developed technology (39%), and in-process research and development (9%). Other intangible assets typically included were non-compete agreements, licenses, permits, and other contracts or agreements. It is not surprising that more value is being allocated away from goodwill, which is subject to an annual test for impairment. But this may change if the new rules which no longer require annual impairment testing of goodwill are implemented.

Discount Rate for Damages

Delaware Appraisal Case Decides Correct Discount Rate

One of the frequently contested elements in the so-called battle of the experts is the appropriate discount rate to be used in valuations using the Discounted Cash Flow (DCF) method. In simple terms, the discount rate is the expected rate of return required for attracting capital to an investment. Shannon Pratt, one of the foremost sources in the area of business valuation offers:

> **Definition of a Discount Rate**. In economic terms, a present value discount rate is an "opportunity cost", that is, the expected rate of return (or yield) that an investor would have to give up by investing in available alternative investments that are comparable in terms of risk and other investment characteristics.
> The discount rate is the cost of capital for that particular category of investment. The discount rate is determined by market conditions as of the valuation date as they apply to the specific characteristics of the subject contemplated investment."[1]

In a recent Delaware "appraisal rights" case[2], the dissenting shareholders claimed they were entitled to receive more than the $4.80 per share offered in a May 29, 2009, merger of CXR into its majority shareholder, Cox Enterprises, Inc. The petitioners' valuation expert maintained that the petitioners' shares in CXR had a fair value of between $11.05 and $12.12 per share.

In an unusual display of harmony, the valuation experts for both sides agreed that the DCF approach to value was the proper method to value the shares and were also in close agreement as to the proper discount rate to be used to discount the projected cash flow, 8.1% and 8.0% for petitioners and respondent, respectively. This is substantially less than the 15-25% discount rates usually deemed necessary by parties in litigation seeking to undercut claims of damages.

The disparity in final values was occasioned by the parties' disagreement on the rate at which post-2009 cash flow would improve. The Court held that the dissenting shareholders' expert's anticipated growth was too high and ruled the appropriate value was $5.75 per share.

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[1] Shannon P. Pratt, DBA, CFA, FASA, Robert F. Reilly, CPA, CFA, ASA, and Robert P. Schweihs, ASA, "VALUING A BUSINESS The Analysis and Appraisal of Closely Held Companies" (Third Edition) at p. 157-8
[2] *Towerview LLC et al. v. Cox Radio, Inc.* C. A. No. 4809-VCP (Del. Ch. June 28, 2013)

Trademark Decisions

Owner of FAMOUS RAY'S PIZZA Could Receive Damages Award From Infringing Competitor

Wolters Kluwer's IP Law Daily reports that the owner of the federally registered trademarks RAY'S PIZZA, FAMOUS RAY'S PIZZA, FAMOUS ORIGINAL RAY'S PIZZA, and similar marks is entitled to nearly $223,000 in damages, attorney's fees, and costs from a competitor -- Famous Ray's Pizza Buffet -- that used the FAMOUS RAY'S PIZZA mark in connection with its Manhattan restaurant. In a Report and Recommendation written for the federal district court in New York City (*U.S.A. Famous Original Ray's Licensing Corp. v. Famous Ray's Pizza Buffet, Inc.*, September 26, 2013, Gorenstein, G.), the magistrate also determined that an injunction was warranted. The injunction would prohibit further infringement of the plaintiff's marks and require the destruction of the infringing materials.

"Footlong" Too Generic

As also reported by Wolters Kluwer's IP Law Daily for October 8, the franchisor of Subway's could not register the standard character mark, FOOTLONG, for sandwiches in International Class 30, because the proposed mark was generic for sandwiches that were one foot in length. (Trademark Trial and Appeal Board in *Sheetz of Delaware, Inc.* (September 5, 2013, Bergsman, M.)).

Cybersecurity

Privacy Complaint Filed Against LinkedIn In Class Action

A class action, *Perkins et al v. LinkedIn,* was filed on September 17, 2013, in US District Court for the Northern District of California, alleging that LinkedIn's advertising revenues are based on "LinkedIn's practice of breaking into its users' third party email account, downloading email address[es]...without consent,...and indefinitely stor[ing] email addresses...". The Complaint alleges that LinkedIn harvests member email accounts of "Yahoo! Mail, Microsoft Mail, Google Gmail..." so that:

> *When a new member signed up for LinkedIn, LinkedIn asked for that new user's external email address. This request is made without any warning of what the email address will be used for.*

The Plaintiffs complain that the Terms of Service and Privacy Policy are not adequately disclosed and do not authorize LinkedIn to harvest email information.

More Reasons To Harden Your Network Security
Adobe warns 2.9 million customers of data breach after cyber-attack