



The Franchise Valuations Reporter

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Damages, Valuations and Cyber Crime

Welcome to our newsletter focusing on issues unique to our practice that we don't think are addressed anywhere else: valuation and damages, cyber crime, expert testimony and tax nexus – the issues we know best, that matter to our clients – franchise executives and the consultants, attorneys and other professionals who advise them. We hope you find information that warns, informs and benefits you.

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WARNING: CYBER CRIME AND FRANCHISORS, DISTRIBUTORSHIPS AND DEALERSHIPS

Does your system's Confidential Operating Manual address the issue of cyber security? Do you even know what cyber security is? The common definition is the protection of any computer system, software program, and data against unauthorized use, disclosure, transfer, modification, or destruction, whether accidental or intentional. Cyber attacks can come from internal networks, the internet, or other private or public systems. Businesses cannot afford to be dismissive of this problem because those who don't respect, address and counter this threat will surely become victims.

Franchises, dealerships and distributorships commonly have 60-70% of their market value in intangible property (IP). These assets are particularly vulnerable to cyber criminals – “hackers” - and penetration of computer systems is becoming rampant. The

2009 Davos conference concluded that organized criminal gangs of hackers are invading the Internet and that cyber crime will cost \$1 trillion this year.

Franchise Technology Risk Management (FTRM), a division of Franchise Valuations, Ltd., provides cyber security analysis, penetration testing and consulting services for the franchise, distributorship and dealership community. FTRM founders Henfree Chan and Bruce Schaeffer invite you to test your own company's cyber security preparedness by answering these “**Twenty Questions on Cyber Crime**” (<http://www.franchisevaluations.com/press/FBLAMarch2009.pdf>) which appeared in the March 2009 edition of *LJN's Franchising Business & Law Alert*.

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Cyber Crime

Chan Scale of Cyber In-Security to Measure a Company's Exposure to Cyber Crime

On average there has been at least one cyber event per day, every day since 2006. Thus, all companies with large IP components (such as know-how, confidential operating manuals), or particularly those that use wireless point of sale terminals, must assess their cyber risk and insure against it as best they are able by implementing the best prophylactic protections they can obtain.

To assess the situation we have formulated a "Chan Scale of Cyber In-Security"©, based on the potential harm that can be caused by a breach of network security:



1 Chan – Low risk. Hacker has gained entry to system but minimally. Minor risk of business disruption, but access can aid attackers in information gathering and planning future attacks.



2 Chans – Medium Risk. Malware has been implanted in the company's network which could cause malfunctions and mischief. Significant risk of a business disruption occurring that could result in financial loss and/or damage of goodwill.



3 Chans – Medium-to-High Risk. Using sniffers or other equipment, hackers have obtained Personally Identifiable Information (PII) from POS systems. Significant risk of a business disruption that could create financial loss and/or damage of goodwill.



4 Chans – High Risk. Inside job: data stolen by disgruntled employee. Potential risk of business disruption, resulting in financial loss, damage of goodwill; PII may be taken, as well as company's confidential information and financial information.



5 Chans – Critical Risk. Hackers have gotten into the system and can access PII as well as the company's financial information and confidential information. Severe risk of business disruption, financial loss, damage of goodwill. System, application, and database has been compromised.

YOU SHOULD BE FRIGHTENED!

Links to Recent Articles on Cyber-Crime

Personal Data of 45,000 Exposed In FAA Data Breach

<http://www.darkreading.com/security/attacks/showArticle.jhtml?articleID=213402894&cid=RSSfeed>

CVS to pay \$2.25 million to settle HIPAA violation

<http://www.scmagazineus.com/CVS-to-pay-225-million-to-settle-HIPAA-violation/article/127570/>

ID theft up, and 20somethings suffer most

http://news.cnet.com/8301-1009_3-10173702-83.html

Facebook users suffer viral surge

<http://news.bbc.co.uk/2/hi/technology/7918839.stm>

Security of wireless networks often leaves

Valuation Decisions

Election of Remedies: Lost Profits or Lost Business Value

Think first! In the case of *Environmental Biotech v. Sibbitt Enterprises*, (USDC FL November 24, 2008) BUSINESS FRANCHISE GUIDE ¶14,032, the US District Court held that a franchisee who had abandoned his “lost profits” claim had made an election of remedies in favor of his

Damages Decisions

Lost Profits: Definition of “Speculative”

It is generally considered hornbook law that lost profits will not be allowed if the proof is vague, speculative, or uncertain. However, in the recent case of *Progressive Child Care v. Kids 'R' Kids International*, BUSINESS FRANCHISE GUIDE ¶14,018, the court held that such a rule of damages “relates more especially to the uncertainty as to cause, rather than uncertainty as to the measure or extent of the damages. See *T.C. Prop. Mgmt., Inc. v. Tsai*, 600 S.E.2d 770, 772 (Ga.Ct.App. 2004). Mere difficulty at fixing the exact amount of lost profits, where proximately flowing from the alleged injury, does not constitute a legal obstacle in the way of their allowance. *Id.*” (emphasis added). And under Georgia law, “generally, [a reviewing court] affirms civil awards that are supported by any evidence.” (emphasis added). So disputants are well advised to address damages aspects of their cases with

retailers, credit card firms at risk

<http://www.chicagotribune.com/business/chicago-fri-t6-retail-wireless-securmar06,0,7139232.story>

damages claim for the lost value of the business. However, the court found that under Florida law a franchisee could only claim the lost value of its business if the business was actually destroyed. There was no destruction in the case. Thus, the claim for lost business value was denied and the claim for lost profits could not be revived.

great scrutiny as early in the process as possible because in most cases the measure of damages is what the whole fight is about.

Rescission: The Continuing Quizno’s Sagas

In *Quizno's Franchising II v. Zig Zag Restaurant Group*, Colo. Dist. Ct., BUSINESS FRANCHISE GUIDE ¶14,046, one of the many Quizno’s litigations, a Colorado state trial court determined that a sandwich shop franchisee was entitled to rescissional-type damages in the amount of \$349,797 and post-judgment interest at the rate of 24 percent as a remedy for the franchisor’s wrongful termination of their agreement. The franchisor argued that it terminated the franchise because the franchisee breached its agreement by materially impairing the goodwill associated with the franchisor's trademarks. But the court held to the contrary – that the franchisor breached the agreement by wrongfully terminating the franchisee.

Daubert Decisions

Exclusion of Expert Upheld – Former Quest CEO Nacchio Going to Jail

Last year Joe Nacchio, the convicted former CEO of Quest, had his conviction overturned by a three-judge panel because the trial court excluded his expert who was going to testify that Nacchio's sales were not based on insider information but conformed to certain economic parameters. The government appealed the decision to the full Tenth Circuit submitting a 63 page brief.

The result: the exclusion of the expert was sustained based on his failure to provide an adequate report in a timely fashion under Rule 16 and the failure of Nacchio in carrying his burden to show that his expert's proffered testimony was admissible under Rule 702. The trial court rejected the expert's "reliability" – in essence his "underlying reasoning and methodology." As a result, the conviction was re-instated and Nacchio is going to jail.

Nexus Notes

“Physical Presence” –BAT Legislation

Pro-business anti-nexus legislation denominated Business Activity Tax (BAT) bills have been repeatedly introduced in Congress. These bills generally provide that states cannot levy income or sales tax on entities that do not maintain a “physical presence” within the taxing jurisdiction of at least a certain number of days.

The proposals reject the concept of “economic nexus” and have been strongly attacked by organizations representing state and local governments which estimated that such laws would reduce BAT revenues to state and local governments by an average of 10.4% costing them \$6.6 billion. No such measures have been passed to date.

In February 2008, Reps. Rick Boucher (D-Va.) and Bob Goodlatte (R-Va.) reintroduced BAT legislation. And in February 2009, in the new Congress, Rep. Boucher introduced the bill again. The legislation would prohibit a state from

imposing a BAT on any taxpayer, unless the taxpayer has a physical presence in the state for 15 days or more during the year. Presence in a state "to conduct limited or transient business activity" would not establish physical presence. Senator Bunning (R-Ky), the current bane of the Republican Party, introduced a similar bill in October, 2008.

New York --Sales and Use Tax: Amazon and Overstock's Challenges to Provision Taxing Internet Sales Fail on Appeal

New York and other states have passed legislation accepting economic nexus as sufficient for taxation (without physical presence), requiring on-line retailers to collect sales and use tax. The New York statute survived attacks on its constitutionality brought by Amazon and Overstock. *Amazon.com LLC v. New York Department of Taxation and Finance*, New York Supreme Court, New York County,

Index No. 601247/08, January 12, 2009. Similar legislation has been introduced in Connecticut, Hawaii, Minnesota, California, Tennessee and North Carolina. Utah appears to have taken the same position by regulation.

Physical Presence and Internet Travel Companies

One business sector getting a lot of nexus attention lately is on-line travel companies (OTCs). For example, Orbitz and Expedia have appealed from California rulings

holding them liable to collect and pay over sales taxes for CA transactions, where they have no physical presence.

And a Georgia court ordered Expedia to collect hotel occupancy taxes based on the prices its online consumers pay on Expedia.com rather than the wholesale prices it pays to the hotels. Expedia was deemed liable because it acted as the collecting agent. Similarly Indiana declared OTCs are obliged to collect sales and use tax; and South Carolina has ruled the same way.

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 and can be reached at 404 Park Avenue South, New York, NY 10016. 212.689-0400 or www.franchisevaluations.com and www.ftm.biz.