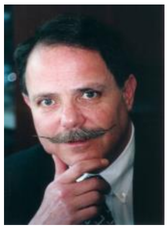
Volume 11 - Issue 11 **November 2019**

The Franchise Valuations Reporter

Our Expertise



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

- Valuations, Damages & Expert Testimony
- Finance, Accounting and Tax

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Call us for a free, confidential consultation. And we're always interested in your comments about the newsletter.

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We Write the Book

Franchise Regulation and Damages, the only treatise that covers valuations and damages in franchise disputes, 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

Damages

Banned Supplements Have Zero Value, Causing Economic Injury on Purchase

In *Debernardis v. IQ Formulations, LLC*, the Eleventh Circuit reversed and remanded a dismissal for lack of standing, finding that an illegal supplement has no value and that therefore, its purchase results in economic harm. The appellate court reversed a district court decision dismissing a putative class action for lack of standing due to lack of injury in fact. The class members' purchase of an illegal dietary supplement constituted an injury under a benefit of the bargain theory as the purchasers exchanged money for something that had no value. The case was remanded to the district court (November 14, 2019, Pryor, J.).

Maaco Awarded $449k in Lost Future Royalties From Franchisees

In *Maaco Franchisor SPV, LLC v. Cruce*, a default proceeding, Maaco was entitled to the lost future profits, as well as damages for unpaid royalties and past expenses, following a breach of contract by the franchisees of four Maaco franchises. Additionally the franchisor's claims for future advertising contributions, and attorney fees for the franchisees' breach of the franchise agreement, were awarded. Maaco established future damages through calculations using data specific to those franchises based on a historical analysis of actual revenues. The court awarded approximately $460,000 in past due accounts receivable and $449,000 in lost future royalties for the four franchise locations at issue in the breach of contract, as well as damages related to promissory notes executed by the franchisees and subsequently breached (October 18, 2019, Cogburn, M.).

Valuations

WeWork - Lies and Phony Metrics

According to the *Wall Street Journal*, WeWork was scrambling to reassure regulators at the SEC about its financial reporting just weeks before its planned IPO (which was cancelled in the light of massive over-valuation). WeWork fought hard to sustain a fictional valuation metric they called the "contribution margin" which WeWork had previously called community-adjusted Ebitda. It was widely derided as a useful data point because it excludes costs to such an extent that it flipped WeWork's bottom line for 2018 from a net loss of about $1.9 billion using standard accounting, to a $467 million profit. According to the article, "The SEC is stepping up scrutiny of creative financial measures, lawyers said. Nearly all big companies now use at least one non-GAAP financial metric. Last year, 97% of S&P 500 companies used non-GAAP metrics, up from 59% in 1996, according to an analysis for the *Journal* by research firm Audit Analytics." Read the WSJ article here.

Tax Affecting - Recent Cases Kress and Aaron

Chris Mercer, a well-respected valuation expert, has long believed that an S Corporation, at the enterprise level, is worth no more than an otherwise identical C Corporation. Thus, when valuing S corps he imposes a C

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Corporation tax rate on his estimated profit flow. This is known as "tax affecting" i.e. modifying the cash flow value of a pass through entity (PTE) to impose a fictional tax on the profits as if it were a C Corporation. This author and the IRS and the Tax Court (until recently) thought this an imposed fiction to discount the value of a PTE to take account of a non-existent liability, i.e. the obligation to pay entity level taxes which are not imposed on LLCs or Sub S Corporations.

But two recent cases have reinforced the argument for those advocating "tax affecting". In *Kress v US* [1] and in *Estate of Aaron Jones* [2], a federal district court and one judge from the Tax Court in a Tax Court Memorandum decision, held that tax affecting can be appropriate and that it is a question of fact and not a question of law. Thus Judge Pugh in the *Jones* case approved tax affecting and the use of the income method rather than the net asset method. Thus, the IRS claim for an additional $49 million of gift tax was denied.

Fair Value in Delaware Again

In *In re Appraisal of Jarden Corp. (I)*, 2019 Del. Ch. LEXIS 271 (July 19, 2019), after an in-depth analysis, the Delaware Court of Chancery found the unaffected market price was the most reliable indicator in a major statutory fair value case. At issue was the acquisition of Jarden Corp. by Newell Rubbermaid for cash and stock yielding a merger price of $59.21 per share. There was no auction, and the company did not reach out to other potential strategic buyers or financial sponsors. The petitioners' trial expert found $71.35 per share was the fair value; Jarden's (respondents') expert said it was $48.01 per share. The unaffected market price was $48.31 per share and the court in siding with respondent noted the valuation of the petitioners' expert "implies that the market mispriced Jarden by over $5 billion." That was not accepted.

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[1] USDC ED WI, Case No 16-C-795 (March 25, 2019, Griesbach, Chief Judge).

[2] US Tax Court, (TC Memo 2019-101, August 19, 2019).

Joint Employer, Independent Contractor, Vicarious Liability

Realty Company Could Be Vicariously Liable For Agent's Infringement of Photo

In *Stross v. PR Advisors LLC*, it was held that it was not necessary for the company to have knowledge of the infringing activity to be liable for vicarious infringement. The Plaintiff, a professional photographer, adequately stated a claim for vicarious copyright infringement against Pinnacle Realty Advisors (PRA) by asserting both that PRA's sponsored agent directly infringed Stross's copyright by displaying his photograph on her website without his permission and by pleading the two elements of vicarious copyright infringement: (1) PRA had a direct financial interest in the infringement and (2) PRA was able to supervise the infringing act but failed to do so. The federal district court in Dallas rejected PRA's argument that the agent was solely responsible for the content of her website, noting that Stross alleged that the infringement occurred under the auspices of PRA's sponsorship and that, under Texas law, PRA had a legal duty to supervise a sponsored agent's conduct (October 31, 2019, Fish, A.).

California Passes AB-5 Ensuring Joint Employer Liability Issues

Signed into law on September 18, 2019, Assembly Bill 5 (AB-5) adopts the

"ABC test" for certain California employment laws. The ABC test will be used to determine when an individual (such as a franchise owner) is an employee rather than an independent contractor under California law. Although the stated purpose of AB-5 is to classify workers in the "gig economy" for companies such as Uber and Lyft as employees rather than independent contractors, the decision reached about the same time in *Vazquez v. Jan-Pro Franchising International, Inc.* shows that franchising is also impacted by the broad-reaching ABC test.

In Wage-Hour Lawsuit Alleging It Misclassified Franchisees, 7-Eleven Advances Counterclaims, Third-Party Complaint

7-Eleven claimed that because the plaintiffs held themselves out as employees when they were presumed to be independent contractors under the franchise agreements, it adequately alleged a breach of contract claim, and that it was also entitled to indemnification. In a putative wage-hour class action brought by 7-Eleven franchisees alleging they were misclassified as employees, 7-Eleven survived a motion to dismiss its counterclaims and third-party complaint seeking declaratory relief to void the franchise agreements and claims for breach of contract and indemnification. The federal district court in Boston allowed both claims to advance, finding in particular that dismissal of the breach of contract claim would be premature since the underlying dispute -- whether plaintiffs were independent contractors or employees -- required some factual inquiry into the parties' employment relationships (*Patel v. 7-Eleven, Inc.*, September 6, 2019, Gorton, N.).

CCH Antitrust Law Daily and IP Daily

Top Antitrust and Intellectual Property Law Developments

This is an unsolicited testimonial for CCH's daily reporters: Antitrust Law Daily and IP Law Daily. In case you missed the highlights from the October issues, you can see synopses for Antitrust Law Daily here and for IP Law Daily here.

Goodwill Accounting and the Great Mandela

New Proposals to Amortize Goodwill

Goodwill is the ultimate rubric asset. After specifically allocating the purchase price of an acquired business to specific assets, everything that's left over is denominated 'goodwill'. When I started in the tax and financial arena, goodwill was a nightmare asset for tax purposes because it was deemed to have an eternal useful life; thus, a taxpayer could never recover the cost of purchased goodwill for tax purposes while for financial accounting it had to be amortized giving the company an artificial loss. Then Congress adopted IRC Section 197 and provided for amortizing the asset over 15 years for tax purposes; but for financial reporting goodwill was deemed to have constant value and therefore only subject to adjustment for impairment. Well that's been a nightmare too. Now they are proposing amortizing the cost of good will for financial accounting rather than adjusting for impairment. So the more things change, the more they circle back to how they used to be - for better or for worse.

Attorneys' Fees - Prevailing Party

Octane Fitness' Standard Now Guides Lanham Act Attorney Fee Awards in Seventh Circuit

Under the Lanham Act attorneys' fees are to be awarded in trademark cases only if the circumstances are "exceptional". Recently the Seventh Circuit joined other circuits in adopting a totality of circumstances test for determining what qualifies as "exceptional." In *LHO Chicago River, LLC v. Perillo*, the Seventh Circuit Court of Appeals, joining several other circuit courts, has adopted the totality-of-circumstances test set forth by the Supreme Court for evaluating whether a case is exceptional under the Patent Act's fee shifting provision. Because the district court in this case had rejected the defendants' request for attorney fees under the Seventh Circuit's previous prevailing more restrictive abuse-of- process test, the decision was vacated and the case remanded for reconsideration under the Supreme Court's *Octane Fitness* standard (November 8, 2019, Manion, D.).

Quotations

"The current moment [in history] disproves Darwin" -- Henry Adams, a scion of presidents.