The Franchise Valuations Reporter

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Our Expertise

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

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

Have a Question About Succession Planning for Franchise Owners?

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.

This Day In History

October 16, 1941 – The Closest the Nazis Came to Taking Over the World

On this day in history 79 years ago, during the Russo-German part of World War II, the Wehrmacht was advancing on Moscow as part of Operation Typhoon and came close to winning. The main highway from the Southwest was wide open. In Moscow, government workers, completely panicked, were fleeing to Kyubishev, the railroad stations and river boats were filled with Communist aparatchiks trying to escape the Nazis and the NKVD was being ridiculed and ignored openly in public. The city-wide terror lasted two days until martial law was declared and from then on was referred to as the great *Bolshoi drap* or Moscow skedaddle. But right after that the weather changed and Marshall Zhukov saved the day (and perhaps mankind) although at the cost of millions of Soviet casualties.

Joint Employer/Vicarious Liability

FTC Franchise-Specific Regulatory Scheme Governed Over General Independent Contractor Test In Massachusetts

In view of the conflict between the Massachusetts Independent Contractor Law and the regulatory scheme promulgated under the Federal Trade Commission (FTC), a federal district court in Massachusetts held that the **franchise-specific regulatory regime** of the FTC governed over the general independent contractor test. Because the FTC Franchise Rule requires a franchisor to exercise "significant" control or else risk not being in compliance, the rule established a regulated classification status unique from that of an employee or independent contractor. The result was a finding that the Massachusetts

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ICL did not apply to 7-Eleven. The Court held that to find that the franchisees were employees under the FTC definition would "eviscerate the franchise business model." Thus, the court granted summary judgment in favor of 7-Eleven in a class action lawsuit by franchisees claiming they were misclassified as independent contractors, instead of employees (*Patel v. 7-Eleven, Inc.*, September 10, 2020, Groton, N.).

Marriott, Inter-Continental Skirt Liability for Hotel Franchisees' Alleged Tolerance for Trafficking

Allegedly obvious trafficking activity at a Fairfield Inn (a Marriott brand) and a Holiday Inn (part of the Inter-Continental family) did not open the franchisors to liability without averment that they knew of the particular trafficking at issue. Thus, a child victim in Michigan could not maintain federal or state claims against the hotel chains for failing to take action to prevent or interfere with sex trafficking that was obviously taking place at hotels in Detroit and Ann Arbor, according to a federal district court in Flint. Although the victim pleaded "deeply disturbing" facts suggesting that staff at the hotels knew or should have known that she was being sex trafficked, those allegations did not satisfy the state-of-mind element of her federal William Wilberforce Trafficking Victim Protection Reauthorization Act ("TVPRA") claims against the hotels' franchisors. Moreover, her common law claims of negligence were barred by Michigan's three-year statute of limitations. The defendants' motions for dismissal were therefore granted, and the claims were dismissed with prejudice (*H.G. v. Inter-Continental Hotels Corp.*, September 23, 2020, Leitman, M.).

Expert Testimony

Maryland Commits to Daubert For Evaluating Admissibility of Expert Testimony

In *Rochkind v. Stevenson*, 2020 Md. LEXIS 414 (Aug. 28, 2020), Maryland's highest court recently changed the standard for the admission of expert testimony when it abandoned its previous two-channel approach in favor of *Daubert.* The decision aligns Maryland with the majority of states that follow *Daubert,* but it reflects a split (4-3) court.

In 1978, Maryland's Court of Appeals (state's supreme court) adopted *Frye* in the *Reed v. State* decision. The test became known as the *Frye-Reed* standard. In 1993, the U.S. Supreme Court, in *Daubert*, held that Federal Rule of

Evidence (FRE) 702 superseded *Frye.* Thereafter, Maryland adopted Rule 5-702, the counterpart to FRE 702, while holding onto *Frye-Reed.* In the recent case, after a lengthy discussion of the existing approach, a majority of judges found it was appropriate to adopt *Daubert* solely. The two-channel approach, the Court found, had led to a "duplicative analytical process" and had "muddied" the waters of admissibility. "Instead of perpetuating a process wherein expert testimony must pass through *Frye-Reed* and Rule 5-702, we implement a single standard by which courts evaluate all expert testimony: *Daubert."* Adopting *Daubert* will "streamline" the process and permit trial courts "to evaluate all expert testimony—scientific or otherwise—under Rule 5-702."

The majority opinion provides a list of 10 factors that are "persuasive in interpreting Rule 5-702," five *Daubert* factors and five additional factors courts have used to determine whether expert testimony is sufficiently reliable. The court remanded the case for a new trial "consistent with this opinion."

Valuations

McDonald's, Chipotle and Domino's Are Booming During Coronavirus While Your Neighborhood Restaurant Struggles

According to the Wall Street Journal a health crisis is creating a divide in the restaurant world. The coronavirus pandemic is splitting the restaurant industry in two. Big, well capitalized chains are gaining customers and adding stores while tens of thousands of local eateries go bust. "Larger operators generally have the advantages of more capital, more leverage on lease terms, more physical space, more geographic flexibility and prior expertise with drive-throughs, carryout and delivery. A similarly uneven recovery is unfolding across the business world as big firms have tended to fare far better during the pandemic than small rivals, thinning the ranks of entrepreneurs who could eventually become major U.S. employers. In the retail world, bigger chains like Walmart Inc. and Target Corp. are posting strong sales while many small shops struggle to stay open."

Accounting for COVID-19 in Fitness Center Valuations
In a case[1] which proceeded under the Small Business Reorganization Act (SBRA) and in large part focused on the intricacy of the Bankruptcy Code and secured vs

unsecured creditors, the Bankruptcy Court of the Eastern District of Pennsylvania addressed how COVID-19 impacts valuations. The debtor's objection to a creditor's election to have its claim treated as fully secured under 11 U.S.C.S § 1111 (b) was sustained, and the claim was bifurcated into both secured and unsecured components to be treated according to the reorganization plan. The question of how to value a fitness club in the context of COVID-19, and the economic uncertainty that comes along with it, was the central theme of this case.

Analyst Develops a COVID-19 Marketability Discount

According to Business Valuation Resources **Greg Caruso** of Harvest Business Advisors, reports that he has been using a "COVID-19 marketability discount" on control interests to make an extra risk adjustment. "In many situations, I favor the methodology of showing a separate COVID-19 marketability discount," he says "because it clearly shows the valuator's thought process and the actual discount being applied for the current high level of uncertainty." His methodology is based on factors such as those used in *Mandelbaum* and the IRS DLOM Job Aid but with categories modified to fit the current situation. He first developed the technique for use in a valuation for an SBA loan concerning a company that was temporarily shut down and appeared to be fully recovered. Yet, there was still the risk of another shutdown and customers would have economic issues if a recession hit, so Caruso's basic capitalization rate was a buildup for "normal times," which included a normal company-specific risk that he further discounted by the COVID-19 marketability discount.

'Overstated' Projections Sink Plaintiff's Fair Value Determination

In *Magarik v Kraus,*[2] a "fair value" oppressed shareholder dispute, both valuation experts used the income and market approaches but reached very different value conclusions. The petitioner's expert using an income method, valued the company at $21.9 million; under the market approach, he arrived at a value of almost $38.8 million. Averaging the two values, he said the company was worth $30 million. In contrast, the respondents' expert, using a single-period capitalization method and cash flow, valued the company in the range of $5.9 million to $6.1 million. He generated a value range of between $5.3 million and $6.1 million. Giving greater weight to the income approach, he valued the company at $6.05 million. The court agreed with the respondent finding that the success of the company, as shown by a rapid growth in sales, "was not as great as petitioner contended … nor was it

accurately predictive of future success or of the true value of [the company].” It added that the projections “were, put mildly, ambitious, and, in fact, were overstated. In reality, the value of the business was never $30 million.”

Delaware Court of Chancery Uses Company’s DCF Model

In another fair value dispute[3] both parties offered expert testimony and used the same three valuation techniques (analyses of prior purchases of company stock, comparable transactions analyses, and discounted cash flow models). The experts even “materially agreed on several important inputs,” the court observed. However, “as has become standard fare for appraisal litigation, the experts reached monumentally different valuations,” the court said. The petitioner’s expert arrived at a fair value of $4.1876 per share. The company’s (respondent’s) expert declined to provide a single valuation but his summary values ranged from $0.06 per share to $0.11 per share. The Court found that the fair value of the company on the merger date was $0.228 per share,—a notable drop from the $0.42899-per-share price that had been offered to the dissenting shareholder in the context of the squeeze-out merger.

[1] IN RE: BODY TRANSIT, INC. d/b/a RASCALS FITNESS, Debtor Bky. No. 20-10014 ELF 08-07-2020
[2] Index No:606128-15, Nassau County, Supreme Court of New York, J. Destefano (April 10, 2020)
[3] *Kruse v. Synapse Wireless, Inc.*, 2020 Del. Ch. LEXIS 238 (July 14, 2020)

Attorneys' Fees

Rothschild Digital’s Litigation History and Conduct Warrant Attorney Fee Award

Rothschild Digital Confirmation, LLC’s pattern of vexatious litigation, its conduct during litigation, and the relatively weak merits of its patent infringement claims justified an attorney fees award. Evidence that Rothschild had engaged in a pattern of questionable patent infringement litigation in other cases combined with its conduct during the litigation and the relatively weak merits of its legal claims in this case met the exceptional case requirement for an award of attorney fees under the Patent Act, the U.S. District Court for the District of Delaware ruled (*Rothschild Digital Confirmation, LLC v. Companycam, Inc.*, October 13, 2020, Noreika, M.).

Quotations From Murphy's Law Corollaries

"Never Argue With A Fool, People Might Not Know The Difference"

"There's Never Time To Do It Right, But There's Always Time To Do It Over"

"When In Doubt Mumble. When In Trouble, Delegate"

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