

NOVEMBER/DECEMBER 2011

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BRIEFING

***Chemtura* addresses business appraisals in a volatile economy**

Calculating damages

Tricks of the trade secret

Why the valuation date is so important

Marketability discounts for controlling interests?

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Chemtura addresses business appraisals in a volatile economy

In *Chemtura*, the U.S. Bankruptcy Court for the Southern District of New York issued a lengthy decision confirming the debtors' reorganization plan under Chapter 11 of the U.S. Bankruptcy Code. Bottom line: The valuation reports offered in the case fell short in their ability to sway the court.

Valuing the debtors

The case involved Chapter 11 petitions filed by Chemtura Corp., a public company, and 27 of its affiliates (collectively, the "debtors"). With operations in the United States and Canada, the debtors produced specialty chemicals and other products sold worldwide.



The debtors and almost all of their creditors supported the reorganization plan, but the equity holders opposed it. Their objection was that the plan — which called for distributions of both cash and stock to most creditors — undervalued the debtors. As a result, they argued, the plan overpaid creditors and underpaid equity holders.

In deciding whether to confirm the reorganization plan, therefore, the critical issue for the court was whether the valuation on which the plan was based fell short of the debtors' actual total enterprise value (TEV). If it did, the creditors would be overpaid. The court concluded that it did not, and confirmed the plan.

Evaluating the valuers

Several valuation experts — all with investment banking firms — prepared reports, but the court focused primarily on UBS, which prepared the equity committee's analysis, and Lazard, which prepared the debtors' analysis. Although each valuation report had its weaknesses, the court reserved its harshest criticism for UBS.

UBS estimated that the debtors' TEV fell within a range from \$2.3 billion to \$2.6 billion, with a \$2.45 billion midpoint. Lazard's estimate ranged from \$1.9 billion to \$2.2 billion, with a midpoint of \$2.05 billion (the value on which the plan was based).

Both firms employed three valuation methodologies:

1. Discounted cash flow (DCF),
2. Comparable companies, and
3. Precedent comparable transactions.

The firms differed, however, in their application of the methodologies. Lazard considered all three

THE CASE FOR INDEPENDENT EXPERTS

In the *Chemtura* case (see main article) the court questioned the credibility of the valuation experts, although it didn't exclude their testimony. Factors that caused the court to take their opinions "with a grain of salt" included:

- ◆ Inconsistencies between trial and deposition testimony,
- ◆ Unwillingness to give straight answers on cross-examination,
- ◆ Statements indicating bias, and
- ◆ Financial incentives in engagement agreements.

The last factor, which took the form of "transaction fees" or "deferred fees" contingent on plan consummation or achievement of distribution targets, gave the experts a financial stake in the outcome. Such arrangements are customary, the court explained, but they "can't be ignored when investment bankers testify."

Given the inherent conflict of interest when an advisor with a contingent fee arrangement testifies, it's advisable in most cases to engage independent experts to opine on critical valuation issues.

methods, while UBS based its valuation solely on DCF, using the other two methods as a "sanity check" on the reasonableness of its DCF computation. The court criticized this approach, observing that in an uncertain economic environment the comparable companies method — and, to a lesser extent, the precedent transactions method — were more persuasive indicators of value than DCF.

The court found flaws in Lazard's methods for capturing cyclicity. But UBS failed to even address the issue.

Court's other conclusions

Here are additional highlights of the court's valuation conclusions:

DCF. Both firms assumed continuously increasing growth over a five-year period, relying on admittedly aggressive projections by the debtors' management. But UBS calculated the debtors' terminal value based

on projected earnings in the final year of the period, while Lazard tried to "normalize" earnings to reflect the cyclical nature of the business.

The court found flaws in Lazard's methods for capturing cyclicity. But UBS failed to even address the issue, instead calculating terminal value based on a level of earnings the company had never achieved. Although valuers traditionally base terminal value on cash flows in the last projected year, the court found this approach inappropriate given the cyclical nature of the business and the uncertainty of overly aggressive projections in a volatile economy. Thus, UBS's analysis overstated the debtors' value.

Comparable companies. UBS criticized Lazard for excluding DuPont and PPG as comparable companies, but the court agreed with Lazard. Those companies dwarfed the debtors in sales, earnings enterprise value and market capitalization and, therefore, were less risky and traded at higher multiples.

The court also agreed with Lazard's inclusion of European companies in its analysis, saying UBS was wrong to leave them out. These companies operated in many of the same markets as the debtors did, made similar products, and were subject to similar tax

and regulatory regimes. In addition, half the debtors' revenue came from outside the United States.

Precedent transactions. Again, the court found Lazard's analysis to be more sound. Among the errors in UBS's comparable transactions analysis was that UBS included transactions that predated the financial crisis. Using the Lehman Brothers bankruptcy filing on Sept. 15, 2008, as the cutoff date, the court agreed with Lazard that "advanced economies are fundamentally different today, and that relying on multiples from a time period before the crash is inappropriate."

The court rejected UBS's contention that comparable transactions that hadn't yet closed should be excluded. Given their proximity in time, these deals may be the best comparables available, provided the price is fixed by binding documentation.

Two other factors supported the court's conclusion that the debtors weren't undervalued. First, vigorous efforts to market the debtors for sale at a price ranging from \$2.2 billion to \$2.7 billion failed to yield any offers. Second, the creditors had a strong preference for cash distributions, with the majority electing the minimum level of stock. Had they believed the stock was undervalued, the court said, they would have "snapped it up."

Why valuation methods matter

The *Chemtura* decision addresses several significant valuation issues, shedding light on the court's analysis of valuation methods and assumptions as well as its views on the credibility of valuation experts. To help ensure success in cases involving appraising a business's value, work with a qualified valuation expert. ♦

Calculating damages

Tricks of the trade secret

Quantifying damages in trade secret cases can be tricky. Unlike other forms of intellectual property (IP), trade secrets retain their value only as long as they remain secret. Owners of patents, copyrights and trademarks, on the other hand, share their creations with the public in exchange for exclusive rights, for a limited time, to commercialize their work.

This article discusses how a plaintiff can maximize damages in trade secret cases, as well as how the defendant can link the plaintiff's loss to factors other than trade secrets.

Understanding the dangers

Trade secrets encompass a broad and vaguely defined array of assets, including customer lists, know-how, manufacturing processes and marketing plans. So long as secrecy is maintained, there's no time limit on

seeking damages for misappropriation through theft or breach of a confidentiality agreement.

But unlike other forms of IP, there's no protection against someone who discovers or re-creates a trade secret legitimately. What's more, assigning a dollar value for trade secret damages in regard to misappropriation may be hard to ascertain, since this unique form of asset erosion must be accounted for.

Measuring damages

Common measures of trade secret damages are similar to those in other IP cases. They include the plaintiff's lost profits, the defendant's profits (unjust enrichment) and reasonable royalties. But while patent, copyright and trademark cases are governed by federal law, trade secret cases are governed by state law, which can vary dramatically from state to state.

It's critical, therefore, to identify applicable state law and understand the types of damages available. Generally, lost profits, unjust enrichment and reasonable royalties are considered mutually exclusive alternatives. But in some states, they may overlap. For example, a plaintiff might collect lost profits plus the defendant's profits in excess of the plaintiff's profits. Also, some states allow plaintiffs to recover punitive damages, attorneys' fees or prejudgment interest.

Other damages may be available in place of, or in addition to, the above. These might include the plaintiff's development costs in creating a trade secret or the costs saved by the defendant by misappropriating the plaintiff's trade secret.

Tracing causation

One big challenge is establishing a causal link between the defendant's conduct and the claimed damages. If the defendant misappropriates a trade secret and incorporates it into a product, causation issues are similar to those in patent infringement cases. But what if the trade secret is a customer list or a marketing plan that the defendant uses to promote its existing products? The challenge for a damages expert is to determine the portion of the plaintiff's loss that's attributable to the trade secret,

as opposed to other factors, such as the quality of the defendant's products.

What if the defendant uses the misappropriated trade secret in a noncompetitive business? The plaintiff would be hard pressed to show that it suffered any lost profits as a result (unless the defendant made the trade secret public) or that the defendant's profits came at the plaintiff's expense. In these cases, a reasonable royalty may be the most appropriate measure of damages.

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Formulating a strategy

To maximize damages, plaintiffs must establish a connection between the misappropriated trade secret and their lost profits or the defendant's unjust enrichment. And to minimize damages, defendants should try to link the plaintiff's loss to factors other than trade secrets, such as general economic conditions or the plaintiff's failure to use the trade secret effectively.

In addition, the defendant may be able to show that the value of the trade secret hasn't been impaired through its misappropriation or that it's not competing directly with the plaintiff. Alternatively, depending on state law, defendants should try to limit the damages period to the time it would have taken to re-create the trade secret legitimately. ♦



Why the valuation date is so important

When you consider how the value of an asset will be determined in a matter, it's common to think about what method the appraiser will use or whether discounts may apply. But a critical factor that may not immediately come to mind is the appraisal date.

Valuing an estate

For estate tax purposes, assets normally are valued on the date of death. But under certain circumstances, an executor may elect to use the “alternate valuation date,” which is six months *after* the date of death. The later date may be advantageous if the decedent's estate includes securities, real estate or other property that's declined substantially in value since the date of death.

There's a catch, though. The executor can't selectively apply the election to assets whose values have declined sharply. Rather, if the alternate valuation date is selected, it must be used for all assets in the estate (except for those sold between the date of death and the alternate valuation date, which are valued on the sale date).

Divorce cases

For purposes of divorce, the valuation date is usually prescribed by state law. Typically, it's the date the divorce action commenced, but it could also be the trial date, the date a divorce decree is issued or some other date established by law or by agreement of the parties.

In some states, the court may select a valuation date that would be fair to both parties. In most cases, however, it's up to the attorney to decide which date should be used.



Business valuations

When valuing a closely held business, appraisers generally can't benefit from hindsight's 20/20 vision. In fact, IRS Revenue Ruling 59-60 states, “Valuation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal.”

As a rule, valuers consider only information that was “known or knowable” at the valuation date. Why not include subsequent events from valuers' analyses? Because fair market value should be based only on information hypothetical buyers and sellers would have known at the valuation date. But because subsequent events may be foreseeable and may provide valuation evidence, there are exceptions. In addition, site visits and management interviews may not occur near the valuation date. Last, courts often cite U.S. Tax Court cases as valuation precedent.

No steadfast rule applies to all cases. The valuator must evaluate the circumstances and use professional judgment to determine how to treat subsequent events.

Shareholder oppression cases

In these cases, applicable law often provides that the presumptive valuation date is immediately before the wrongful act that triggered the litigation. But it's not unusual for parties to argue for an alternate valuation date if they feel that using the presumptive date would be unfair.

Circumstances might call for an alternate date, for example, when sufficient market information on the presumptive valuation date is unavailable, or when a contingency or potential liability that wasn't yet resolved on the presumptive date is discovered.

In addition, an aberration that temporarily increased or decreased the stock's value around the time of the corporation's wrongful act might call for an alternate date. So too might evidence that the corporation's wrongful act was timed to take advantage of a historically high or low stock price.

All in the timing

Because the valuation date is so critical, discuss it with your valuator before he or she begins the appraisal. That way you can make sure he or she is determining value as of the appropriate date. ♦

MARKETABILITY DISCOUNTS FOR CONTROLLING INTERESTS?

Discounts for lack of marketability are well established when valuing minority interests in closely held businesses. Several empirical studies support and quantify these discounts. Restricted stock and pre-IPO studies, for example, demonstrate the spread between prices paid for freely traded shares and identical shares that are less marketable because they're restricted or not yet publicly traded. Discounts typically average between 30% and 45%.

Although the U.S. Tax Court has accepted them in some cases, using marketability discounts for controlling interests is controversial. Most valuation experts agree that the size of marketability discounts shrinks as the level of control increases. But while many experts argue that some amount of discount is available at all levels of control — even 100% — others say it's inappropriate to apply a marketability discount to a controlling interest.

The argument in favor of marketability discounts is that the discount for lack of marketability measures the relative inability to quickly convert property to cash at a minimal cost. Even with a controlling interest, it takes time and expense to complete a sale. The discount reflects the uncertainty and risk associated with the timing of the sale and the ultimate price. Also, a discount would be merited since there's no ready market (such as no access to public markets), because a subject company isn't listed on a stock exchange.

Critics counter that the value of an enterprise is derived from expected cash flows, expected cash-flow growth, and risks associated with each. Any risk factors or timing issues related to marketability, they argue, are reflected in the valuation conclusion. Further, a controlling owner has full access to the cash flows of the company during the time that the owner may be working to sell the business.

Proponents respond that, in determining enterprise value, valuers examine the risk and timing of expected cash flows, but not the risk associated with actually collecting determined value, which is captured by the marketability discount.

If a marketability discount for a controlling interest is an issue, work with your valuation expert to be sure you're prepared to support or, if appropriate, challenge application of the discount.



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