Valuation & Litigation Briefing

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Kars 4 Kids Inc. v. America Can! Cars for Kids

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Do you know the difference between lost profits and disgorgement?

A recent trademark infringement case involving competing not-for-profit organizations addresses several interesting issues regarding plaintiffs' remedies and the calculation of damages. As the case made its way through the appeals process, the courts addressed the importance of supporting infringement claims with a comprehensive analysis of the case facts.

District court assesses illegal profits

In *Kars 4 Kids*, both parties sold donated vehicles to fund children's programs and used similar trademarks. In this case, the plaintiff claimed that it was first to use its trademark in Texas and that the defendant infringed that trademark in the state.

> ***Disgorgement of the defendant's profits was more appropriate for the plaintiff's claim than compensatory damages.***

Federal trademark law provides victims of infringement with several potential remedies, including lost profits damages and "disgorgement" (or repayment) of the defendant's ill-gotten gains. In this case, the plaintiff framed its damages theory as a claim for its own lost profits, arguing for an award of the defendant's profits as a "rough proxy measure" of its own damages. The plaintiff reasoned that it would have received all donations to the defendant but for the infringement.

The district court found that disgorgement of the defendant's profits was more appropriate for the plaintiff's claim than compensatory damages. The purpose of the disgorgement remedy, the court explained, is to avoid the difficulties of proving an

actual diversion of sales (donations) by assuming that the infringer's profits are derived from sales the plaintiff would have made. Because disgorgement is an equitable remedy, there's no right to a jury trial. Also, because disgorgement would provide an adequate measure of damages, the court rejected the plaintiff's claims for royalties and the cost of corrective advertising on grounds they'd result in a double recovery.

Experts disagree on damages

At the bench trial on damages, each party presented expert testimony on the calculation of disgorgement damages. The experts agreed that the defendant's net revenue in Texas was $16,067,943, but they disagreed on expenses and other adjustments that should be deducted from that amount to arrive at net profits.

The defendant's expert felt that revenue should be reduced to reflect factors other than the trademark that influenced donors. So, he apportioned revenue between infringing and non-infringing factors based on the ratio of advertising expenses to total operating expenses. However, the court declined to accept apportionment. It found the expert's methodology to be illogical — plus there was no other evidence of donors' motivations to donate cars.

Factoring current market conditions into an expert's analysis

Businesses are facing unprecedented levels of uncertainty today. With geopolitical issues, supply chain shortages, interest rates hikes and record inflation, the business environment is unpredictable and evolving. As a result, historical performance is becoming increasingly less relevant when valuing businesses or estimating economic damages.

In today's markets, experts can't simply multiply historical cash flow by an expected growth rate when forecasting future cash flow or assume that a company's current cost of capital will be sustainable over the long run. Likewise, older comparable transactions may be less meaningful in the current marketplace.

It's important for experts to consider changing economic conditions when developing cash flow projections, discount rates and pricing multiples. For instance, changes in interest rates, tax laws and the availability of financing may impact the cost of debt. Plus, some companies might decide to carry more buffer stock to combat supply shortages, which could affect their working capital requirements.

Additionally, when quantifying lost profits, experts should consider the extent to which a company's deteriorating financial performance could be attributable to *external* market trends. For example, some losses may be due to new government regulations or increased costs and, therefore, unrelated to the alleged wrongdoing of a defendant.

Likewise, in volatile markets, experts can evaluate industry trends to help separate losses caused by a defendant's alleged wrongdoing from losses caused by external events. If competitors are also experiencing losses, it may be harder to claim that a plaintiff's losses were caused by the defendant.

The experts agreed that $3,447,191 in Texas-specific advertising expenses should be deducted from the defendant's net revenue in Texas. But they disagreed on the treatment of overhead and other common expenses.

The plaintiff's expert used an incremental cost approach. He opined that these expenses shouldn't be deducted because they would have been incurred even if the defendant hadn't operated in Texas. But the court felt that the defendant's expert's full absorption approach — which apportioned common expenses among all revenue sources — better reflected its revenue and expenses in Texas.

The court also held that grants weren't deductible business expenses. In a nonprofit context, grants aren't expenses used to generate revenue. The court explained that they're more akin to dividends paid to shareholders in the for-profit world.

To calculate net profits, the court started with net revenue. Then it subtracted Texas-specific advertising expenses and a portion of overhead and national advertising expenses, arriving at damages of $11,247,542.

Judgment vacated on appeal

The U.S. Court of Appeals for the Third Circuit vacated the judgment, finding that the district court failed to consider many of the key factors that support disgorgement:

1. Whether the infringer had the intent to confuse or deceive,
2. Whether sales have been diverted,
3. The adequacy of other remedies,
4. Any unreasonable delay by the plaintiff in asserting its rights,

5. The public interest in making the misconduct unprofitable, and

6. Whether it's a case of palming off (counterfeiting).

The district court addressed only the second factor. So, the appellate court remanded the case to the lower court to consider the other factors.

Lesson learned

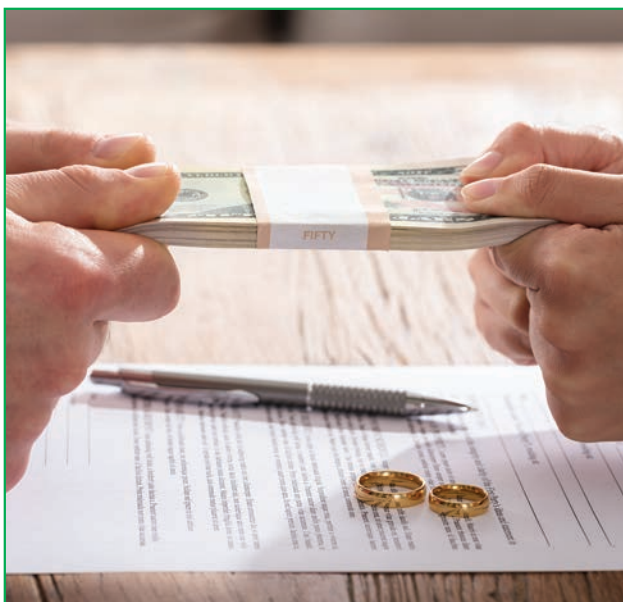
The moral of this case is that plaintiffs seeking lost profits in trademark infringement cases should be prepared to present evidence related to the factors that support a disgorgement claim. Contact an experienced financial expert to ensure you provide a comprehensive analysis of the case facts. ■

Divorce valuation hinges on expert credibility

A recent Nebraska divorce case, *Cain v. Cain*, illustrates how differences in experts' assumptions can have a dramatic impact on valuations. The main issue was the value of the husband's 50% interest in a roofing business as of December 31, 2018.

Battle of the experts

Both experts relied on a capitalization of earnings approach. However, the husband's expert also used the asset and market approaches as "sanity checks."



In estimating the company's cash flow, each expert adjusted revenue for certain management fees. Those fees — which ranged from $271,000 in 2015 to more than $2 million in 2018 — were paid to a company the two co-owners used as a "payroll paying entity," apparently to save on taxes by shifting income from one entity to the other.

5 key assumptions

The experts' approaches were similar. But the court noticed five critical differences in their assumptions:

1. Salaries. In estimating cash flow, the wife's expert assigned each owner a $150,000 annual salary. The husband's expert assigned salaries to the husband and his co-owner of $374,470 and $273,996, respectively.

2. Expenses. The wife's expert excluded a $295,539 bad debt expense in 2018, finding it to be nonoperating and nonrecurring. He also excluded a $16,000 charitable contribution in 2018 as a discretionary expense. The husband's expert included both expenses.

3. Cash flow. The wife's expert used cash flows for 2016, 2017 and 2018, weighted equally. He argued that the most recent three years were the best predictors of future performance. The husband's expert

used cash flows from 2014 through 2018, but he assigned greater weight to the more recent years.

4. Cost of equity. The wife's expert calculated the company's cost of equity capital to be 19%, from which he derived a capitalization rate of 14.67%. The husband's expert determined the cost of capital to be 21.9%, from which he derived a 19.1% capitalization rate.

5. Valuation discounts. Both experts applied a 5% discount for lack of control. But the wife's expert applied a 15% discount for lack of marketability, whereas the husband's expert applied a 20% discount.

Based on these assumptions, the husband's expert valued the 50% interest at $494,000. In contrast, the wife's expert valued it at $2,525,000 — more than five times the opposing expert's conclusion.

Court decisions

The wife's expert also provided the court with an alternative valuation of $1,830,500. In arriving at his valuation conclusion, the wife's expert didn't factor in certain nonowner wages paid by the payroll entity. He explained that he couldn't determine whether those wages were solely for services to the roofing company. If the court were to determine that they were, then the company's value should be lowered to the alternative amount.

The trial court adopted the wife's expert's alternative valuation of $1,830,500. And the Court of Appeals of Nebraska affirmed the trial court's decision. The appellate court found that the valuation accepted by the trial court wasn't unreasonable. Further, the court ruled that differences between the experts' conclusions "reflect [their] different perspectives and independent exercise of professional judgment."

Credibility is essential

Although both parties provided extensive evidence, the trial court found the valuation by the wife's expert to be more credible. "It is not our role to second-guess the [trial] court's determinations of weight and credibility when presented with a conflict in plausible evidence," explained the appellate court. This lesson is universal: The credibility of a business valuation expert is a top concern in Nebraska divorce cases and beyond. ■

ESOP valuations: How much is too much?

The U.S. Department of Labor (DOL) recently suffered a resounding defeat in *Walsh v. Bowers*. In that case, a federal district court rejected the DOL's claim that an employee stock ownership plan (ESOP) overpaid for the sponsoring company's stock.

Background

The owners of an engineering firm formed an ESOP, then they sold the ESOP all of their shares of the firm's stock for $40 million. The DOL sued them, alleging that they violated the Employee Retirement Income Security Act (ERISA) by making the ESOP pay more than the company's fair market value (FMV).

FMV is determined in good faith by the ESOP trustee. Under ERISA, this is the appropriate standard for determining whether an ESOP has paid adequate consideration for a company's stock.

DOL errors

The ESOP trustee relied on an independent appraisal of the company's value as of the transaction date. The $40 million price tag was derived from the guideline public company method, the guideline transactions method (described by the court as the "industry acquisition method") and the discounted cash flow method. Each method resulted in a value exceeding $40 million, supporting the conclusion that the purchase price didn't exceed FMV. At trial, several defense valuation experts agreed with this conclusion.

> ***Differences "reflect [the experts'] different perspectives and independent exercise of professional judgment."***

The court found several errors in the DOL's valuation, including:

- The DOL's expert, who valued the company at $26.9 million, ignored Uniform Standards of Professional Appraisal Practice (USPAP) by failing to interview management or gather information via deposition and other discovery tools. As a result, he erroneously deducted certain consulting fees that had been passed through to clients as company expenses. The expert also violated USPAP by applying certain valuation discounts based on events occurring *after* the valuation date. As a result of these errors, the expert undervalued the company by more than $13.5 million.
- The DOL relied on a third party's "nonbinding preliminary indication of interest" in buying the company for $15 million. The court found this informal offer to be irrelevant, likening it to someone who offers $15,000 for a used luxury car with a Blue Book value of $40,000.
- The DOL also relied on a post-sale appraisal from the firm that valued the company at only $6.53 million as of the transaction date. But the post-sale valuation included debt incurred to buy the stock.

Part of the DOL's argument was that the ESOP trustee spent relatively little time on the valuation and quickly accepted a price near what the owners were seeking. The court pointed out, however, that the trustee negotiated favorable terms on the seller notes used to finance the purchase, saving the ESOP millions of dollars.

ABCs of business valuation

The ESOP prevailed in large part because the judge understood basic valuation principles and how they apply in the context of ESOP transactions. Not all judges are this informed about these issues, however. That's why it's critical to engage experts who can help educate judges on often complex and nuanced valuation concepts. ■

Beware of 3 common valuation pitfalls

The presence of an error, misstatement or erroneous deviation from customary business valuation practice in an expert's report is a risky proposition. Here are three common pitfalls that qualified valuation pros know to avoid — and to which less-than-qualified ones often fall prey.

1. Using outdated data

Business appraisals capture a company's value at a specific point in time. Therefore, they're contingent on the subject company's financial health, industry trends and general economic conditions on the valuation date.

To illustrate, consider the novice appraiser who values a restaurant as of June 30, 2022, using financial data and comparable transactions from before the start of the pandemic. Operating a restaurant has changed dramatically in recent years, and the sector continues to be adversely affected by market trends, such as the high cost of food and labor, along with supply chain shortages and workplace safety concerns. Historical financial performance and many older comparables may be irrelevant when valuing a restaurant today.

2. Overlooking adjustments

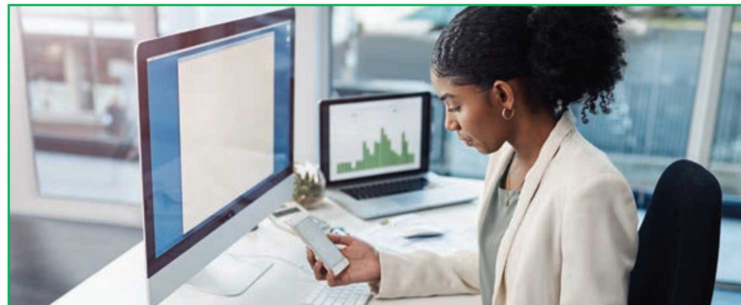
Valuation pros frequently adjust the subject company's financial statements to reflect industry norms, arm's-length transactions and unrecorded items. Appropriate adjustments vary from one valuation to the next.

Examples include owner's compensation and other discretionary expenses, related-party expenses, and unusual or nonrecurring expenses (such as a change in accounting method or a gain from the sale of equipment). Failure to consider these or other appropriate adjustments can leave a valuation report with critical flaws.

3. Double dipping

Many valuation issues overlap. For example, marketability and control are interrelated and virtually impossible to separate completely.

Suppose a valuator was estimating the value of a family business engaged in many related-party transactions. When applying the income approach, she adjusted the company's cash flow for above-market related-party expenses and excess officers' compensation. Then, because the company treated family members favorably, the valuator increased the company's cost of capital. Finally, she added a control premium to her preliminary value conclusion because she was valuing a large block of stock that possessed the requisite control to alter related-party expenses.



Clearly, in this hypothetical case, there's some degree of overlap between cash flow adjustments, factors used to build up the discount rate and the control premium. To the extent that the expert "double dipped" the effect of related-party transactions on the company's risk and return, her value estimate may be off the mark.

Get it right

When a valuator succumbs to one of these pitfalls, it could trigger — or worsen — an IRS inquiry or perhaps lead to an embarrassing courtroom mishap. That's why it's critical to vet business valuation candidates and their qualifications before hiring one to handle your situation. ■

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- Valuing Closely Held Businesses
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