Sanli Pastore
& Hill

Business Valuations
Fairness Opinions
Solvency Opinions
Expert Testimony

Experts in Business Valuation

ESOP Due Diligence

cont. from page 3

the court held, "When the record establishes that the overlooked matter was one that no one perceived to be a material concern at the time or to be outcome determinative, it cannot be said that the overall investigation was imprudent or in bad faith." Thus, the Seventh Circuit upheld the district court's decision that the ESOP trustees did not engage in a prohibited transaction.

This newsletter is a publication of Sanli Pastore & Hill, Inc. Our firm concentrates on the valuation of businesses, business ownership interests, intangible assets, and in financial litigation support. This work has been performed for a wide variety of businesses and for many purposes including estate and gift taxation. We also have substantial experience in the defense of these valuations and analyses. For further information on experience and capabilities, or for additional copies of this newsletter, do not hesitate to call or write to the address listed below:

Nevin Sanli
Sanli Pastore & Hill, Inc.
1990 South Bundy Dr., Ste. 800
Los Angeles, CA 90025
Phone (310) 571-3400   Fax (310) 571-3420

www.sphvalue.com

Articles, comments and suggestions are welcome. Please contract *Patricia Aviles at (310) 571-3400, or pavlies@sphvalue.com*

Business Valuations
Fairness Opinions
Solvency Opinions
Expert Testimony

1990 South Bundy Drive, Suite 800
Los Angeles, California 90025
www.sphvalue.com

PRSRT STD
U.S. POSTAGE PAID
LOS ANGELES, CA
PERMIT NO. 33

www.sphvalue.com

Sanli Pastore
& Hill

Business Valuations
Fairness Opinions
Solvency Opinions
Expert Testimony

Financial Brief

Fall, 2005

Foreign Sales Used to Support a Projection of Sales in the Domestic Market

In *Frontier Medical, Inc. v. Ronald Weinstock*, No. G032381 (Cal. App. 4 Dist. June 29, 2005), unpublished, the California Court of Appeals, Fourth District considered a lost profits award in this fraudulent inducement action. Weinstock designed a magnetic resonance analyzer (MRA) for treating pain. The patent on the MRA was held equally by him and his ex-spouse. The MRA was successfully marketed in Asia for 16 years and had been the subject of many overseas medical studies.

In 2000, Weinstock granted Frontier Medical Inc. (FMI) the exclusive right to sell the clinical and home use MRA devices in California, Arizona, and Nevada for a five-month period. The agreement also granted FMI the right of first refusal on distributing the MRA devices throughout the United States. FMI was obligated to pay $180,000 upon signing the agreement for a lease on three clinical machines. It also was obligated to purchase at least 100 home use machines. The home use machines were payable in two $100,000 installments: the first was due when the working prototype was delivered and the second when the 100th machine was ordered. The contract further required FMI to meet minimum sales requirements in each state to maintain its exclusive rights.

FMI had five years experience designing and distributing pain management technology like the MRAs. It had a distribution system in place and operating in California, but had never penetrated the Nevada or Arizona markets prior to this agreement.

Shortly after signing the contract with FMI, Weinstock contracted to provide other companies with similar rights in the same territory. Moreover, the prototypes were largely unsatisfactory when received by FMI, which lead to a dispute over when the first $100,000 payment was due. Thereafter, FMI brought suit against Weinstock for fraudulent inducement.

The trial court noted that recovery for fraudulent inducement is to place the defrauded party in the position he would have been in had the representation been true. FMI presented expert testimony as to its lost profits. The expert limited his lost profits calculation to the minimum sales requirements (2060 units) to maintain the exclusive contract in California because FMI had no prior experience in Arizona or Nevada. He consulted both FMI's profit and loss statements and financial statements for several years prior to 2001 as well as Weinstock's business plans, a private placement memorandum, and the foreign company's financial data. Based on that analysis, he determined that Weinstock's gross margin in Asia was between 75 and 90 percent, and he utilized 75 percent gross margin, which was also in line with FMI's financials. He concluded that FMI suffered lost profits greater than $4 million. The jury awarded FMI lost profits of $3 million. Weinstock appealed.

On appeal, Weinstock challenged the lost profits award. He argued that the award was speculative because this was a new business. He argued that there was no established market for the MRAs, the technology was unproven, there was no history of profitability in connection with the MRAs, and there were no market or comparables sales studies entered into evidence. The appellate court disagreed. It found that there was sufficient evidence to support the award. It noted that Weinstock had a sufficient history of sales in Asia and anticipated significant sales of the device to consumers in his business plan to support a market for this device. Moreover, it noted that FMI had a history of profitably distributing similar devices in California. Therefore, it found that Weinstock's and FMI's operating histories provided a sufficient basis from which to make a reasonable projection of profitability despite the newness of the MRA product into the U.S. market. Moreover, it found the calculation of the gross margin was sufficiently supported by both FMI's operations with similar devices and Weinstock's Asian sales of this device. It also affirmed the use of the minimum sales requirements listed in the contract between FMI and Weinstock as reasonable considering Weinstock's business plan anticipated significantly greater sales of MRAs during the same period. Thus, it found that the award based in part on FMI's expert's analysis had a reasonable basis.

Court Considered Present Value Calculation for Lost Profits Award

In *Diesel Machinery, Inc. v. B.R. Lee Industries, Inc.*, No. 03-2652 (8th Cir. August 8, 2005), the U.S. Court of Appeals considered the appropriate methodology for reducing lost profits to present value. B.R. Lee Industries, Inc. (LeeBoy) and Diesel Machinery, Inc. (DMI) entered into a dealership agreement in 2000. Under the agreement, DMI would be the exclusive dealer of Lee's paving equipment in South Dakota and certain Minnesota counties. The agreement had a one-year term, which renewed annually, and was governed by South Dakota's Franchise Act. Under this act, DMI could only be terminated for misconduct.

In early 2001, LeeBoy acquired an asphalt equipment company and sought to consolidate its existing and acquired dealerships. LeeBoy terminated DMI's dealership in July 2001, citing the existence of the asphalt dealership as the reason. DMI brought suit under the franchise act.

The district court granted DMI's motion for summary judgment with respect to LeeBoy's liability for its violation of the act. A DMI shareholder testified to DMI's lost profits. He utilized a ten-year projection because DMI historically had 10-year relationships with manufacturers. He estimated the amount of sales of LeeBoy products, including parts and service, and sales of related equipment. LeeBoy then put on testimony regarding the present value of the income streams from a financial expert. The financial expert utilized a two-step method that estimated the discount rate as if the lost profits award would be reinvested into the company.

The expert calculated a total discount rate of 17.5 percent. The first step involved determining "the interest rate or return that DMI could reasonably be expected to receive on an investment of the lump-sum payment." The second step involved increasing that interest rate for the risks associated with DMI. DMI objected to the second step, and the district court agreed, striking that portion of the expert's testimony. It found that the second step "conflicted with South Dakota law on present value reduction."

The jury awarded DMI $665,000 in lost profits plus punitive damages. Both parties appealed.

On appeal, LeeBoy contested the admission of lost profits testimony from the DMI shareholder. The Eighth Circuit rejected this argument. It noted, "A business owner's testimony is sufficient to support an award of lost profits." Moreover, it stated, "LeeBoy's objections to this testimony go to its weight, which LeeBoy could vigorously attack during cross-examination, rather than its admissibility." Thus, it affirmed the admission of the owner's lost profits assessment.

LeeBoy also appealed the district court's decision to strike the portion of its expert's present value calculation that adjusted the discount rate for the reinvestment of the proceeds in DMI. The appellate court stated, "There is a difference between discounting to present value damages awarded in a lawsuit, and discounting to present value the value of a business based on a future stream of lost profits." It noted that while the expert's method was appropriate for the second use, South Dakota law did not require the reinvestment of lost profits back into the business. It concluded that since the court utilized the model jury instruction as to the calculation of present value, which utilizes a risk-free investment rate, it was appropriate to strike the second part of the expert's testimony.

Adequate Financial Due Diligence Protects ESOP Trustee

In *Debra K. Keach, et al. v. U.S. Trust Company*, No. 04-1901 (7th Cir. August 17, 2005), the U.S. Court of Appeals for the Seventh Circuit considered whether an Employee Stock Option Plan (ESOP) trustee breached its fiduciary duty when it purchased a controlling interest in the company. F&G is a mail order company that utilized a sweepstakes marketing plan to sell its products. Its sweepstakes marketing plan was reviewed annually by an attorney to ensure compliance with (prior to 1988) the infrequently enforced laws governing sweepstakes. F&G was a closely held company. The ESOP was established in 1988 and U.S. Trust was the plan's trustee. Keach and the other defendants were enrolled in the plan.

In 1995, F&G's founder became terminally ill. He and the ESOP entered into negotiations to sell his controlling interest to the ESOP. He obtained a professional appraisal indicating a per share value of $24. The ESOP also retained both financial and legal assistance to perform due diligence into the proposed transaction. It selected a professional appraisal firm to analyze the value of F&G. While the appraisal firm challenged some of the management projections and assumptions, it did not identify F&G's reliance on sweepstakes marketing as a risk. A footnote in F&G's audited financial statements discussed the trends in sweepstakes advertising. The ESOP's appraisal indicated a value of $18.50 per share. The trustee did have discussions regarding the state of the business including sweepstakes advertising and concluded that the advertising campaign was in compliance with the then current laws and no changes in the laws were foreseeable. The ESOP and F&G's management eventually agreed upon the transaction at $19.50 per share and the ESOP's appraisers issued a favorable fairness opinion.

F&G's business prospered under the sweepstakes marketing plan until 1997. At that time several state attorney generals as well as several news organizations launched investigations into the sweepstakes marketing programs of many companies, including a F&G subsidiary. As a result of the investigations and negative publicity surrounding sweepstakes promotions, the laws regarding sweepstakes promotions changed. The changes had a negative impact on F&G. Its profits declined and in 2001, it sought bankruptcy protection.

Keach brought suit against U.S. Trust in 2001. Keach alleged that U.S. Trust breached its fiduciary duty and engaged in a prohibited transaction when it entered into the 1995 transaction. She claimed that U.S. Trust failed to adequately identify F&G's reliance upon sweepstakes marketing and the changing landscape of sweepstakes marketing compliance as a risk to the ESOP. The district court concluded that U.S. Trust had adequately performed its financial due diligence, but questioned its legal due diligence because many documents could not be located. Nonetheless on balance, it found that in 1995, sweepstakes marketing was a viable marketing technique and state laws and attorney general inquiries, which had been resolved in F&G's favor, were not materially impacting or would impact the company adversely. Keach appealed.

On appeal, Keach renewed her argument that U.S. Trust breached its fiduciary duty by failing to identify the risk to F&G posed by the sweepstakes marketing in 1995. The Seventh Circuit noted that generally a transaction between a corporate insider and an ESOP is a prohibited transaction unless it occurs for adequate consideration. Adequate consideration is defined as not more than fair market value as determined in good faith by the plan's trustee. The appellate court found that U.S. Trust had adequately completed its financial due diligence by engaging a professional appraisal firm which "analyzed exhaustively F&G's financials, had conducted independent valuation analyses and had challenged the financial forecasts made by F&G management as too optimistic." Moreover, the court noted that the lead bank that provided the $70 million in financing for the transaction prepared its own memorandum which did not identify sweepstakes marketing as a risk nor did the appraisal obtained by F&G's management. Furthermore in early 1997, the ESOP and F&G management again discussed a purchase of F&G stock for $25 per share, which the management determined was too low. The court inferred from this that the company's prospects were still good and a materially adverse change to regulatory compliance of sweepstakes was not identified as a concern. The Seventh Circuit reasoned, "[U.S. Trust] hired a qualified financial advisor, conducted its own interviews and review of industry information and negotiated a price for the F&G shares that was twenty percent lower than the original offer price. We conclude that the district court properly ruled that the fact that U.S. Trust failed to identify a risk that would not have been considered material does not render U.S. Trust's evaluation of the ESOP … transaction imprudent or in bad faith…." Therefore,

The summaries in this publication discuss only some valuation or taxation aspects of the cases, and are not complete analyses. The reader is referred to the actual cases for more detail. This publication does not constitute legal, tax, accounting or valuation advice. It is provided as an informational service only. Please contact a professional advisor if you need specific advice. No liability whatsoever is assumed in connection with the use of this newsletter. Copyright © 2005