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LITIGATION AND VALUATION ADVISER

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A trademark is a powerful symbol of a company's (or product's) reputation in the marketplace. Whether it signifies high quality, excellent service or some other feature that customers value, a trademark can easily become one of a company's most valuable assets. So it comes as no surprise that most businesses invest a great deal of capital in developing and preserving their trademarks — and will fight tooth and nail to protect their investment.

Like most types of intellectual property, trademarks provide their owners with a variety of remedies for infringement, including injunctive relief and monetary damages. But there are some important differences between trademarks and other intellectual property rights that present interesting challenges for financial experts. (*See sidebar "Protecting the Public Interest" on page 3.*)

Establishing damages

Experts use several approaches to measure trademark damages, including:

Plaintiff's lost profits. The most common measure of damages for trademark infringement, lost profits are computed by projecting the revenues the plaintiff would have earned on lost sales and subtracting the incremental costs of making those sales. To determine lost sales, a financial expert might look at both the plaintiff's and the defendant's sales trends before and after the infringement. The expert might also compare the plaintiff's "after" sales to preinfringement sales projections made in the ordinary course of business.

To compute lost profits, a financial expert must be able to distinguish lost sales caused by the infringement from those caused by other factors, such as industry and economic conditions, competition, pricing, and the relative quality of the plaintiff's

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From Marty…

It's fall – the articles this season build on our theme of teaching our clients and attorneys how a little bit of science, forensic analysis of the facts, and a dash of chutzpah create art.

Our base article on Z scores gives you an empirical way to support an expert's analysis of the financial condition of a business. Then we roll to the most fundamental question an appraiser must answer – what is the standard of value. Our article on computing damages for trademark infringements discusses important analysis and fact finding the expert and attorney should perform to help determine merits of the plaintiff's and defendant's case.

Lastly, I would like to congratulate the admittance of Phil Kanyuk, CPA, ASA, my long time right hand, as a partner of the Firm.

Martin P. Landa

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The LVC group is part of Holtz Rubenstein Reminick LLP, one of the top 25 largest accounting firms in the New York metropolitan area, with 30 partners and over 180 professional staff.

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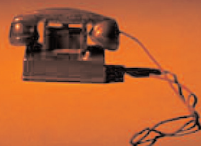

Tax Court Looks at Stock Sales Between Family Members

In *Huber v. Commissioner*, the Tax Court ruled that intrafamily stock sales in a closely held corporation were at arm's length and, therefore, the prices supported stock values family members claimed on gift tax returns.

Petitioners' stock appraisal

The case involved J.M. Huber Corp., a privately held corporation with sales in excess of $500 million and approximately 250 shareholders, most of whom were Huber family members. Huber's bylaws provided that there would be no public market for its shares, but allowed shareholders to transfer shares to nonprofit organizations with the board's permission.

The company retained an independent accounting firm to conduct annual appraisals of its stock. The appraiser regularly applied a 50% lack-of-marketability discount to the shares' freely traded value. The appraised values were used for all transactions involving Huber stock, including sales between family members, corporate redemptions and gifts to nonprofit organizations. Huber also used the appraisal reports to fix board-member compensation and value stock options issued to its CEO.

The petitioners in this case were Huber stockholders who had given stock to family members. They valued the stock for federal gift tax purposes based on sales prices in transactions between shareholders.

IRS arguments, the court's decision

The IRS argued that the arm's-length transactions of Huber stock shouldn't be used to determine the gifts' value. Among other things, the IRS argued that the sales were not at arm's length because, by not offering their shares for sale to the public, the shareholders failed to obtain the optimum price. But the court rejected "the notion that Huber must take itself public in order to sell its shares at a fair price. Courts have long recognized the rights of shareholders in closely held companies to remain private."

The court also dismissed the IRS's contention that "the bona fide business purpose of maintaining family control should be set aside if it serves as a device to 'pass an interest to the natural objects of one's bounty or to convey that interest for less than full and adequate consideration.'" The court stressed that the same stock values were used for many purposes, including charitable donations, for which "a higher value would be preferable because that would result in a larger deduction."

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Protecting the Public Interest

Perhaps the most important distinction between trademarks and other types of intellectual property is that trademarks are intended primarily to protect the public interest. Patents and copyrights, for example, are designed to protect owners by giving them exclusive rights to exploit the economic benefits of their work for a certain period of time. Of course, this protection also benefits the public by providing financial incentives for innovation, technological advancement and creative pursuits.

Trademarks, on the other hand, are meant to protect the public by avoiding confusion and ensuring that customers can buy products and services with confidence that they're getting what they expect. The trademark holder's commercial benefits are secondary. But unlike patents and copyrights, trademark rights usually last as long as the holder continues to use the trademark for commercial purposes.

An important byproduct of the emphasis on the public interest over private commercial rights is that courts generally make it tougher for plaintiffs to recover damages than to obtain injunctive relief. Most courts require plaintiffs trying to collect damages to prove actual confusion resulting in actual harm, not just a likelihood of confusion. To prove actual confusion, a plaintiff may introduce market surveys or customer testimony.

What's in a Name?

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and defendant's products and salespeople. For example, a defendant may argue that, absent the infringement, the plaintiff couldn't have duplicated the defendant's sales of the infringing product because the defendant had superior distribution channels and a larger sales force.

Defendant's profits. A plaintiff may also recover the defendant's ill-gotten gains under the theory of disgorgement. One advantage of this approach is that the plaintiff need establish only the defendant's infringing sales. The burden then shifts to the defendant to quantify the costs that should be deducted in computing lost profits.

Price erosion. Another method of establishing lost profits is to show price erosion — in other words, to show that, absent the infringement, the plaintiff could have commanded a higher price for its goods or services.

In addition to the remedies described above, trademark infringement damages may be available for the cost of corrective advertising, damage to the plaintiff's goodwill, reasonable royalties and, in cases involving counterfeit trademarks or unlawful domain names, statutory damages. In the case of a famous trademark, the holder may also seek damages for dilution of the mark's distinctive quality.

Defending against damages claims

Once a plaintiff establishes confusion in the marketplace, it's incumbent on the defendant to offer evidence of other industry, economic or market forces that explain the plaintiff's injuries. If a plaintiff alleges price erosion, for example, the defendant might attempt to show that the parties would have competed on price regardless of the infringement.

A defendant may also be able to reduce a plaintiff's damages through apportionment — that is, by demonstrating that a portion of the plaintiff's lost profits is attributable to causes other than trademark infringement. Suppose, for example, that a plaintiff sues a defendant for trademark infringement and false advertising. The defendant might argue for apportionment of the plaintiff's lost profits based on the percentage of the defendant's advertising that uses the infringing trademark.

On your marks

Establishing or challenging damages in trademark infringement cases requires sophisticated financial and economic analysis. A company's performance can be affected by a variety of interrelated industry, market and company-specific factors. To calculate damages accurately, therefore, it's important to trace the plaintiff's losses and distinguish between those caused by the infringement and those caused by other factors.

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Putting Valuation into Context

Whether you're developing a valuation position for your client or poking holes in an opposing expert's report, context is everything. The term "value" means different things to different people, and can vary with the situation. The same business interest can have different values depending on the valuation's purpose, standard of value and value premise.

The purpose

Why is the valuation being performed? It may be necessary or desirable for a variety of reasons. For instance, the parties involved may want to:

- Buy or sell the business,
- Merge, acquire or reorganize the business,
- Finance a project or other aspect of the business,
- Create buy-sell agreements or other shareholder or partnership agreements,
- Set up an employee stock ownership plan (ESOP) or other employee benefit plan,
- Plan for gift and estate tax purposes,
- Engage in charitable giving,
- Have assets valued for prospective divorce settlement purposes,
- Resolve shareholder disputes, or
- Settle commercial litigation and insurance claims (for example, business interruption or lost profits).

Each of these purposes has a different set of considerations and circumstances and may result in different values for the business.

The standard of value

The valuation's purpose also determines the most appropriate standard of value. Here is a brief summary of the three most common standards of value.

#1: Fair market value (FMV). This is the most widely recognized valuation standard. It's the legal standard for most federal and state tax matters, and it's used in a number of other contexts. According to IRS Revenue Ruling 59-60, FMV is:

"The price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of relevant facts and the ability to buy or sell."

Valuators often use FMV to value businesses for purchase or sale. But in some cases it may make sense to deviate from FMV. For example, the willing buyer and seller described in Revenue Ruling 59-60 are hypothetical parties, and sometimes it's appropriate to determine a business's value for a *specific* buyer.

#2: Investment value. This considers special circumstances that make a business more or less valuable to a specific buyer. These circumstances involve potential benefits available to a specific buyer that would not be available to another buyer. For example, if a particular investor could take advantage of tax benefits not available to the seller or enhance the target's earnings through economies of scale or other synergies, it might be willing to pay a premium above the FMV.

#3: Fair value. In many situations, the applicable standard of value is dictated by statute or case law. In dissenting shareholder suits, for example, most states have adopted a fair value standard for valuing the shareholder's stock. The definition of fair value varies from state to state, but it's almost always different from FMV. In some states, fair value doesn't reflect discounts for lack of marketability and other adjustments commonly made in arriving at FMV. Many dissenting shareholder statutes provide that fair value excludes any appreciation or depreciation in anticipation of the corporate action that gave rise to the dispute.

Special circumstances

It's important to understand any case law or statutes that govern the applicable valuation standard. In many states, for example, FMV is the legal standard for valuing a business or professional practice in connection with a divorce. But a careful reading of the statutory language or case law may reveal modifications of traditional FMV principles.

Consider the treatment of goodwill in a professional practice. Typically, a practice possesses two types of goodwill: practice (or enterprise) goodwill, which is associated with the firm or practice as an entity, and personal (or professional) goodwill, which is associated with an individual practitioner.

A majority of states treat practice goodwill as a marital asset subject to equitable distribution but treat personal goodwill — which they view as related to personal earning capacity — as the professional's separate property. Some states treat all goodwill as marital property, while a few exclude all goodwill from the marital estate.

(continued on next page)

Valuation Case Study

A financially troubled manufacturer was on the verge of bankruptcy. One major customer, reluctant to find a new supplier, offered to buy the struggling manufacturer and integrate the business into its own operations. The two companies negotiated an arm's-length price based on the discounted book value of the manufacturer's operating assets. But the company's creditors challenged the sales price.

The creditors claimed that the price was too low. They noted that the price should have been based on the manufacturer's value as a going concern (the value premise) because the buyer was in a position to continue the manufacturer's operations. What's more, the creditors also argued that, because of the strategic fit between buyer and seller, the prospective buyer should have paid a premium. (In other words, the standard of value should have been investment value.)

But the negotiated price was based on the buyer's realization that the manufacturer's demise was imminent as well as on the manufacturer's board of directors' desire to maximize the company's assets' value. Forced liquidation in bankruptcy would likely have yielded a less than orderly sale and, therefore, a lower price.

Assuming that the appropriate standard in this case is fair market value (FMV) (as opposed to investment value, which can be significantly higher), the key factor is not what a specific buyer can do with the business. Rather, it is what a hypothetical buyer would do with the business.

If a typical buyer couldn't save the business, liquidation would be the appropriate premise of value. If the typical buyer could continue to operate the business, it would be valued as a going concern.

In this example, using a going-concern value premise would penalize the buyer, who is atypical, for having the ability to make good use of the manufacturer's assets.

Phil Kanyuk: Newest HRR Partner

It is with great pleasure that we announce the promotion of Philip H. Kanyuk, CPA, ASA to Partner in the Litigation and Valuation Consulting Group of Holtz Rubenstein Reminick LLP.

Phil has worked as the right hand man for Marty Randisi for eight years. He started with Marty's organization in 1992 and quickly excelled in the forensic accounting and business valuation fields.

In 1996 he took a sabbatical and worked solely in Manhattan to broaden his horizons. He testified in civil and criminal matters, state and federal – both bench and jury trials. He worked on major forensic engagements such as Xerox and the NYC Board of Education with a multi-billion dollar budget while also keeping in touch with the more typical small to middle market company valuation and litigation projects.

When Phil returned several years ago, he became the cornerstone on which we expanded our practice. He continues to impress the courts, clients and attorneys who have placed their trust in our organization. At Holtz Rubenstein Reminick we have entered a new phase of service to the legal community but never forgetting the commitment to "help you build a better case."

Phil, Marty and the rest of our firm are committed to earning the trust you give us every day.

The value premise

Under any standard of value, it's also important to determine the appropriate value premise. In other words, should value be based on the assumption that the business will continue to operate as a going concern or the assumption that its assets will be sold? If the latter, will the assets be sold to a single buyer as a unit or will they be sold piecemeal? Will the assets be sold in an orderly disposition, which will likely command a higher price, or in a forced liquidation?

The answers to these questions can have a dramatic impact on value. In fact, the standard of value and the value premise often are intertwined. (*See the sidebar "Valuation Case Study."*)

The engagement

These are some — but not all — of the ways that a valuation's context shapes the valuation conclusion. Clearly, to develop a meaningful valuation, it's essential to define the engagement as precisely as possible. **h**

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The Z Score

Bankruptcy Predictor Can Be a Valuable Litigation Tool

A company's financial viability may be relevant to several important litigation issues, including commercial disputes, divorce, shareholder litigation and lender liability cases. Armed with a balance sheet, an income statement, and a calculator or spreadsheet, a financial expert can use a relatively simple analytical tool — the Altman Z score — to quickly gauge the likelihood that a company will fail within the next two years.

Z Score Formula

Z = (1.2 x X1) + (1.4 x X2) + (3.3 x X3) + (0.6 x X4) + X5

Where X1 = working capital/total assets,
X2 = retained earnings/total assets,
X3 = earnings before interest and taxes/total assets,
X4 = market value of equity/total liabilities, and
X5 = sales/total assets.

Knowing the score

The Altman Z score was introduced in the late 1960s by Dr. Edward Altman, a professor at New York University's business school. Since that time, Altman has further developed and refined his methodology. Today, the Z score is an established and accepted tool for evaluating a company's financial health.

To determine a company's Z score, the expert calculates several financial ratios and multiplies each ratio by a weight factor. The resulting figures are added together to arrive at the Z score.

The original Z score, which incorporated five financial ratios, focused on publicly held manufacturing companies. Later, Altman developed an alternate five-ratio version for private manufacturing companies and a four-ratio version for private nonmanufacturing companies. The original Z score formula is shown in the box above.

In this original model, companies with a Z score of less than 1.81 are likely to fail. Those with a score higher than 2.99 are considered safe, while scores falling between the two thresholds are indeterminate.

Applying the score

The Z score has a number of potential applications in litigation, such as the following:

- In cases involving business valuation, a company's financial health can determine whether it should be valued on a going-concern or liquidation basis. The Z score could be useful in determining the appropriate value premise. (*For more on the value premise, see "Putting Valuation into Context" on pages 4-5.*)

- In cases involving lost profits, the Z score can help assess the likelihood that the plaintiff would have generated the projected sales on which lost profits damages are based. A low Z score may suggest that the plaintiff would not have survived more than two years regardless of the defendant's conduct.

- In a lender liability case in which the lender has withdrawn a line of credit from a corporate borrower alleged to be in financial trouble, the Z score can be used to support or challenge the lender's position.

By calculating Z scores for several historical financial periods, a financial expert can identify upward or downward trends in the score and develop an accurate picture of a company's financial health.

Using the score

The Z score is no substitute for more in-depth financial analysis. The original model described here uses old, unadjusted accounting data from relatively small firms. But it can be a useful tool for determining whether a deeper inquiry is warranted and for benchmarking the results of other analytical techniques.

Stock Sales

(continued from page 2)

Finally, the court rejected the IRS's suggestion that the lack of negotiation between the parties reflected a lack of intent to realize the best price for the shares.

A victory

Huber is an important victory for shareholders of private companies. It confirms that independent valuations based on private stock transactions can be sufficient for gift tax purposes. But it's important to recognize the weight the Tax Court gave to the fact that the valuations were also used for transactions other than intrafamily gifts.

It also underscores the importance of a credible, independent valuation that substantiates the final determination of value.

Interesting & Helpful Statistics

Treasury yields[1]

30 day: 4.67% | 5 year: 4.56% | 20 year: 4.83%

Prime lending rate[2]

8.25%

Dow Jones 20 year bond yield[3]

5.81%

Barron's intermediate grade bonds[3]

6.92%

High yield estimate[2]

Median: 13.54%
Mean: 9.60%

IBBOTSON: Total rate of return for years 1926–2005[4]

Small Cap: 17.4% | Large Cap: 12.3%

Dow Jones Industrials P/E Ratios[3]

On current earnings: 22.18
On 2006 operating earnings estimate: 14.60
On 2007 operating earnings estimate: 13.10

S&P 500 Index P/E Ratios[5]

On current earnings: 17.46
On 2006 earnings estimate: 16.19

U.S. Equity Indexes – YTD Returns[5]

S&P 500: 4.45%
Dow Jones Industrials: 6.19%
Dow Jones Transports: 2.07%
Dow Jones Utilities: 9.24%
NASDAQ Composite: - .98%
NYSE Composite: 8.18%
Wilshire 5000: 4.35%

Long-term inflation estimate[6]

2.5%

Unemployment

US: 4.7%[7] | NYC: 5.1%[8]

Average vacancy rates NYC[8]

Hotels: 13.0% this year | 15.0% last year
Office space: 5.1% this month | 5.4% last month

Zagat Survey Cream of the Crop[9]

MOST IMPRESSIVE DEBUT: per se (www.perseny.com)
TOP FOOD: Le Bernardin (www.le-bernardin.com)
TOP DECOR: Daniel (www.danielnyc.com)

1/Source: *Federal Reserve Statistic Release*; www.federal reserve.com; as of October 2, 2006
2/Source: *Wall Street Journal*; as of October 2, 2006
3/Source: *Barrons, September 4, 2006*
4/Source: Ibbotson, *SBBI Valuation Edition, 2006 Yearbook*; Total returns for 1926–2005 Table 2-1, Arithmetic Mean
5/Source: *The CPA Journal*, October 2006; data as of August 30, 2006
6/Source: 10 year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, June 7, 2006
7/Source: United State Department of Labor; Statistics as of October 2006
8/Source: New York City Economic Development Corporation, *A Summary of New York City's Economy*; October 2006; rate as of September 2006.
9/Source: *Zagat Survey; www.Zagat.com*

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