

# Litigation &

V a l u a t i o n

# REPORT

JULY/AUGUST 2008

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## Valuing manufacturing companies

How experts appraise these  
asset-intensive businesses



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# Valuing manufacturing companies

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A business's value depends on many factors. These include the valuation's purpose (for example, merger and acquisition, tax, or shareholder disputes), the type of interest being valued (for example, controlling or minority) and the relevant standard of value (for example, fair market value, fair value or investment value).

Another key factor is the type of business being valued. While every valuation involves similar approaches, methods and techniques, the precise combination of tools a valuator uses depends on the particular business and its industry.

When valuing manufacturers, appraisers consider these companies' specific characteristics — such as the quality of plant and equipment, capacity and supply chain risk — to reach a reliable estimate of value.

## Methods

Most valutors consider and use one or some combination of the following general approaches:

**Income.** This method converts anticipated economic benefits, such as earnings or cash flows, into a present value that takes into account the risk associated with a company.

**Market.** Using this approach, valutors analyze valuation multiples from acquisitions of similar businesses or from the stock prices of comparable publicly traded companies and adjust for the subject company's particular characteristics.

**Cost or asset-based.** Valutors use various methods to determine the replacement cost or market value of a company's assets, net of liabilities.

Typically, the income and market approaches produce more reliable estimates of a company's fair market value, and manufacturers are no exception. But because manufacturing companies are usually more asset-intensive than other businesses, asset-based methods may have greater



relevance and, therefore, may be weighted more heavily. As a result, appraisals of equipment, machinery and inventory play an important role in these valuations.

Regardless of the appraisal approaches used, a valuator needs to visit the manufacturer's facilities to view the hard assets. This provides the expert with insights into any value that isn't apparent on paper. (See "Site visit key to an accurate valuation" on page 3.)

## Intellectual property

Despite the importance of hard assets to manufacturing operations, intangible assets also have a significant impact on value. Patents, trademarks, customer lists, formulas, proprietary processes, trade secrets and other intangibles are all important components of value.

In many cases, valutors can identify intangible assets manufacturers didn't know they possessed. For example, a company that develops a unique manufacturing process, technique or tool may be entitled to a patent or some other intellectual property protection. By taking steps to register or otherwise protect these assets, a manufacturer can enhance its value.

## Workforce

Depending on the extent to which a manufacturer depends on skilled labor, the value of its "trained and assembled workforce" may be significant to its overall value. Typically, the most appropriate valuation approach

for a manufacturer's workforce is a cost approach. For example, the valuator might estimate the cost — in terms of recruiting, hiring and training — of duplicating the manufacturer's workforce.

Valuators can determine this cost in two ways: 1) estimate the cost of reproducing the existing workforce, or 2) hypothesize a more cost-efficient workforce — a smaller number of more highly skilled employees, for example — that could match the current workforce's output. The right method depends on the nature of the business and its industry.

### Industry trends and risks

For a manufacturing company, the valuator also needs to assess the impact of industry trends and risks, such as:

**Global competition.** Manufacturers with foreign operations may enjoy cheaper labor, lower taxes and other advantages over domestic companies.

**Obsolescence.** If a manufacturer's equipment, technology or products are at risk of becoming obsolete, the result can be diminished sales, an enormous investment in new plant and equipment, or both.

**Supply chain risk.** Most manufacturers are highly dependent on other companies that are upstream

(suppliers) or downstream (customers) on the supply chain. Valuators will scrutinize a manufacturer's supply chain relationships and contracts to determine whether it is highly dependent on one or two large suppliers or retailers. These relationships create two types of risk that can affect the manufacturer's value. First, if one of these companies runs into financial difficulty or goes out of business, the manufacturer could lose sales or have trouble meeting its raw material needs. Second, its reliance on these partners increases their bargaining power.

**Rising costs.** Like most businesses, manufacturers are sensitive to rising labor and health care costs. Company value is also significantly affected by the increasing cost of materials and energy, and safety and environmental compliance.

**Potential liability.** Some manufacturers have high exposure to certain liability risks, such as environmental or product liability. Valuators assess these risks and incorporate them into the value calculation.

### Beyond the numbers

A manufacturing company's value depends to a large extent on the quality of its hard assets, though intangible assets also must be considered. It's critical for valuators to look beyond the financial statement numbers to develop a full and accurate picture of a company's worth. □

## Site visit key to an accurate valuation

There are some things that documents won't tell you about a company's value. That's why a site visit is an indispensable part of the valuation process — particularly when valuing a manufacturing company.

Only a site visit will tell the valuator whether:

- The manufacturer's property, equipment and other assets are well maintained and in good working order,
- Inventory is in good condition and well organized,
- Safety and environmental regulations are being followed, and
- The plant is being operated in an efficient manner.

A site visit also gives the valuator an opportunity to evaluate the manufacturer's capacity. Value derived from projected growth is illusory if the manufacturer lacks the capacity to support it.

In addition, interviews with management and other personnel can reveal important value indicators. Issues that won't appear on the financial statements include employee morale problems or potential liability concerns.

## Music promoter wins “record” damage award

In *Popovich v. Sony Music Entertainment*, the Sixth Circuit Court of Appeals upheld a \$5 million damage award for Sony’s failure to affix Popovich’s record company logo to four albums. In doing so, the court approved using a “hypothetical market” standard to determine the value of Popovich’s logo rights.

### A meaty dispute

In 1977, Popovich, doing business as Cleveland International Records, entered into a production agreement with Sony’s predecessor, CBS Records. The agreement gave CBS first refusal rights on any artists Popovich signed in exchange for operating expenses and royalties.

In addition, the agreement required CBS to place Cleveland’s name and logo on any recordings it produced. But it limited Popovich’s remedies for breach of the logo requirement, stating that CBS’s sole obligation would be “to rectify the error in all such materials prepared after its written receipt of written notice thereof.”

The same year, Popovich signed the musician known as “Meat Loaf” and introduced him to CBS. Between 1977 and 1984, CBS produced four Meat Loaf records, including “Bat Out of Hell,” which went on to sell more than 30 million copies worldwide.

In 1995, Cleveland sued Sony for unpaid royalties (but not for violation of the logo requirement) under the 1977 agreement, and the case settled in 1998. The settlement agreement required Sony to pay Popovich a substantial sum in exchange for a release of past claims by Popovich and Cleveland. It also required Sony to continue placing Cleveland’s logo on Meat Loaf recordings and

reaffirmed the 1977 agreement, except as otherwise provided in the settlement agreement.

In 2002, Popovich sued Sony for failure to comply with the logo requirement in the 1998 settlement agreement with respect to 1) the four original Meat Loaf recordings, 2) compilations containing songs from the four albums, and 3) Internet downloading of songs from those albums.

### Words and music

Much of the debate in the trial and appellate courts focused on the meaning of language contained in the 1977 and 1998 agreements. The trial court ruled, for example, that the 1998 agreement unambiguously excluded Internet downloads from the types of recordings subject to logo rights and granted summary judgment for Sony on that issue.

*Sony challenged Popovich’s expert’s qualifications and methods because the expert had little experience valuing logo rights.*

But the 1998 agreement was ambiguous as to whether logo rights extended to compilations. It also was unclear whether the liability limitation in the 1977 agreement applied to logo rights granted by the 1998 agreement. The trial court allowed the jury to decide both issues.

Although the court agreed that the 1998 agreement reaffirmed the remedy limitation in the 1977 agreement, it found the limitation applied only to logo obligations contained in the earlier agreement. To the extent that the 1998 agreement contained *new* logo obligations — for CDs and compilations, for example — the limitation didn’t apply.



The jury found Sony liable for breach of contract and awarded Popovich more than \$5 million in damages. In reaching its verdict, the jury found, among other things, that the 1998 agreement required Sony to place Cleveland's logo on compilations and that the 1977 agreement's logo obligations did not extend to CDs. Thus, the 1998 agreement created new logo obligations with respect to CDs and compilations and the remedy limitation didn't apply.

The trial court denied Sony's motions for judgment as a matter of law or, alternatively, for a new trial. On appeal, the Sixth Circuit affirmed the district court's rulings regarding the meaning of the two agreements.

### The price of rights

Sony challenged Popovich's expert's qualifications and methods because the expert had little experience valuing logo rights. But the Sixth Circuit deferred to the trial court's conclusion that the expert's "extensive experience in business valuation, including valuation of business units and business assets, [was] sufficient to qualify him as an expert on the value of the contract right in this case."

To place a value on the logo rights, the expert analyzed the market for custom CDs bearing a corporate customer's name and logo. He also looked at the value of license agreements for co-branded credit cards. Based on this evidence, he arrived at a value of \$3 per CD. The parties disagreed on the number of CDs without the logo, but the highest estimate would have resulted in total damages of \$30 million. Sony's expert testified that damages should not exceed \$105,000.

Sony argued that New York law (which governed the agreement) didn't allow this type of "cost of completion" damages, but the Sixth Circuit emphatically disagreed. In New York, the court observed, breach-of-contract damages are measured by "the value of the promised performance." When a breach deprives a party of an asset, the proper compensation is the asset's market value.



And while an asset is easier to value if it has a readily identifiable market, it "does not lose its value simply because no such market exists."

In cases involving intangible assets, the court continued, "New York courts have adopted the hypothetical market standard," the price a willing buyer would pay a willing seller when neither is under any compulsion and both have reasonable knowledge of the relevant facts. The trial court properly allowed Popovich to pursue a damages theory consistent with this standard: the amount it would cost Popovich to obtain the logo rights elsewhere.

The Sixth Circuit noted that courts should defer to a jury's award of damages unless "it deviates materially from what would be considered reasonable compensation." In this case, the jury's award fell between the opposing experts' estimates and the appellate court found no reason to disturb its determination.

As this case demonstrates, a party that loses an asset through the fault of another shouldn't be deprived of damages simply because no ready market for that asset exists. Attorneys should work with their financial experts to develop alternative theories, including a hypothetical market standard, for quantifying a party's financial loss. □

# Show me the money!

Net worth analysis can reveal hidden assets

Uncovering hidden assets can be important in a variety of litigation contexts, including fraud investigations, shareholder disputes, divorce and business valuations. Experts use several techniques to demonstrate the existence of these assets, and one of the most effective is net worth analysis.

## How it works

Conceptually, net worth analysis is quite simple. A financial expert looks at changes in a person's net worth from year to year and reconciles those changes with income and expenses.

Of course, determining someone's net worth, income and expenses can be challenging, especially if he or she is actively concealing assets. So the first step is to reconstruct this data, which may involve some detective work. Financial experts search for clues in a variety of places, including:

- Bank records,
- Tax returns,
- Real estate and court filings,
- Payroll records,
- Expense reports,
- Phone documents,
- Insurance documents, and
- Credit reports.

They might also interview the subject's accountants, former spouses, former business partners or real estate agents.

Employment and loan applications also can provide a wealth of information, including current and previous residences, family members' names, education, and previous jobs. Knowing where the subject has lived and other names he or she may have used can help the expert search for assets.



## 3 methods

Once financial data is collected, experts typically use three primary methods to detect hidden assets:

- 1. Asset.** An expert compares the subject's net worth at the beginning and end of the year, adding known income and subtracting known expenses. A result other than zero indicates income from unknown sources.
- 2. Expenditures.** An expert using this method looks for discrepancies between the subject's expenditures and his or her sources of funds, including salaries, inheritances, loans, gifts and cash on hand at the beginning of the year. If the subject's spending exceeds the available funds, an unknown source of funds exists.
- 3. Bank deposits.** This method relies on the assumption that all money is either spent or deposited (as opposed to hidden under a mattress). The expert starts with net deposits to all accounts during the year and adds cash expenditures to arrive at total receipts for the year. If that amount exceeds funds from known sources, the difference represents an unknown source of funds.

## Following the clues

Keep in mind that the existence of an unknown source of funds doesn't necessarily mean the subject is wrongfully concealing assets. Perhaps he or she borrowed money from a friend, received a generous gift or hit the jackpot in Vegas. But these unexplained gaps provide a basis for further investigation, which may lead to the discovery of new evidence or new avenues of recovery. □

# Cruise line faces rough seas in court

A series of court decisions involving Celebrity Cruises Inc. provides insight into the “yardstick method” of computing lost profits. It also illustrates the importance of presenting direct evidence to support a damages claim.

## The high price of seasickness

In 1994, Celebrity’s ship *Horizon* traveled from New York to Bermuda, leaving a long trail of litigation in its wake after several passengers contracted Legionnaires’ Disease. The multiple lawsuits included Celebrity’s claims against Essef Corp., the manufacturer of a defective spa filter that caused the outbreak.

At trial in the U.S. District Court for the Southern District of New York, the jury returned a verdict in favor of the passengers, apportioning liability 70% to Essef and 30% to Celebrity. It also found that Essef was liable to Celebrity. In a separate trial, Celebrity won more than \$190 million in damages, including \$48 million for profits it had lost between 1994 and 1997 (when it was sold to a competitor) and \$135 million for lost enterprise value.

## Expert’s testimony didn’t hold water

The court granted Essef’s motion for judgment as a matter of law on lost enterprise value, finding that the expert’s calculations relied on inappropriate assumptions. It also ordered a new trial on lost profits, criticizing several aspects of Celebrity’s case.

First, Celebrity had no *direct* evidence of lost bookings in the form of customer surveys or testimony from travel agents or potential passengers. Second, Celebrity’s attempt to prove lost profits *indirectly* was flawed.

Using the yardstick method, the expert compared Celebrity’s actual earnings with the earnings it could reasonably have anticipated but for the outbreak. He based expected earnings on management projections as well as the performance of three other cruise lines.

There are two ways to validate yardstick earnings, the court said. One is to establish that the plaintiff’s past performance paralleled that of the yardstick companies. The other is to demonstrate that the yardstick companies are similar enough to be considered comparable. In this case, however, Celebrity failed both tests. First, it lacked a sufficient track record of past performance. Second, two of the three yardstick companies were strikingly different in terms of size and market.

In the second trial, the jury awarded Celebrity \$15 million in lost profits, and the court upheld the verdict. This time, some direct evidence of lost profits existed. But more important, Celebrity’s expert supplemented his yardstick analysis, showing that one of the companies was sufficiently comparable and that the lost profits calculation using that company alone was not significantly different from his analysis of all three companies. The court reduced the award by 30%, however, to reflect Celebrity’s comparative fault.

The *Celebrity* case reaffirms the importance of direct evidence of lost profits. It also serves as a reminder that when your damages expert uses indirect methods, such as the yardstick method, it’s important to ensure that the underlying assumptions are supportable — and that your expert has an opportunity to explain his or her reasoning to the court. □



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### Our Valuation Expert



**Donald W. Nalley, Jr., CPA, CFP®, CVA, AM, ABV**, is a founder and a director of the CPA and consulting firm Beason & Nalley, Inc. He is a holder of the appellation of Certified Valuation Analyst (CVA), an accreditation that recognizes special training and experience in business valuations and adherence to the standard established by the NACVA and an Accredited Member (AM), awarded by the American Society of Appraisers. Mr. Nalley, a former tax manager with Price Waterhouse, has over twenty-five years of valuation, management consulting, litigation, tax and accounting experience, and is a member of the NACVA, the American Institute of Certified Public Accountants, the Alabama Society of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the American Society of Appraisers, a former member of the NACVA advisory board, and the former president of the Alabama Chapter for the NACVA. Mr. Nalley has performed multiple business valuations for gift, estate and inheritance tax, corporate and marital dissolutions, stock options, income tax, shareholder disputes, business transfers, and other personal and litigation related matters. Mr. Nalley has also served as special master and an expert witness in litigation matters.