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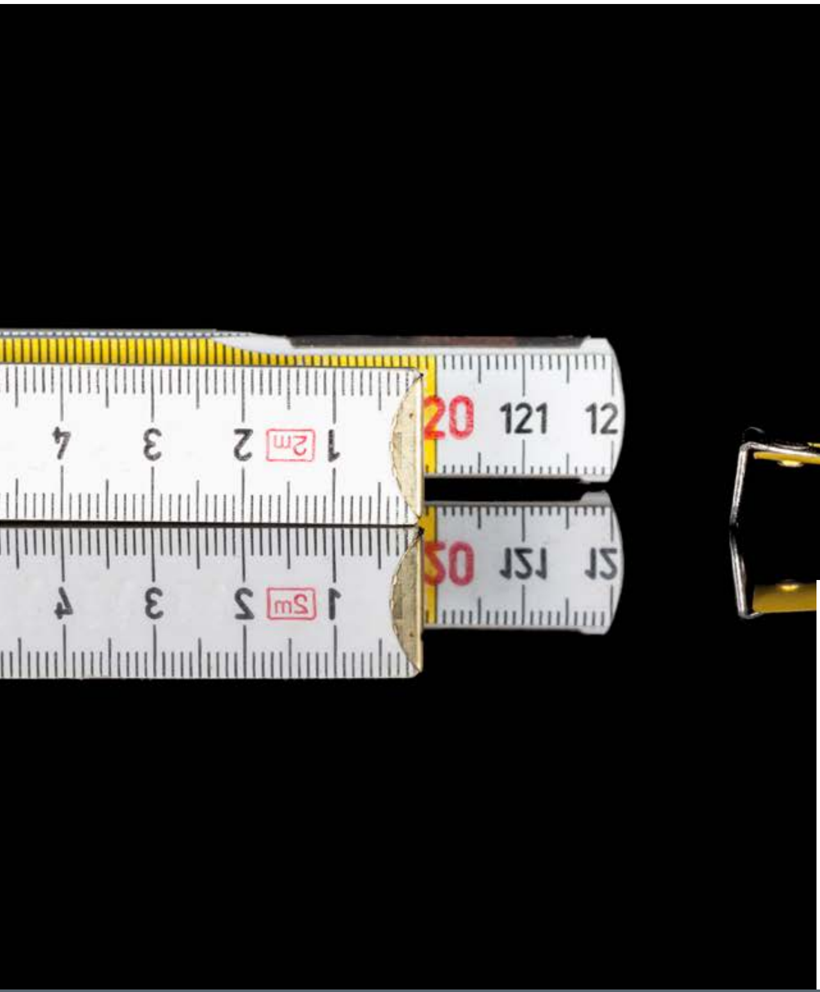
ADVOCATE'S EDGE



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Compare and contrast

Using the yardstick method to estimate a start-up's damages

The yardstick method, which bases economic damages on the performance of comparable "guideline" companies, is a tried-and-true approach for estimating damages, but, like other methods, it has its limits. For example, courts typically don't favor it in cases involving a plaintiff that's a start-up company. In one recent case, though, a federal district court did allow expert testimony that calculated damages for a start-up maker of compression sports apparel based on comparisons with the market leader.

Licensing deal falls apart

The case, *Washington v. Kellwood Co.*, involved the alleged breach of a licensing agreement.

In 2002, the plaintiffs created a brand of compression sports apparel and developed several licensing marks. The defendant told the plaintiffs that MTV, the television network, wanted to partner with them and would promote their brand, which would lead to hundreds of millions of dollars in product sales. Shortly thereafter, the plaintiffs entered an exclusive licensing agreement with the defendant to use the plaintiffs' marks on various types of apparel and accessories.

The MTV deal was never finalized, and the defendant subsequently terminated its arrangements with the plaintiffs, including those under the licensing agreement. The plaintiffs sued the defendant under several theories, including breach of contract, and sought damages in excess of $50 million.

The defendant challenged the admissibility of the plaintiffs' expert's yardstick analysis, arguing that the guideline company used as a standard (or the yardstick) must be as "nearly identical" to the subject business as possible. The expert had used Under Armour, the well-established market leader in the compression sportswear industry, as the yardstick.

Yardstick testimony admitted

The court agreed that asserting that the success of the plaintiffs' new company paralleled that of Under Armour might have been a seemingly improbable conclusion for an expert to reach. But the court pointed out that the expert had at least provided some explanation as to how he'd come to his conclusion and the methods that substantiated it.

> The defendant argued that the guideline company used as a standard must be as "nearly identical" to the subject business as possible.

The court also explained that the test of reliability is flexible — and that the factors courts apply to assess accounting methods don't necessarily apply to all experts in every case. Moreover, "the selection of comparators will seldom approach the 'utopian ideal' of identifying the perfect clone."

At any rate, the court found that the expert had more than satisfied the general minimum reliability standards. In particular, he had offered a number of bases upon which he built his comparison, including:

- The nature of Under Armour's then-primary focus on the sale of compression sportswear,
- The similarities between the arrangements between Under Armour and the sports channel ESPN and those between the plaintiffs' company, the defendant and MTV,
- The geographical reach and cultural influence of MTV,
- The defendant's manufacturing capacity and industry relationships,
- The fact that Under Armour was in its early start-up stage during the period the expert had considered,
- The relevance of Under Armour's experience as an illustration of the industry's growth potential,
- The apparent belief of the defendant and MTV that the new company could have broken into the market with success, and
- The similarities between Under Armour's marketing strategies and those anticipated for the new company — if the MTV deal had gone through.

The court also noted that the expert had examined a number of underlying documents, including various SEC financial disclosure statements for the defendant, MTV and Under Armour, and profit-and-loss statements for the defendant and Under Armour.

A matter of weight, not admissibility

The court in the *Washington* case emphasized that its role as gatekeeper wasn't to divest the defendant of the task of challenging the weight of evidence underlying the expert's yardstick analysis. It cited the case of *Celebrity Cruises Inc. v. Essef Corp.* as "a worthy illustration of allowing a questionable yardstick analysis" to be presented to the court.

In that case, an expert compared the Celebrity and Carnival cruise lines. The judge listed several reasons the comparison was unconvincing. For example, Carnival was a much larger business and benefited from economies of scale. In addition, Carnival was "more diversified," and the companies had different itineraries. According to one relevant witness's admission, the two were "very different companies."

While these factors undermined the legitimacy of this comparison as a predictor of Celebrity's performance, the court concluded, they didn't render the expert's analysis inadmissible. Rather, they only diminished its value in establishing lost profits.

In the end, the expert's yardstick testimony was admitted. The court left it to the defendant and its expert's "robust efforts at trial" to call into question the weight the jury should give the testimony. (See "A matter of weight, not admissibility" above.)

A possible outlier

Although this court allowed the expert to use the yardstick method to calculate a start-up company's damages, neither experts nor attorneys should interpret this case to mean that guideline companies don't need to be similar to the subject company in terms of, say, size, financial performance, market share or target markets served. Other courts have taken a more stringent approach. ■

Smartphones: The next fraud frontier

Smartphones quickly have become a standard part of life for much of the population. Not surprisingly, they've also now become a standard target for hackers and other individuals with fraud-related intent. Understanding the risks associated with smartphones is the first step in staying secure.

Smartphone risks

According to the U.S. Department of Homeland Security's United States Computer Emergency Readiness Team (US-CERT), smartphone security hasn't kept pace with traditional computer security. These devices rarely contain technical security measures, such as firewalls and antivirus protections, and mobile operating systems aren't updated as frequently as those on personal computers (PCs).

Yet users routinely store a wide range of sensitive information — including calendars, contact information, emails, text messages, passwords and user identification numbers — on their smartphones. Geolocation software can track where smartphones are at any time. In addition, apps can record personally identifiable information.

Even users who have little sensitive information on their smartphones are at risk. A hacker can target a phone and use it to trick its owner, or the owner's contacts, into revealing confidential information. They also use targeted smartphones to attack others. Using malicious software, an attacker can control a phone by adding its number to a network of devices (called a "botnet"). And smartphones can spread viruses to PCs, which can be a big problem for companies with bring your own device (BYOD) policies.

A user might install an app that turns out to be malicious or a legitimate app with weaknesses an attacker can exploit.

Access points

An attacker can gain access to a smartphone through a variety of avenues. Sometimes an attacker obtains physical access, as when a phone is lost or stolen. More frequently, a hacker achieves virtual access by, for example, sending a phishing email that coaxes the recipient into clicking a link that installs malicious software.

Apps can be dangerous, too. A user might install an app that turns out to be malicious or a legitimate app with weaknesses an attacker can exploit. A user could unleash such an attack simply by running the app.

Protective measures

Experts suggest that individual smartphone users, as well as those charged with managing an organization's smartphones or administering a company's BYOD policy, take several steps to reduce the odds of damaging attacks. Encryption is probably the most highly recommended precaution. When data is encrypted, it's "scrambled" and unreadable to anyone who can't provide a unique "key" to open it.

Two-step authentication, such as that offered by Gmail, is advisable when available. This approach adds a layer of authentication by calling the phone or sending a password via text message before allowing the user to log in. Of course, if the fraud perpetrator has obtained the phone illicitly, these authentication services put him or her one step closer to accessing the owner's accounts.

Many users fail to enable all of their phones' security features. If available, an owner should always activate remote find-and-wipe capabilities, the ability to delete known malicious apps remotely, PINs or passwords, and other options such as touch ID and fingerprint sensors if available. Conversely, users should disable interfaces such as Bluetooth and Wi-Fi when not in use. They also should set Bluetooth-enabled devices to be nondiscoverable, which prevents devices from being listed during a Bluetooth device search process.

Can you hear me now?

Just as smartphone technologies are evolving rapidly, so are the threats to their security. Users and managers need to stay on top of the risks. Take the necessary precautions to protect these valuable but vulnerable devices. ■

Determining the value of human capital

A trained, skilled and innovative workforce able to work as a team to achieve strategic goals is worth its weight in gold. But beyond the metaphor, how do employers determine the worth of human capital to their businesses? Is it possible for companies to measure the value of such an intangible asset? A valuation professional can provide objective market data and financial analysis to help support an accurate human capital appraisal.

What is it?

Human capital comes in many forms. The most obvious example is employees on the company's payroll. But it also may include relationships with independent contractors, consultants and celebrities, as well as employment contracts, noncompetes and confidentiality agreements.

Employees who hold professional licenses may be considered another type of human capital, because they allow professional services firms and other industries to conduct business and, therefore, add value. But these licenses can't be transferred to third parties and, therefore, are typically the property of individual practitioners, not the company.

What's the best approach?

A logical starting point for valuing an assembled workforce is to estimate the cost to reproduce or replace the company's workers. This estimate includes the costs to recruit, hire and train each level of the company's workforce. Valuators consider such items as headhunter fees; salaries and benefits of recruiting and training staff; costs of background checks, drug tests and screening exams; and relocation fees, moving costs and signing bonuses. They also look at classroom materials and fees, as well as lost productivity of new and existing staff during the recruiting and training processes.

When valuing workforce assets, a valuation makes an important distinction between reproduction and replacement cost. Reproduction cost is the current cost of an *identical* property — in other words, the same number of employees with the same skills, education levels, experience and salary requirements.

Replacement cost is the current cost of employing a *similar* workforce that has the nearest equivalent utility to the existing workforce. Replacements might be younger employees who are willing to perform the work for less money — or fewer employees who are more qualified and efficient — than the existing workforce.

In some cases, an appraiser may decide that the company is paying higher labor costs than it should. Sometimes, however, excessive labor costs arise from union agreements or family commitments and may be unavoidable.

Valuators also watch out for employees nearing retirement who may need to be replaced soon. If a significant number of key employees are nearing retirement, it could affect the value of a company's workforce.

Does it make sense?

Although the cost approach is the most common way to value an assembled workforce, the income or market approaches are sometimes used to gauge whether the results of the cost approach make sense.

For example, an appraiser could divide the value of a professional practice's workforce under the cost approach by the number of employees to calculate the average value per employee. He or she could then compare this amount to the average net realizable billable hours per employee to impute the firm's return on human capital.

Assembled workforces aren't normally sold as separate assets. So the market approach is rarely used to value human capital. But an appraiser might calculate the value of a workforce under the cost approach as a percentage of the company's total value and ask: Would a buyer be willing to pay this much to acquire these assets? Or would a seller be willing to give up these assets for this amount?

> When valuing workforce assets, a valuator makes an important distinction between reproduction and replacement cost.

What's it worth?

Although an assembled workforce isn't a separately identifiable intangible asset when accounting for business combinations under Generally Accepted Accounting Principles, there are many circumstances — such as business combinations, divorce or shareholder disputes — in which companies might find it useful to put a number on the value of their people. An experienced professional valuator can provide the expertise needed to quantify this seemingly unquantifiable asset. ■

Court rejects adjustment for tax consequences of a possible sale

Should you adjust business value for taxes associated with a possible sale? This continues to be a subject of debate among the courts. In a recent divorce case, an Ohio court tackled this issue.

The husband in the case, a 44-year-old orthopedic surgeon, held interests in four businesses related to his practice. Both spouses retained financial experts to value the interests. Although their pretax valuations were similar, the husband's expert reduced the values by more than $1 million for the tax consequences of a possible sale. The trial court adopted this adjustment in its distribution of marital assets.

The wife appealed, arguing that when a business isn't being sold — or isn't required to be sold due to asset distribution in a divorce — the potential tax consequences of a future sale are too speculative. An Ohio statute expressly provides that a trial court must consider the tax consequences of a property division in a divorce. Ohio courts have clarified, though, that tax consequences may be proper considerations *only* if those consequences aren't too speculative.

According to the appellate court here, tax consequences might not be considered too speculative if 1) there's a sufficiently definite future sale, 2) the tax rates aren't likely to change in that time, and 3) the tax consequences to the individuals would be the same or similar.

Although the husband planned to sell his businesses at retirement, he had no imminent plans to retire, and the distribution of marital assets didn't require him to sell the businesses. Moreover, the husband's expert had used current tax rates to estimate taxes due on possible sales of the interests, speculating that the rates would be the same, or substantially similar, in the future.

> Courts have clarified that tax consequences may be proper considerations *only* if those consequences aren't too speculative.

States have varied positions regarding the propriety of factoring in the tax consequences of a possible sale. But they generally tend to frown upon speculative adjustments to value. If adjusting for taxes at disposition would require assumptions about, for instance, the abolition of or a spike in the capital gains tax, an owner's percentage interest in a business at retirement, or the value of the interest at that time, a court might reject the adjustment as too speculative.

Because circumstances could change by the time the husband eventually sells his interests, the appellate court determined that taxes due at disposition were too speculative to consider. So, the case was remanded to the trial court to recalculate the values of the businesses without considering the tax consequences. ■

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