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Warren Distributing et al. vs. InBev USA LLC [REVISITED]

U.S. District Court for New Jersey.

The Fall newsletter reported on one aspect of the above federal case. The plaintiffs, whose beer franchise distribution rights were terminated by InBev following its purchase of Anheuser-Busch, had a valuation prepared based on the discounted cash flow [“DCF’] method; it found a fair market value [“FMV”] of $65.7 million or considerably more than $25.1 million paid by InBev. Under New Jersey's alcohol control laws, a brewer terminating such rights must pay the fair market value of the business. The brewer's valuation expert, using a market approach based on New Jersey sales transactions, selected 2.5 times gross profit for the domestic brands and 3.3 times gross profit for the imported brands. InBev challenged the DCF method as un-reliable and un-proven under Daubert, but the Judge disagreed.

This was by no means the end of the case, since the plaintiffs had requested a jury trial. In the end, the jury did not believe the plaintiffs' DCF-based conclusion, and found for InBev's market-based conclusion.

DCF-based valuations often generate a large terminal value, which represents the stabilized value of the business after the projection period and is calculated using projected earnings in perpetuity. Like the cash flow during the projection period, the terminal value is present-valued. Business appraisers are somewhat biased against using market data because it is difficult to support whether the companies sold in guideline transactions are comparable to the subject company.

The market approach used by InBev did not address overhead, just gross margin. Of course, the gross margin is only one component of profitability besides overhead, but it can be argued that it, too, is largely dictated, in practice, by the brewers on their distributors. On the theory that a buyer buys because of the profit he thinks the business will generate, and particularly an FMV buyer, this method correspondingly remains difficult to support. Many business brokers using the market approach select a fixed dollar amount for each case of beer sold annually based on the brand and the territory, but this was not used by InBev's expert. Some industry observers also believe that the market approach is best used to value brands, not an entire distributorship; that argument appears misplaced since a distributor is only a collection of brands in a particular territory fixed by contract and sanctioned by state law. All market multiples are a short cut, often, of an implied income valuation based on industry norms.

The domestic brands sold by the plaintiffs were not national in scope, nor were they "craft" beers in any sense of the word ["craft" beers like S. Adams typically have higher selling prices than domestic beers and their margins are comparable with foreign brands.] Perhaps the jury sensed that the national brewers which currently control most of the beer market have been known to side-line such weaker brands as circumstances change. For once, a non-national brand makes little long term economic sense in a low-margin business because volume is needed to support advertising costs. Accordingly, perhaps the jury did not believe in the perpetual aspect of the domestic franchises. Perhaps the DCF was based on "pie-in-the sky" projections. Without a copy of the plaintiffs' valuation report and the ability to probe the projection which the DCF analysis was based upon, it is difficult to understand the jury's exact reasoning.

Another confusing aspect to the decision is that market transactions may or may not represent FMV because this "3-tiers" regulated industry often results in few wholesalers becoming available for sale. When they do, other distributors and other bidders often need to out-bid each other in order not to miss the chance of growth by acquisition in this mature, low-growth industry. Accordingly, the winning bid may represent more than FMV.

We contacted the expert retained by the plaintiffs, who now believes that a judge would have reached a different final conclusion. Of course, juries often prefer simple solutions. Also, intangible asset valuations prepared under the fair value standard to support the audited financial statements of brewers routinely use a DCF approach, and reflect values at an estimated 6 times gross profit multiple; it is difficult to argue that, in this instance, fair value is all that different from FMV. Finally, this decision notwithstanding, the market

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place is not limited to one state, and the defense here was clearly more nimble and followed a riskier but successful strategy of presenting only one expert. The brewers' expert testified to the effect that, in New Jersey, brands are traded at a multiple of gross profits. We have asked for his comments/report but the call was not returned. The case is being appealed to the 3rd U.S. Circuit by the plaintiffs.

Appraisers now have to deal with case law which, at best, is grounded in a heavily regulated industry, and, at worse, is difficult to understand from a valuation perspective.

Daubert and the Lost Profits Expert: Recent Cases

Can a lost profits analysis ever be too "simple" under the Daubert standard? The answer might be "it depends," as the following three recent court decisions demonstrate.

1. *Coyne's & Co., Inc. v. Enesco, LLC,* (D. Minn.) (Aug. 16, 2010)

The plaintiff sued the defendant for interfering with their contract. The defendant challenged the plaintiff's expert under Daubert. His lost profits calculations were "simply rudimentary math" and failed to account for alternative causes of the plaintiff's losses. He failed to corroborate sales data provided by the plaintiff, despite their "material difference" from the records the plaintiff produced in discovery.

The court agreed that the plaintiff's expert used a "simple" analysis that did not address "a number of apparently relevant factors." For instance, he did not consider incremental costs, the risk and uncertainly of realizing actual sales, competition, supply chain disruptions, and general economic conditions—including the recent recession. Nevertheless, the court found these weaknesses did not render the expert evidence "fundamentally unsound." Similarly, the differences in the sales data—which amounted to two pages of records—did not undermine his opinion. An expert is not generally required to independently verify all of the underlying records, the court held, and admitted his opinion, subject to cross-examination at trial.

2. *Truman Arnold Companies v. Hammond and Consultants Enterprises, Inc.*, (Tex. App.)(July 30, 2010)(unpublished)

The plaintiff sued the defendant for breach of contract to pay commissions for customer referrals. Before trial, the defendant unsuccessfully challenged the plaintiff's expert under *Daubert*, and the jury ultimately awarded the plaintiff approximately $325,000 for actual lost commissions and nearly $500,000 for future losses. The defendant appealed the *Daubert* ruling as well as the damages, claiming the plaintiff's expert relied on flawed records of income and expenses.

The court disagreed, finding that the defendant had produced "unusual" records regarding its customer sales, which significantly understated profits. The plaintiff had made every effort to obtain more specific records, but its expert ended up having to rely on the defendant's documentation. Any resulting gap between the data and the expert's analysis did not render it unreliable, and the court sustained its admission under *Daubert*. It also found the jury's award of actual damages ($325,000) fell within the range of expert evidence presented at trial.

At the same time, plaintiff did not establish that any of its current referrals intended to buy from the defendant in the future. Moreover, the plaintiff's expert had specifically declined to offer an opinion on future damages. Instead, he simply extended the actual damages amount into the future, discounted back to present value, so the jury might use his figures if it determined future damages were warranted. As such, the court found the evidence insufficient to support lost profits damages and reduced the jury's award by $500,000.

3. *Gresh v. Waste Services of America*, (E.D. KY.) (Sept. 1, 2010)

The plaintiff held stock options in a closely held company, which amounted to a 5% interest. He sued the majority owners for preventing him from exercising the options until after they sold the company and claimed over $500,000 in damages, including prejudgment interest. The defendants challenged the plaintiff's damages expert under *Daubert, arguing that he'd* merely calculated the plaintiff's 5% interest at the time the company was sold rather than value the entire company under "one of many accepted methods of business valuation," such as the net assets approach, the income approach, or the market approach.

The court found the market approach would be inappropriate in this case, given the company's closely held status. Moreover, the fact that the plaintiff's expert could have valued his 5% interest in ways "other than a mere computation of his proportionate share" of the company did not make his damages opinion unreliable, the court held. The court struck the expert's prejudgment interest calculations, however, because applicable state law gave the trial court discretion to decide prejudgment interest for unliquidated damages.

Court Prefers Expert with BV Experience and Better Application of FV Law

***California DHI, Inc. v. Erasmus*, (C.A. 10 (Colo.)) (Aug. 20, 2010)(unpublished)**

In the early 1990s, a veterinarian formed a company to develop an animal food supplement with two partners, including the defendant. When the company discovered the defendant was creating a competitive supplement based on the same formula, it sued and won an $800,000 verdict. Six months later, the company merged with a California firm and the defendant invoked his statutory right to dissent and demanded purchase of his shares. Not surprisingly, the parties were unable to agree on the fair value of his 33% interest and found themselves back in court.

The parties' experts proposed widely divergent fair value appraisals. The company's expert was an experienced business appraiser who valued the enterprise at approximately $3.7 million. The defendant's expert, an investment banker with experience in the natural foods industry, valued the company at more than twice that amount—or $7.6 million. The federal district court ultimately adopted the lower value by the company's expert, finding it more reliable for several reasons, including her "significant appraisal experience; her application of the fair value standard as reflected in Colorado law; her reliance on [the company's] financial records; and the thoroughness with which she explained and duplicated her methodology." By contrast, the court noted several "gaps" in the methodology used by the defendant's expert, questioned his choice of comparable companies and products, and discredited his anticipated growth rate calculation.

The court accepted the defendant's assertion that the company's $800,000 judgment against him was too contingent on collectability to be included as an asset. However, the court declined to subordinate the company's debt to the defendant's share, and ultimately reached a going concern value of roughly $2.3 million—or just $800,000 for the defendant's 33% interest (ironically, just about the same amount as the defendant owed the company in the prior lawsuit).

After an unsuccessful request for reconsideration, the parties appealed to the U.S. Court of Appeals for the Tenth Circuit. On "careful" review of the record and the applicable state law, the 10th Circuit summarily dismissed all claims. The district court correctly determined the valuation date and the more credible valuation. It also correctly decided that the $800,000 judgment in favor of the company was too contingent to include in the fair value appraisal, but that all corporate debt should be included before an award of the defendant's proportionate share.

Five Potential Problems in Today's Fairness Opinions

Corporate attorneys, boards of directors, and trustees frequently rely on fairness opinions from valuation specialists when evaluating merger and acquisition transactions. Changes in the economic and regulatory environment have altered the analytical landscape for fairness opinions. In particular, watch out for the following five pitfalls:

1. **Inadequate due diligence.** In providing a fairness opinion to a corporate board or special committee, the financial analyst should have performed a thorough due diligence and analyzed the company and the transaction from qualitative and quantitative perspectives. At any presentation, be sure to ask questions that plumb the analyst's depth of knowledge about the company, its business and operational procedures, and how these relate to the conclusions of value.
2. **Poor selection of guideline companies and transactions.** It's not enough to simply look at multiples of revenues or earnings from guideline companies and/or transactions. Given the cyclicality of asset prices and earnings over the last few years, make sure the valuation analysts have made a good match between the effect of the recession on the subject company and the guideline comparables. For example, more recent transactions are likely to be more relevant than older transactions, but they also may have been made under economic "duress." M& A transactions now require closer scrutiny, and analysts must be more careful when applying the data in the market approach.
3. **Mismatch of discount rates and projections.** One of the most common, recurring analytical errors is to mismatch the discount rate with the inherent risk in management's projections. Remember, the discount rate is a long-term measure, but in a discounted cash flow analysis (DCF), a substantial portion of the risk might end up in the terminal value. For example, the current market environment may justify a higher discount rate, but any DCF that uses the higher rate will be applying it in perpetuity, through the terminal value,

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rather than for the shorter period of the relevant projections.

4. **Omission of critical market data**. Given the current uncertainty in market pricing, the analyst must carefully consider general economic factors as well as industry-specific transaction data. An uptick in economic indicators or industry deals does not spell the end of stock market volatility. No analyst should ignore today's asset prices when conducting any valuation, particularly when evaluating the financial fairness of any proposed transaction.
5. **Inappropriate valuation discounts and premiums.** Most fairness opinions focus on valuing marketable interests, and the applicable fair value standards will specifically preclude the application of marketability and related discounts. But in today's financial markets, the analyst must consider whether some factors at the entity level might restrict the sale of the company.

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