

Business Valuation Notes

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Courts Now Expect...

ELECTRONIC FILES EVIDENCE

Failure to Keep Files May Increase Risk of Loss ...

Companies and their counsel must pay closer attention to their document retention policies as a result of the December 1, 2006, amendments to the Federal Rules of Civil Procedure (FRCP) that address the discovery of electronically stored information. These amendments revamp and clarify previous rules to facilitate the discovery of electronically stored information in litigation matters.

According to MBVG Affiliate Stephen Shulman, CPA/ABV, CVA, and Anchin, Block & Anchin's Director of Business Risk Services John Dodge, J.D., CISA, the changes in the rules are causing companies to watch and rethink what, how, and when their electronically stored information is being saved. "These amendments put companies and their counsel on notice," Shulman said.



Shulman

Shulman and ABA are affiliates of the Minnesota Business Valuation Group. MBVG President Randall Schostag noted that many of MBVG's valuation cases are conducted for litigation purposes and that many others, which are prepared for other reasons, are expected to be defensible in court. "The ability to store electronic

transmissions of information between MBVG and clients takes on a much more important dimension as a result of these amendments," Schostag said.

The amendments require companies to: be prepared to address early in the litigation process their system for maintaining electronic information, identifying information considered privileged and confidential, securing and preserving their electronic data and the forms in which it is stored, Dodge observed.



Dodge

"You have to know what electronic information is being stored and where it is located and be prepared to deal with the broader definition of electronically stored information and a more specific definition of the form in which it must be produced."

Under the amendments, companies may not rely on the undue burden argument to avoid discovery and the turning over of electronic information. Systems that are overly complex may imply an intentional effort to avoid discovery, according to Shulman and Dodge.

(Continued on page 3 ... Record Keeping)

COURT RELAXES HINDSIGHT RULE

In mid December 2006 the court released an opinion made as of September 2006 which relaxes the 'hindsight rule'. This rule has confused both judges and valuation analysts alike, as it stipulates that occurrences subsequent to the effective date of a valuation may not be considered and thus cannot affect value.



Schostag

The case was adjudicated in the United States Court of Appeals for the Second Circuit in the matter of Mark Boyce versus Soundview Technology Group, Inc. (formerly known as Wit Capital Group, Inc.) MBVG President Randall Schostag believes that the case makes the use of subsequent information much clearer for appraisers. "The cut-off for information which can be considered is arbitrary in my opinion," Schostag said. "Most valuation professionals will include information which was 'known or knowable' and not simply use information relative to an actual public occurrence."

The rule often followed by courts prohibits courts from considering valuation evidence 'in hindsight' or which occurs after the effective date of the valuation. "For example, the effective date of a valuation may be set by a breach for contract cases, a date of separation for divorce, a date of discharge

(Continued on page 2 ...Hindsight Rule)

HINDSIGHT RULE

(continued from page 1)

for employment, a date of filing a complaint, the date of death of a party, or other dates. The point is that both parties have agreed to a specific time which will be used for a valuation," Schostag said.

While courts often are very strict about admitting any evidence which was manifest subsequent to the effective date, the Second Circuit Court of Appeals relied on an older tax decision to push the boundaries of the rule a bit. Schostag believes that considering such evidence which was implied if not yet established fact offers better evidence of what hypothetical willing buyers and sellers would consider as of the effective date.

The case arose from consulting work Mark Boyce, the plaintiff, had performed during the late 1990's. Boyce had done work for the predecessors of the defendant, Wit Capital Group, Inc. Subsequent to leaving the company, Wit Capital had undergone two different acquisitions, so the eventual defendant carried a different name: Soundview Technology Group, Inc.

While working for Wit Capital, Boyce received an option to purchase 800,000 shares of the company's stock for \$1 per share. Both Wit Capital and Boyce signed a memorandum of understanding on February 20, 1997 which permitted Boyce to exercise his option within one year of termination. The company in October 1997 sent him a more formal agreement which revised the exercise period to span one month post-termination, but Boyce never signed it.

"Revising an option agreement from a length of time of one year to one month is huge," Schostag noted. "Such a change substantially reduces the option's value. When valuing options, the period to termination is critical. The longer the exercise period before the option expires, the more valuable the option."

Boyce was terminated in May 1998, but he did not exercise his stock option at that time. Over the next few months, the company sold about 44 million shares in private placements with institutional investors, most in a Series D stock at \$1.50 per share. Later in March the company sold 16.6 million shares to Goldman Sachs Group at \$1.50 per share for a Series E stock. Between those dates, the company publicly announced its intention to launch an Initial Public Offering (IPO) during the second quarter and filed a registration statement with the SEC, indicating a 'proposed maximum aggregate offering price' of \$80 million. On March 18 (prior to the Goldman Sachs purchase) the company filed an S-1 Registration Statement.

Anticipating the stock would be worth more than \$1 per share, on March 31, 1999, Boyce sent the company an \$800,000 check and his option exercise form. On April 5, 1999, the company rejected both, saying they were untimely. Within two months, the company went public, selling 7.4 million shares at \$8.37 per share. On its first day of trading, the stock closed at nearly \$15 per share.

Boyce relied on the memorandum of understanding and won a breach of contract claim against the company. Thus the expiration time became a non issue. However, based on the district court's "bright line" evidentiary ruling which excluded all valuation evidence after the breach of contract date, the jury awarded Boyce damages based on the prior placement value of the stock before the IPO or \$1.50 per share. The district court had based its opinion by excluding information about the IPO or the stock price performance because it was considered subsequent information.

"It has to be understood," Schostag said, "that an IPO takes a very long time to assemble. There is an initial drafting of documents, considerable discussion about pricing, and review of the drafts through

several iterations by both the investment banker and the company. In our opinion, the information was clearly knowable if not known."

Boyce filed suit in March 2003, but the court would not accept the S-1 filing into evidence. That filing had included the anticipated \$80 million goal for the offering.

The 2nd Circuit found the court was too restrictive by excluding admissible evidence, and vacated the damages judgment, remanding it a new trial.

TAX COURT APPLIES INTERESTING BLOCK-AGE DISCOUNT

In a recent Tax Court Memorandum (2006-270) of *Gimbel versus the Commissioner of Internal Revenue*, the United States Tax Court ruled on the fair market value of restricted shares, providing an interesting approach to appraising a large block of publicly traded common stock.

The process and thinking of the tax court is of interest as MBVG Principle Ashok Abbott has developed a way to determine discounts for lack of liquidity called the Abbott Index. The Abbott Index applies 'real world' trading of securities to ascertain how much, if any, discount is appropriate.

The IRS had determined a Federal estate tax deficiency of \$5.2 million with the only issue to be determined by the court a decision as to the value of 3,601,267 shares of common stock of Reliance Steel and Aluminum Company of which all but 52,817 shares were unregistered. There were a total of 27,786,030 shares of outstanding common stock, so the subject block comprised about 13% of the outstanding.

Since the stock is publicly traded, based on the \$20.8125 trading price on the valuation effective date, Reliance's aggregate equity market capitalization

(Continued on page 3 ... Tax Court)



Boyce

Record Keeping

(Continued from page 1)

"Frankly, you better be prepared to incur significant costs if your systems are not organized to provide the information requested in discovery" Shulman said.

Many believe that the process of updating the FRCP began in March 2000 during a Department of Justice probe into then-Vice President Al Gore's fund-raising activities. Gore reported that he could not immediately produce e-mails related to the probe. White House counsel Beth Nolan stated White House e-mails were recorded on a series of 625 tapes that would take up to six months to search.

More recently, the production of electronically stored information was addressed in the much cited decision from the Southern District of New York, Zubulake v. UBS Warburg LLC, 220 F.R.D. 212 (S.D.N.Y. 2003). In Zubulake, Judge Shira Scheindlin set forth a series of standards to guide companies with respect to document preservation.

Zubulake, who brought suit for gender discrimination and retaliation, sought sanctions against her employer for its failure to preserve electronically stored information and related documents. Specifically, Zubulake claimed that evidence supporting her claims was contained in e-mails among various company employees. The defendant, however, failed to retain a subset of these relevant e-mails. The court found that the defendant's failure to retain a small subset of documents was "negligent and possibly reckless."

Former Vice President Gore's experience and the decision in Zubulake v. UBS Warburg LLC serve as pertinent examples of the rationale behind the changes to the FRCP. These amendments demonstrate the willingness of the U.S. legal system to follow through on its promise to force companies to produce electronically stored information as evidence in civil court cases.

Dodge said, "As of December 1, 2006, companies and their IT departments must produce information earlier in the litigation process, and if they cannot, they must be ready to explain why."

In UBS Warburg's case, the company claimed that old, deleted e-mails requested by the plaintiff were stored on 94 separate backup tapes, and the cost of retrieving them would be \$300,000 – making the recovery of the information "unreasonable."

E-mail has been used as evidence in court cases for years. The amended rules now also cover electronic documents, spreadsheets, image and sound files, and database information. Dodge and Shulman believe that the language is inclusive enough to cover any electronic media developed in the future.

The amended rules explicitly state that requested information must be turned over within 120 days. Failure to meet these deadlines can result in serious consequences. In the instance of a defendant sitting on potentially damaging evidence, courts are empowered to levy fines and other penalties.

"It is obvious that the legal system now disdains companies that intentionally destroy electronically stored information," Shulman said. "Morgan Stanley in May, 2006, paid \$15 million to settle Securities and Exchange Commission charges that it destroyed more than 200,000 e-mails and failed to cooperate with SEC investigators looking into Wall Street business practices."

As part of the Morgan Stanley probes, the SEC, between 2000 and 2004, asked the firm to hand over copies of e-mail it believed to be relevant, but "Morgan Stanley did not search diligently for backup tapes containing responsive e-mails until 2005," according to an SEC statement in May.

As the reliance upon technology continues to grow in the corporate sector, electronically stored information is fast becoming more timely and relevant than

paper evidence. "While the amended rules give the courts flexibility to determine accessible versus inaccessible data, do not expect much sympathy when judges suspect you may be withholding potentially important evidence," Dodge said.

"IT departments will want to use document-management and other systems to give their lawyers specifically what they ask for, rather than mountains of data. The fees associated with your law firm evaluating and organizing information for a court case can be prohibitive," Shulman added.

TAX COURT

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was approximately \$578 million. However, the court acknowledged that decedent's stock was unregistered and since the decedent was considered an 'affiliate', the estate was, therefore, restricted from selling more than a small amount over any three-month period: about 39 months.

The court considered the chance of selling the shares in both a secondary public offering and in a private placement but ruled both unlikely, the first due to negotiations by the company to make a large purchase of another firm and the second due to the resale restrictions attached to the common stock.

The court also considered the chance of Reliance repurchasing the stock, but concluded that the number of shares and total cost would have been prohibitive to purchase all of the block, and, therefore, would have been limited to 20% of the total; the court thought that a repurchase of about 20% of the block was reasonable given limitations on company cash. For the remaining shares, the court accepted that a 'dribble-out method must be considered, reflecting the restrictions on stock sales of the unregistered shares into the public market (SEC Rule 144).

Dribbling out over an extended time period (more than three years) involves additional risk and reduces value.

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

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Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

BUSINESS ASSET VALUATION

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

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Property Records

Fiduciary Review

Sale / Leaseback Structuring

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**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

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INSTRUMENT.**

WE WILL CONNECT OUR COMPUTER.

PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.