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Cost Method 'Strikingly Inappropriate' to Value Technology

***Holber v. M&T Bank (In re Scheffler)*, 2012 Bankr. LEXIS 2568 (June 5, 2012)**

Back in 2005, the debtor worked for his family's business, a firm that supplied equipment to the high-speed printing and reprographic industry. Much of his time and effort went into developing a robotic "stacking" technology, which, at first, drew a great deal of interest from the trade. The business sold its first three units for just about $1 million apiece and received seven additional orders—but its overall costs of production always exceeded the sale price by hundreds of thousands of dollars per unit. As the federal bankruptcy court noted in its review of the facts, "this was not a good way to stay in business."

Indeed, initial outlays on the new technology forced the family business to exhaust its available capital and open a new line of credit. By 2006, it decided to staunch the "river of red ink" associated with the "money-losing stacker," the court said. The son, however, still wanted to pursue his "dream" of making the technology profitable and started his own company with the blessing of his family and the unfettered right to use the technology. At the same time, he felt "morally responsible" for the financial drain on the family business and promised to repay its development costs. None of these transactions were ever put in writing.

To replace its depleted capital, the family business acquired two loans from M&T Bank totaling $650,000 in April 2007. In June, the son guaranteed the loans, secured by mortgages on his primary residence. Importantly, the son did not specifically pledge the stacker technology as collateral. However, more than a year and a half after guaranteeing the loans, the family business issued a highly restricted (nonexclusive, terminable-without-cause) license to the son's business, permitting him to use the stacker technology as of or around the time of the guaranties.

The son "never had a chance," the court noted. Saddled with monthly debt payments in addition to a product that continued to sell at well below production costs, his business "lost ever more money, spiraling into inevitable financial oblivion." In 2009, the business closed and the son filed his Chapter 7 petition. His home was valued at $350,000, but was encumbered by a primary mortgage loan as well as real estate taxes and the $650,000 lien to M&T Bank, for a total of $775,000 in debts.

Two very different approaches to valuing the technology. To defend against the trustee's fraudulent transfer claims, the bank maintained that the son received reasonably equivalent value in exchange for guaranteeing the loans—to wit, the transfer of the stacker technology via the 2008 licensing agreement, which by its terms, was made retroactive to July 1, 2007.

Regarding the value of the technology license. The court turned to the "battle of the experts" and their "very different approaches" to valuing the assets.

1. *The trustee's expert.* The trustee offered the managing director of a wellknown regional financial advisory and counseling firm. To calculate the economic value of the stacker technology and the licensing agreement, the trustee's expert reviewed the tax returns and other financial information pertaining to the son's business, including summaries of its hard and soft operating costs as well as any revenues generated by sales. He also looked at general information about the printing equipment industry. At no time from its inception in 2006 through the timing of the loan and guaranty agreements (April/June 2007) did the business have any value, the expert concluded. No matter how many stackers it sold, it had never historically made a profit and never would make a profit, he said, assigning the firm a value of zero at all relevant times.

Further, any value that might be attributed to the license was as of its effective date, July 1, 2007, or two months after the effective date of the loans and the debtor's guaranties. "The time for any valuation, therefore, expired before the technology license came into existence," the court explained.

However, the defendant on cross-examination said that in appraising the son's business, he was referring to "the value that would be embedded in its equity by virtue of having access to the technology license." But the value of the stacker technology was worthless to the company, he added, and due to its deprivative nature, he accorded no value to its license on the open market at any of the relevant times.

2. *The defendant's expert.* By contrast, the defendant presented a local attorney with a practice in intellectual property, whose career also involved the valuation and sale of "numerous" IP assets.

To value the stacker technology, the defendant's expert used two approaches. Under the cost method, he analyzed the original costs to develop the technology by the family business, estimating these amounted to at least $440,000. He also used a "capitalization of hypothetical income approach," under which he assumed an 8% annual profit on sales of the stacker units as well as a 10-year useful life.

One expert opinion credible, the other 'absurd.' After reviewing all the facts and opinion evidence, the court commended the trustee's expert for the "clear, succinct, and credible" presentation of his opinion that the son's business and the stacker technology never had any value at any time applicable to the trustee's claims.

By contrast, the court "could not avoid believing that the defendant's expert would have grasped any approach he could find to establish some value in the stacker technology." Similarly, the defendant's expert appeared to have pulled the figures for his "hypothetical" capitalization of income approach "from thin air."

Accordingly, the court rejected the testimony of the defendant's expert as incredible and adopted the opinion of the trustee's expert. As a result, the debtor accurately claimed in his bankruptcy schedules that the value of his defunct business was zero. If the stacker technology were truly worth the $440,000 to $793,000 the bank claimed, then it might very well be a substantial asset. But "where then is this … technology?" the court asked

In the meantime, the trustee had successfully proven that the debtor's guaranties and related grant of liens in his residence were constructive fraudulent conveyances under applicable law, the court held, and avoided the same.

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