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Two Notable Valuation Decisions from the Delaware Courts

Two recent Delaware cases gave the courts the opportunity to implement “bright line” rules in the often complex world of corporate valuation.

Chancery Court defines ‘funds legally available.’ In *SV Investment Partners v. Thoughtworks, Inc.*, 2010 WL 4547204 (Del. Ch.)(Sept. 8, 2010), a group of preferred stockholders wanted to redeem their $27 million investment in an IT firm. By its terms, their stock agreement permitted redemption “for cash out of any funds legally available” and required the company to value its available assets “at the highest amount permissible under applicable law.”

The stockholders claimed that the phrase “funds legally available,” commonly found in stock redemption agreements, simply meant funds “that carry no legal prohibition on their use.” In other words, any corporate surplus is “legally available” for redemption of stock, the plaintiffs argued, and surplus is the amount by which net assets exceed its stated capital. To support their claims, the plaintiffs’ valuation expert found the company as a going concern ranged from $68 million to $137 million, finding sufficient funds available for the redemption of the preferred stock.

However, the phrase “funds legally available” is not synonymous with “surplus,” the court held. “Distributions are never, and can never be, paid out of ‘surplus’; they are paid out of ‘assets,’” it explained. “No one ever received a package of surplus for Christmas.” Instead, the phrase contemplates funds (cash) that are readily accessible and do not violate statutory or common law restrictions against a redemption that would render the company insolvent. The valuation provisions of the preferred stockholders agreement did not override these basic concepts, the court found. They did not create an obligation to redeem shares when no funds exist, nor did they trump other legal impediments to the use of funds, such as cash flow insolvency. The expert’s valuation—although theoretically defensible—failed to consider the “real economic value” of assets the company could use for redemption while also continuing as a going concern, the court held, and denied the plaintiffs’ suit.

Should market price be presumptive proof of fair value? In *Golden Telecom, Inc. v. Global GT LP*, 2010 WL 5387589 (Del. Supr.)(Dec. 29, 2010), the company appealed the Court of Chancery’s decision that its $105 merger price fell short of its statutory fair value by more than $20 per share. In an efficient market, they argued, Delaware courts should defer exclusively to the merger price in statutory fair value appraisals or, at the very least, regard it as rebuttable “presumption” of fair value.

The Delaware Supreme Court dismissed this argument as too simplistic. The state business statutes require the courts to account for “all relevant factors” in making an independent determination of fair value. Moreover,

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Delaware case law specifically defines "fair value" as the value to a shareholder in the firm as a going concern rather than its value in a merger or other transaction. Accordingly, "there is no basis for a court, in a statutory appraisal proceeding, to conclusively, or even presumptively, defer to a merger price as indicative of 'fair value,'" the court held.

Similarly, the court rejected the dissenting shareholder's claims that the company should have been bound by the financial information it used during the merger process. Such a "bright line" rule would constrain the flexibility of the appraisal process as well as the "significant discretion" given to the Court of Chancery to decide fair value. It would also "pay short shrift to the difference between valuation at the tender offer stage—seeking 'fair price' under the circumstances...and valuation at the appraisal stage, seeking 'fair value' as a going concern," the court ruled, and dismissed the appeal.

DOL Proposes to Make Business Appraisers ERISA Fiduciaries

Since 1976, the U.S. Department of Labor has not held the independent appraisers who value the stock of employee stock ownership plans (ESOPs) to be fiduciaries. However, a proposed change to the Employee Retirement Income Security Act (ERISA) rules could reverse that policy. The proposal expands the ERISA definition of fiduciary to include those who give "investment advice," including as one example: "advice, appraisals or fairness opinions concerning the value of securities or other property."

The DOL believes that this change will cut down on purported abuses, such as incorrect valuations of the stock in private company-sponsored ESOPs, which can impact the participants' retirement savings. However, professional appraisal organizations are concerned that, in an effort to protect beneficiaries of pension plans, the proposed regulation will have a "chilling" effect on the market by exposing appraisers and other investment advisors to the increased risks of litigation. In addition, business appraisers who remain active in the market after any policy change would incur the extra expense of fiduciary liability insurance. Higher internal costs plus less competition among valuation firms doing private stock ESOP valuations might also translate into higher costs for the companies and more difficulty in finding competent work.

Industry groups such as The ESOP Association have already critiqued the proposed rule change. (See www.esopassociation.org/blog/template_permalink.asp?id=332#332.) The DOL plans a public hearing in early March. For a copy of the proposal, originally published in the Federal Register, go to www.federalregister.gov/articles/2010/10/22/2010-26236/definition-of-the-term-fiduciary.

Amendments to FRCP 26 Re: Draft Expert Reports Could Contain Traps

The proposed amendments to Rule 26 of the Federal Rules of Civil Procedure (FRCP) became effective on December 1, 2010. These changes apply the privilege and work-product protections of Rules 26(3)(A) and (B) to expert-attorney communications and draft expert reports.

The revised rules could contain traps for the unwary, however. Litigants can still compel draft reports by a testifying expert if, for example, the drafts form any basis for the expert's opinion under the disclosure guidelines of Rule 26(a)(2)(B) FRCP. Moreover, the new rules apply only to the discovery of draft reports, not to their admissibility at the time of trial. Finally, there are still three attorney-expert communications that are open to discovery:

- Compensation for the expert's study or testimony;
- Facts or data provided by the lawyer that the expert considered in forming opinions; and
- Assumptions provided to the expert by the lawyer that the expert relied upon in forming an opinion.

Appraisers and attorneys alike should wait to see how the new rules play out in practice. Experts, in particular, should continue to exercise good judgment. And of course, the new rule change applies only to matters in federal court. Professionals should stay abreast of local adoption and adaptation of the rules.

Divorce Courts Reject 'Calculation Values' Offered by BV Experts

During these tough economic times, parties and their attorneys may often request a business appraiser to perform a preliminary "calculation valuation" for settlement purposes. Although the majority of cases do settle, these two recent cases highlight problems of presenting anything less than a complete valuation in court.

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***In re Marriage of Hagar,* 2010 WL 4807559 (Iowa App.)(Nov. 24, 2010).** The husband and wife owned three dry cleaning stores, which they bought from his parents for $300,000 with a promissory note. Over the marriage, they paid down the note to nearly $121,000, but when the relationship deteriorated, the husband defaulted and his mother threatened forfeiture, so the wife borrowed money to pay the arrears. At trial, the court faulted the husband for wanting to "ruin the parties' financial picture," and valued the business at $95,000, or the midpoint in a range of $71,000 to $120,000 provided by the family's longtime CPA.

On appeal, the husband pointed out that the CPA actually testified that the business was worth between $71,000 and a *negative* $120,000. However, the wife pointed out that the CPA had offered his figures as a mere calculation of value, using "rules of thumb" and industry standards that did not require the same professional judgment as a complete valuation.

The appellate court agreed that the CPA expressed his $120,000 value as a negative number. "However, we do not use [his] calculations because he admittedly did not 'use judgment.'" The CPA also failed to recognize the family relationships that affected value. Based on the couple's purchase of the business for $300,000 and their creation of equity by paying the note down by $140,000, the appellate court valued the business at this higher amount and confirmed its award to the husband.

***In re Marriage of Cantarella*, 2011 WL 86284 (Ca. App. 4 Dist.)(Jan. 11, 2011)(unpublished)**. In this case, the parties agreed to split the value of the marital business, which they said was worth $60,000, and the trial court adopted their agreement in its final orders.

Four months later, the wife returned to court with an attorney and a business appraiser, whose "preliminary valuation" indicated the business was worth $172,000. However, the appraiser admitted that he lacked the documentation with which he would typically perform a complete business valuation, including aged accounts receivable, payroll tax returns, equipment appraisals, etc.; but the wife had traditionally handled all the business accounting, the husband argued, and withheld the documents to hide the business's debts and depressed accounts.

Based on this evidence, the trial court refused to reconsider its prior orders. At the same time, it *did* revise the value of the marital residence, based on a formal appraisal that the husband had withheld during discovery. The wife appealed the denial of her request to reconsider the value of the business, reasserting her appraiser's preliminary valuation. The appellate court rejected her claims, finding that—unlike the formal appraisal of the house—the calculation of value did not establish clear evidence of a mistake, and it confirmed the prior orders.

IRS Reveals Seven Mistakes of Highly Unsuccessful Appraisals

In recent conferences sponsored by business appraisal professional organizations and industry associations, the IRS has made an effort to discuss, on an informal basis, the most common reasons for auditing a business appraisal associated with a gift or estate tax return. Most of the following "red flags" will not surprise estate and gift tax attorneys (or their financial advisors) so much as confirm the areas that require continued professional oversight and appraisal expertise:

1. **Discounts.** The reasonableness of valuation discounts used in estate and gift tax appraisals is still a primary focus for the IRS, which will often flag discount conclusions that are not supported by the data or that apply study averages without sufficient explanation.
2. **Standard of value.** Likewise, the IRS is still seeing valuation reports that apply the fair value standard instead of fair market value, or consider the perspective of only one person (either the hypothetical willing buyer or the seller) rather than both.
3. **Tax-affecting.** Valuation of S corporations is another problematic area, in which the courts, valuation experts, and IRS examiners have not always been consistent. Rather than focus on the case law, attorneys and appraisers would be well-advised to carefully consider the particular facts and circumstances of any case. Related issues are tax considerations in C to S corporation conversions and the valuation of embedded capital gains tax liability.
4. **Factual errors.** Appraisal inaccuracies will also get the attention of the IRS. More than mere mathematical errors, these include presenting false information or assuming facts related to the appraisal that do not exist.
5. **Valuation errors.** Unfortunately, the IRS is still finding appraisals of business interests that purposefully include or exclude valuation approaches, ignore strong market evidence, or disregard professional standards. Many of these mistakes are made by individuals without the

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appropriate training or experience, and can be avoided by using qualified appraisers.

6. **Analytical errors.** The IRS is also finding appraisals that lack a strong, consistent factual development; an income stream that is inadequately or inappropriately matched to any adjustments (discounts); and an incomplete tax rate analysis. Appraisals that supply a good "analytical fit" to the facts of a case clearly show how the valuation conclusions were reached, what adjustments were made, what data were use, and what law was relied on.
7. **Documentation errors.** Also watch out for: exhibits and computations that fail to follow the analytical narrative or are incomplete, and failure to document according to all relevant professional standards.

Choice of Reliable Growth Rate Is Key to Calculating Business Interruption Loss

Manpower, Inc. v. Insurance Co. of Pennsylvania, **2010 WL 3730968 (E.D. Wisc.)(Sept. 20, 2010).** When its office building partially collapsed, the plaintiff shut down for 14 months until it could relocate. In a suit against its insurance company for business-interruption losses, the plaintiff's damages expert asserted over $7.5 million in lost profits and expenses. The defendant attacked the expert's calculations as unreliable under *Daubert*.

Growth rate nearly doubles under new management. The expert began by forecasting the revenues the plaintiff would have generated but for the collapse and then subtracted its actual revenues during the damage period. He then projected total, net, non-continuing expenses. So far, his calculations were "straightforward," the court said. However, the expert used the revenue period for five months preceding the collapse to extrapolate a 7.76 precent growth rate, despite historical data showing that the plaintiff had grown an average of only 4.8 percent during the four years prior to the collapse and only 3.8 percent during the year before. In support, the expert explained that the company had recently been acquired by new management to boost its performance. After speaking with the managers, the expert concluded they had turned the company around and thus the higher growth rate was appropriate for the entire 14-month loss period.

"Here is where [the expert's] analysis breaks down," the court said. The expert "did little more" than assume that the pre-collapse growth rate would continue unabated, all due to new management. He also failed to analyze other industry or company-specific factors that could have affected the plaintiff's revenues. Importantly, had the expert chosen a longer base period for his revenue forecasts, the court might have taken a different view; but by ignoring the plaintiff's historical track record, he essentially treated the company like a new business, a "notoriously difficult" exercise, the court said, which requires reliable financial indicators and comparables.

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