TRUGMAN Valuation

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Trial Court's Stock Valuation Contravenes Agreement's Buyout Provisions

***R. Kashmiry & Assocs. v. Ellis,* 2018 Ohio App. LEXIS 384 (Jan. 26, 2018)**

This case represents another instance in which business partners made a shareholder agreement to facilitate a potential future stock buyback, but still ended up in court. Per the agreement, the company hired a qualified appraiser to calculate the value of the minority shareholder's interest. However, the parties differed on whether the appraiser followed the dictates of the agreement and whether the trial court erred in disregarding the expert's valuation. The appeals court judges themselves disagreed on the valuation issue. The court's majority found the trial court's value determination contravened the agreement, while the dissent said it complied with the contract.

In spring 2009, the plaintiff (majority shareholder) and the defendant (minority shareholder) decided to combine their insurance businesses. As part of the merger, the defendant entered into an agreement that guaranteed him two years of employment with the company. After that time, both parties could terminate the employment upon prior written notice. Further, under a stock purchase agreement, the defendant received seven shares of company stock in exchange for his book of business. He also acquired another 14.4 shares for about $108,000, approximately $7,500 per share—a price the plaintiff and the defendant had agreed on. The parties were the only shareholders in the company. At the time their business relationship broke down, the defendant owned about 20 percent of the company's stock.

A shareholder agreement provided that if a "triggering event" occurred including termination of the defendant's employment, the plaintiff-majority shareholder would have the option of buying the stock. If he chose not to do so, the company was obligated to buy the defendant's stock based on an "agreement price." That price could be calculated in two ways. One way was for the shareholders to meet annually, determine the fair market value of each outstanding share of company stoc, and issue a certificate of valuation that was valid only for one year.

If no annual valuation had occurred, a second method provided that, in case of a triggering event, the company would hire a qualified appraiser to determine the agreement price based on a number of specified factors, which included the Revenue Ruling 59-60 factors, as well as other factors the appraiser considered appropriate. The appraiser had 90 days within which to determine the agreement price. Importantly, this method also specified that the appraiser had to give "great weight" to prior valuations agreed upon by the shareholders.

In fall 2014, the plaintiff terminated the defendant's employment. The defendant obtained his original book of business in return for seven shares of company stock. The dispute centered on the defendant's remaining shares. Since the plaintiff declined to buy them and there was no certificate of valuation, the company had to buy them. Pursuant to the shareholder agreement, the company hired an appraiser to calculate the agreement price. Before the appraiser was able to finish her valuation, the parties had become enmeshed in litigation. The appraiser did not achieve a value determination until about seven months after the defendant's termination.

At trial, the appraiser testified that she had based the valuation on many factors, including the company's background and history, its financial performance, as well as industry and general economic conditions. The appraiser also applied discounts to account for the lack of control and marketability that came with the defendant's minority interest. According to the appraiser, in 2014, the defendant's ownership interest was worth $28,300, or a little less than $2,000 per share. The appraiser acknowledged that she gave "little to no weight" to the 2009 price: $7,500 per share.

The defendant retained his own expert, a licensed accountant who knew the company, having done work for it for a number of years. This expert explained that the initial $7,500-per-share price indicated the parties had applied a 1.25 multiplier to the 2007 gross revenue commissions for

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their respective companies. The expert did not know how the parties arrived at that multiplier figure. He later testified that the value of the company's shares in 2014 was the same as in 2009: $7,500 per share. However, he did not explain how he arrived at this conclusion. The defendant also asked the court to exclude the opposing expert's opinion because the valuation was not completed in the time the shareholder agreement required.

The trial court denied the motion to exclude. It took note that the defendant's termination represented a triggering event and that given the circumstances, the stock required a valuation under the second method: using a qualified appraiser to value the stock based on a number of factors and also "giv[e] great weight to any prior valuations." The court rejected the price the company's appraiser proposed, noting she failed to give great weight to the 2009 price of the stock. The court did not expressly adopt the defense expert's valuation. However, it found the value of the defendant's shares in 2014 was the same as the value the parties had agreed on in 2009: $7,500 per share.

Both parties appealed aspects of the trial court's findings with the state Court of Appeals. The crux of the plaintiff's argument was that the trial court failed to uphold the provisions of the shareholder agreement, which specified that the parties would be bound by the price a qualified appraiser determined. Also, the trial court erred in considering the parties' original price a "prior valuation." In contrast, the defendant argued his shares were worth more than the value the trial court had assigned.

A majority of the appeals court noted that, during the defendant's employment, the company never issued a certificate of valuation or obtained a binding valuation by a qualified appraiser. The price the plaintiff and defendant agreed upon at the beginning of their relationship was "clearly the agreed valuation of the stock at the time of its purchase." But this valuation did not represent the final valuation at the time of the buyback. The initial price should not have been the sole means for the trial court to use to set the stock price, the court's majority said. The trial court should have used the method the parties agreed upon when assessing the experts' testimony. The 2009 valuation was one factor, albeit one that should have received more weight by the appraiser, but it was not the only factor to achieve a 2014 valuation, the appeals court said. "[G]iving great weight to a five-year-old valuation does not equate to giving it controlling weight," the majority said with emphasis. It found the trial court's valuation was in error and orederd a remand and revaluation of the defendant's stock. This decision also took care of the defendant's argument.

The dissent found the parties' agreed-upon 2009 price was a valuation in accordance with the plain meaning of the word. At the same time, under the terms of the shareholder agreement, the appraiser's valuation was not binding because it was not completed in a timely manner. It was four months "delinquent," the dissent said. Further, the appraiser admitted she did not consider the $7,500 purchase price for her calculation, but considered the other factors listed in the agreement, the dissent noted. Moreover, the defendant presented expert testimony that the value of the shares at the end of the defendant's employment was $7,500. All of these factors suggested the trial court valued the defendant's stock within the terms of the contract, the dissent concluded. For this reason, the trial court's valuation should be upheld.

DOL Sues Over ESOP; Trustee Launches *Daubert* Attack

Acosta v. Vinoskey, **2018 U.S. Dist. LEXIS 64094 (April 17, 2018)**

In a developing ESOP case, the court excluded a chunk of the government expert's damages testimony and dismissed one of the counts for lack of damages evidence. However, the trustee's multifaceted attack on the expert's qualifications was not successful and the government's "overpayment" claim is still alive.

In 2004, the owners of a Virginia company sold 48 percent of their company stock to an ESOP for $220 per share. Late in 2010, they decided to sell the remaining 52 percent interest. An independent trustee and an independent valuation firm acted on behalf of the plan. In an early draft, the valuator said it would be fair to the ESOP to pay $405.73 per share based on the present value of the company's future cash flow. The trustee noted a valuation from a year earlier had indicated a $285-per-share price. The valuator explained the increase in value by noting, among other things, the ESOP owners would control the company as a result of the transaction. The trustee accepted the explanation. A final appraisal said a price between $405.73 per share and $408.58 per share would be fair to the ESOP. On recommendation of the trustee, the owner ultimately accepted $406 per share.

The DOL sued, alleging that the trustee breached its fiduciary duty to the ESOP by causing the plan to pay more than fair market value. In a separate count, the government alleged the trustee improperly allowed the value of existing stock to decrease as a result of the transaction. The government relied on expert testimony to support its claims.

The trustee challenged the damages expert's qualifications under Federal Rule of Evidence 702 and claimed the expert's calculations were unreliable under Daubert. The expert did not have business valuation experience, was not a CPA or CFA and was not part of the ESOP community—that is, he did not know the standard applicable to ERISA transactions, the trustee noted. The court disagreed, finding the expert had been qualified as a witness in many other ESOP cases. It said the expert had significant experience in the private equity industry, a background that "provides guidance on the sort of diligence required in this transaction."

However, the court agreed with the trustee that there were some insurmountable problems with his valuation methodology or the way the expert applied the methodology. In terms of the overpayment claim, the court found that the expert incorrectly applied the guideline public company method and precluded him from using it for his valuation. Further, the expert's approach to determining damages that existing shareholders allegedly incurred due to the transaction "does not provide any basis to figure out what those damages would be." Because there was no damages testimony to sustain this count, it collapsed. The rest of the case will go forward.

Deal Price Represents Unreliable Starting Point for Fair Value Calculation

***Crocker v. Greater Colo. Anesthesia,* 2018 Colo. App. LEXIS 299 (March 8, 2018)**

In a Colorado appeals court case involving a medical practice, the dissenting shareholder claimed the trial court improperly refused to give weight to the deal price in determining fair value. The reviewing court disagreed, finding the transaction price embedded value in anticipation of the merger. This case also included a novel issue of law as to whether the post-merger entity could enforce the premerger noncompete against the dissenting shareholder. Under the facts of the case, the reviewing court found the noncompete was not enforceable as of the merger date.

Minority interest. The dissenting shareholder was an anesthesiologist who owned a 1.1 percent interest in an anesthesiologist practice (old entity). He had paid $100 for his one share. The controlling agreement specified that an employee was a physician and shareholder of the corporation. Employees were subject to a lengthy noncompete provision that set forth a formula for calculating liquidated damages in case of a violation.

In early 2015, the old entity merged with a new entity. As a result of the transaction, each shareholder who had voted for the merger and had executed a series of agreements received $626,000 in cash, $224,000 in the new entity's common stock (fully vesting in five years), and a signing/retention bonus based on prior income. At the same time, shareholders had to sign new employment agreements that provided for a 21.3 percent reduction in pay and a five-year employment commitment.

The dissenting shareholder voted against the merger and the old entity sent him $100 for his share. He refused the payment and gave notice that he would exercise his dissenting shareholder rights. Further, he indicated that he did not know how the merger affected his employment status. He did not return to work for the new entity and a few weeks after the merger went through began working at another hospital that was in the area the noncompete encompassed.

The trial court was asked to determine the fair value of the dissenting shareholder's one share in the old entity and to determine whether the new entity had a damages claim against the dissenting shareholder for the alleged breach of the noncompete. The new entity asked for almost $208,000 in damages.

Both parties presented expert testimony at trial. The new entity's expert found the dissenter's one share was worth between $50,500 and $56,000. The dissenting shareholder's expert valued the interest between $893,400 and $987,400. The trial court found the value gap stemmed from the new entity's expert valuing the old entity based on actual compensation data prior to the merger, whereas the opposing expert applied: (1) an income reduction that was even greater than the one contemplated by the merger; and (2) the price paid on the merger date. The new entity's expert was more credible, the trial found. It observed that the transaction price did not reflect the target company's value as a going concern but was, in substantial part, compensation to nondissenting shareholders for agreeing to a 21.3 percent pay reduction and additional concessions, going forward, the trial court decided. The court said the fair value of the dissenter's share of the old entity was $56,000.

The trial court found that the noncompete was no longer enforceable against the dissenting shareholder. Under one theory, the noncompete terminated with the transaction and was superseded by a new agreement to which the dissenting shareholder was not a party. Also, in exercising his dissenter's rights, the dissenter was forced to give up his employment with the company. In the alternative, the trial court found that, even if the dissenter remained subject to the noncompete, the agreement's liquidated damages were not reasonable in relation to the injury the company suffered. Therefore, the noncompete also was not enforceable under this rationale.

Both parties appealed aspects of the trial court's findings. The dissenting shareholder contended the trial court erred in not relying heavily on the market price. Fair value, he claimed, should be calculated on the closing date of the transaction and should "necessarily" be based on the deal price.

The state's Court of Appeals disagreed. It noted that, under the applicable statute, fair value means "the value of the shares immediately before the effective date of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action except to the extent that exclusion would be inequitable."

The appeals court dismissed the dissenting shareholder's assertion that the trial court refused to consider the deal price because the court mistakenly "believed it was statutorily precluded." Rather, the trial court considered and

rejected the deal price as a starting point for any fair value calculation because that price reflected a willingness by at least 90 doctors to accept 21.3 percent less pay working for the new entity than the doctors made in the old entity, the appeals court clarified. Standing alone the deal price was not an appropriate measure of the old entity's value as a going concern, the Court of Appeals said.

Also, under the applicable statute, "fair value" is the value before the effective date of the corporate action, not the value on the closing date of the transaction, the appeals court emphasized.

The company appealed the trial court's noncompete rulings. The Court of Appeals agreed with the company's proposition that, typically, in a merger, the obligations and rights of the merging entities transferred to the surviving entity. However, the agreements in the instant case "wed" the dissenting shareholder's rights to his rights as an employee, the court noted. The applicable agreements made it impossible for the dissenting shareholder to be an employee and not a shareholder or to be a shareholder and not an employee. Therefore, when exercising his dissenter's rights, the dissenting shareholder was forced to give up his employment with the old entity, the appeals court affirmed.

It pointed out that the parties did not point to any authority deciding the enforceability of a noncompete under similar circumstances. Moreover, the appeals court said it had not found any such authority in this and any other jurisdiction.

Further, Colorado public policy did not favor noncompetes. Any such contracts are only enforceable if they are reasonable. Here, the circumstances indicated that the terms of the noncompete would impose a hardship on the dissenting shareholder, making the agreement unenforceable. What's more, the trial court determined and the appeals court agreed, that the new entity did not suffer harm from the dissenting shareholder's action. There was no evidence that his new employment diverted work from the new entity and that the latter lost revenue or profit. Finally, the statute addressing the right to practice medicine says noncompetes are void, but the law allows for payment of damages "in an amount that is reasonably related to the injury suffered by reason of termination of the agreement." Here, the new entity claimed nearly $208,000 in damages based on the liquidated damages formula—an amount that was not reasonable when there was no actual injury suffered, the Court of Appeals found.

For all of these reasons, the Court of Appeals found the noncompete unenforceable in the instant case. It affirmed the trial court's fair value determination and noncompete findings.

Provocative Delaware Chancery Decision Favors Stock Price Over Other Fair Value Indicators

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., **2018 Del. Ch. LEXIS 52 (Feb. 15, 2018)**

After the Delaware Supreme Court struck down the Court of Chancery's fair value determinations in DFC Global and Dell, the lower court sought to apply the high court's directives in another statutory appraisal proceeding. The Delaware Supreme Court said that when there's an efficient market, "the collective judgment of the many" reflected in the deal price provides a better gauge of fair value than a single analyst's discounted cash flow analysis. But what if there is more than one market indicator, as happened in the recent Court of Chancery case? Neither DFC Global nor Dell addressed this possibility and the Court of Chancery's resolution of the issue is likely to trigger more litigation.

In May 2015, Hewlett-Packard ("HP") acquired Aruba Networks for $24.67 per share. This was a synergy-driven transaction. As part of the statutory appraisal proceeding, the Court of Chancery found the deal price minus synergies was $18.20 per share. In contrast, the 30-day average unaffected market price was $17.13 per share.

The parties' trial experts offered DCF-based valuations. While the petitioner expert's model "appears to be sound," the court was concerned about the degree to which the $32.57-per-share price diverged from market indicators. The company's expert prepared a number of valuations. While his final value—$19.75 per share—was relatively close to the market evidence, the court questioned the "methodological underpinnings" of the analyses. It disregarded the experts' DCF results and did not perform its own valuation.

The choice of most reliable indicator of fair value came down to stock price versus deal price minus synergies. The court, finding this was an arm's-length deal and there was an efficient market, said the stock price represented "direct evidence of the collective view of market participants as to Aruba's fair value." It was preferable to the deal price, which required adjusting for synergistic value as well as value related to the "reverse agency costs." Vice Chancellor Laster, who wrote this opinion, as well as the original Dell opinion, thought the high court's opinions militated against the "judgment-laden exercise of backing out synergies." However, Vice Chancellor Laster also acknowledged that "no one argued for this result." The court's fair value was below the deal-price-minus-synergies and the company expert's DCF-based result, not to mention the petitioners' proposed value.

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