TRUGMAN Valuation

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DLOM Ruling Promises End to 'Most Difficult Case'

Wisniewski v. Walsh, **2015 N.J. Super. Unpub. LEXIS 3001 (Dec. 24, 2015) (Wisniewski II)**

A sister and two brothers owned equal shares in a family trucking business. In 1996, one brother filed an oppressed shareholder action claiming his siblings had tried to oust him from the company. The trial court found that the plaintiff brother in fact was the oppressing shareholder and ordered him to sell his interest either to the company or to the two siblings at fair value.

Both parties retained well-known appraisers. When the first trial court set a value without conducting an evidentiary hearing, the parties appealed. On remand, a different trial court heard valuation testimony and largely adopted the calculation that the plaintiff's expert proposed, which was based on a discounted cash flow ("DCF") analysis. A second appeal followed. The appeals court affirmed nearly all aspects of the trial court's value findings, but said the valuation should have included a marketability discount.

Although a marketability discount was only applicable under "extraordinary circumstances" in a forced buyout situation, it was justifiable here because the plaintiff-seller had engaged in conduct that harmed the two other shareholders and necessitated the forced buyout. Accordingly, the appeals court remanded again, ordering the trial court to determine whether the prevailing DCF analysis embedded a DLOM and to set the applicable DLOM rate.

A third trial judge (two trial court judges had retired during the litigation) first found that, when the prevailing expert built up his discount rate for the DCF analysis, he did not specifically account for illiquidity. In the valuation trial, he had insisted that a marketability discount was inappropriate because the company was successful and would likely take no longer to sell than other closely-held companies of similar size and nature with assistance from "the right business intermediary." He also believed the other shareholders would not lose liquidity during the marketing period.

As for the appropriate DLOM rate, the new trial judge noted that the buyers' expert had valued the company under a market approach and had considered risk factors specific to liquidity—which were pretty much the same factors the opposing expert considered—to arrive at a 35 percent DLOM. A rate that high would unduly punish the seller and give a significant windfall to the buying shareholders, the trial court said. Case law and studies suggested a broader range, starting as low as 20 percent, depending on the equities in a given case. Here, the judge ruled, a 25 percent DLOM was appropriate.

The parties appealed anew, but the reviewing court affirmed. It said that neither side had made a convincing argument for second-guessing the trial court's "thoughtful and well-reasoned determination in this most difficult case."

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Chancery Puts Trust in Merger Price Over Questionable Methodology

***Merion Capital LP & Merion Capital II LP v. BMC Software,* 2015 Del. Ch. LEXIS 268 (Oct. 21, 2015)**

Do not second-guess the result of a robust, arm's-length sales process! That's the view the Delaware Court of Chancery has been taking lately in statutory appraisal actions, and it recently did so again.

The suit involved the sale of one of the largest software companies in the world to a group of private equity firms for $46.25 per share. Following what happens in these transactions, the parties petitioned the Delaware Court of Chancery for a statutory appraisal of their shares alleging that an activist investor had forced the company to sell itself below its value.

At trial, both sides' experts agreed that a discounted cash flow ("DCF") analysis was the way to determine the stock's fair value at the time of the merger, but they reached very different results. The petitioners' expert arrived at $67.08 per share, approximately 145 percent of the merger price. The company's expert calculated a $37.88 per share price—just over half of the value the opposing expert proposed. The court noted the "wildly divergent" outcomes that stemmed from differences over key inputs and decided to perform its own DCF calculation.

In this case, both experts relied on the same management projections, but the company's expert reduced the projected revenue by 5 percent because in the past the company repeatedly had missed its revenue goals. The court agreed that the projections revealed "a bias toward optimism," but for purposes of its DCF found them to be reliable. It called the downward adjustment "too speculative to accurately account for that bias."

There was also a marked difference in the experts' discount rate that had to do with the equity risk premium ("ERP"). The petitioners' expert used a supply-side ERP, reasoning that valuation calculations were forward-looking. The company's expert used a historical ERP, calling it "the most generally accepted ERP" and saying "any model that attempts to estimate future ERP is subject to intolerable estimation errors." The court noted that recent decisions from the Chancery favored a supply-side ERP. But it also said that which ERP to use was "a vigorously debated topic, not just between these two experts, but in the financial community at large." The court added "scholarship may dictate other approaches in the future." For its DCF, the court used a supply-side ERP to arrive at a discount rate of 10.5 percent. The court's DCF analysis yielded a $48.00 per share price.

However, the court ultimately decided to rely on the merger price as the indicator of value, expressing concern over irreducible uncertainty surrounding the key DCF inputs. It pointed to the company's history of "problematic" projections, such that the figures "could distort value," and it said the record did not point to a reliable method to adjust the projections. Also, the continuing debate over the ERP created still more uncertainty that compromised the DCF analysis.

In contrast, the court felt there was integrity in the sales process. The company staged two auctions over a period of several months to test the market and evaluated numerous bids before settling on the final per share price of $46.25. There was no evidence that pressure from the activist investors led to a rushed, ineffective sale, the court determined.

Service Business Valuation Triggers Double Dip Rule

***Gifford v. Gifford,* 2015 N.Y. App. Div. LEXIS 7829 (Oct. 22, 2015)**

In a New York divorce case, the owner of a service business appealed a trial court's spousal support order under the jurisdiction's double dip rule. The appeals court agreed that the spousal award payments were based on the wrong earnings determination.

The husband was a geotechnical engineer who owned his own company. Among other things, the success of his business depended on his ability to perform strenuous fieldwork. At the time of the divorce, the parties agreed that the business was a marital asset and jointly retained an appraiser who valued it at $448,000 based on a capitalized earnings approach, using annual base earnings of $148,000.

The trial court awarded roughly half of the business to the wife by way of a $210,000 payout. Moreover, the court ordered the husband to pay nondurational spousal support under a tiered approach, starting with monthly payments of $6,000 that dropped to $3,000 and ultimately to $800, terminating with one party's death or the wife's remarriage. The court based the spousal support payments on the husband's total average annual income of over $332,400.

The husband contested the trial court's order claiming the awards to the wife amounted to unlawful double counting of his income. The appeals court agreed. It noted that the expert's business valuation methodology, an income approach, triggered the rule against double counting income. "Once a court converts a specific stream of income into an asset, that income may no longer be calculated into the maintenance formula and payout," the court said, citing *Grunfeld v. Grunfeld*, 731 N.E.2d (2000).

The appeals court referenced a leading precedential case. "Double counting may occur when marital property includes intangible assets such as professional licenses or goodwill or the value of a service business," the court said, citing *Keane v. Keane*, 8 N.Y.3d 115 (2006). "It is only where the asset is totally indistinguishable and has no existence separate from the [income stream] from which it is derived that double counting results." The appeals court found that, in the instant case, the husband's solely-owned engineering company was a service business for purposes of the double counting rule.

Because the wife obtained an equitable share of the business, it was obligatory for the trial court to base the spousal support award on the husband's baseline earnings of $148,000 instead of his average annual income of $332,400, the appellate court decided. Pursuant to the reduced income stream available for spousal support, the appeals court downward adjusted the monthly payments starting with an initial sum of $2,700 and declining to $1,350 and ultimately to $360.

Chancery Honors Parties' Deal to Be Bound by Appraisal

***PECO Logistics, LLC v. Walnut Inv. Partners, L.P.,* 2015 Del. Ch. LEXIS 311 (Dec. 30, 2015)**

A recent case involving a major valuation firm shows how willing parties are to use financial experts as pawns in litigating value disputes.

The defendants were related companies that owned preferred units of PECO Logistics. In the context of a merger involving the PECO companies, the parties agreed that the plaintiff would purchase all of the defendants' units within three years of the agreement, following notice that the defendants wanted to sell. The contract required the plaintiff to retain a nationally recognized valuation firm to determine the fair market value of the put units based on a specified valuation formula. Critically, the parties agreed to be bound by the appraiser's calculation. The contract did not provide for judicial or any other form of review of the value determination.

Following receipt of the defendants' put notice, the plaintiff hired one of the most notable BV firms in the country. Displeased with the valuation, the defendants refused to transfer their units to the plaintiff, which prompted the latter to ask the Delaware Court of Chancery for a declaration that it had complied with the agreement and that the defendants were bound by the valuation. The defendants, in turn, attacked the valuation based on alleged problematic judgment calls by the appraiser and claimed that the plaintiff violated the covenant of good faith and fair dealing.

According to the defendants, whenever there was ambiguity in the agreement as to what to do, the appraiser took a position that benefited the plaintiff rather than them. For example, the appraiser picked a valuation date that added an additional $14 million in debt to the liabilities and, therefore, decreased the valuation. But the court noted that the defendants failed to point to any provision in the agreement that mandated the use of their preferred valuation date. In fact, the defendants admitted that the valuator's choice of date was reasonable, but tried to argue it was "the lesser of the two reasonable explanations." The court found the other objections were equally unconvincing.

"When parties to a contract agree to be bound by a contractually established valuation methodology, this Court will respect their right to order their affairs as they wish and refrain from second-guessing the substantive determination of value," the Chancellor said. Had the agreement provided for judicial review, the court might have entertained questions as to the reasonableness of the valuator's assumptions and decisions, but, since no such provision existed, "the Court will not take mere allegations of ambiguity about the valuation methodology as an invitation to circumvent the structure of the deal to substitute its own judgment for that of the valuation firm."

No trial ensued. Based on the parties' motions alone, the Chancery ruled in favor of the plaintiff. The defendants were bound by the appraiser's determination of value.

Destruction of Financial Evidence in Damages Case

***Bruno v. Bozzuto's, Inc.,* 2015 U.S. Dist. LEXIS 156339 (Nov. 19, 2015)**

In a contract action, finance professionals made one bad decision after another, until the case collapsed under a *Daubert* challenge.

A married couple owned and operated a small supermarket chain. The wife, an experienced CPA, was in charge of the books. On the brink of filing suit against the defendant, a wholesale distributor, for the alleged breach of a supply agreement, she destroyed all financial records. During her deposition, she said "the paper copies went in the trash" and the business computer was "thrown out" as well. The court called this impropriety "the most infamous plot twist in the life of this six-year-old litigation."

Destroying the evidence backfired when it came to showing damages. The plaintiffs retained two experts, one a J.D., MBA and the other a Ph.D., MBA, who calculated losses by way of a discounted cash flow ("DCF") analysis. They prepared two joint reports, one in 2011 and one in 2014. Since they originally had no reliable data from the plaintiffs, they decided to use one of the defendant's sales projections from 2007 (prior to the litigation) for their cash flow calculation. The projections appeared in an internal document termed "pro forma." According to the defendant, the sole purpose of the pro forma was to help the defendant decide whether to enter into an agreement with the plaintiffs. It was never intended for projecting sales or for use in a damages calculation. The pro forma pegged the plaintiffs' sales at $150,000 per week. But even before the plaintiffs' experts prepared their first expert report, the defendant had revised its projections after learning that the plaintiffs' sales were no more than $120,000 per week.

Also, after the plaintiffs' experts submitted their 2011 report, the plaintiff's attorney was able to retrieve data that confirmed weekly sales were about $120,000. Inexplicably, in their subsequent 2014 report, the plaintiffs' experts insisted on reusing the 2007 pro forma figures rather than the actual, re-created sales figures. Both experts admitted that they had not independently verified the numbers. "I did not project anything. I used [the defendant's] report," one expert said. And "I think we've tried to make that totally clear to everyone through this whole matter that the basis for our calculations are numbers provided by [the defendant].… I relied on their expertise in that field."

In its *Daubert* motion to exclude the entire testimony, the defendant claimed the plaintiffs' experts took a "no questions asked" approach when selecting the inputs for their DCF analysis. They used weekly sales projections that were "grossly" overstated and that the defendant itself had rejected. By relying on the inflated figures, the plaintiffs' experts created more than $1.3 million in annual sales "out of thin air." The effect of this improper extrapolation was further compounded with each year projected into the future, the defendant said.

The court granted the motion. Experts who do not independently test the accuracy of data failed the jurisdiction's *Daubert* reliability requirement, it said. It also found that the experts' decision was self-serving. Using the contested pro forma "unquestionably yielded a significantly higher damages estimation than what would have resulted had the experts conservatively employed the actual data." The damages analysis suffered from the "garbage in, garbage out" problem, the court concluded.

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