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VALUATION Trends

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No Taboo Against Marketability Discount in Shareholder Suit

Tutunikov v. Markov, 2013 N.J. Super. Unpub. LEXIS 1935 (Aug. 1 2013)

In calculating the fair value of the plaintiffs' interests in a dissenting shareholder suit, the trial court said an investment proposal from a third party presented a "more realistic" value of the target company than the parties' expert valuations. At the same time, the court made a 35 percent upward adjustment to account for the proposal's embedded marketability discount. The defendants and the dissenting shareholders challenged the court's valuation.

In 1997, four partners "anticipated" that they would form a corporation that would provide software applications and consulting services for financial institutions. To this end, they prepared a final draft and a resolution setting down the share allocation. The plaintiffs were two minority partners who left the corporation before the filing of a certificate of formation to work elsewhere. A subsequent operating agreement, which was to override all prior agreements, listed all four men as members. Some seven years later, the minority partners learned that the majority partners had given themselves a 100 percent salary raise and made other adjustments to their advantage, and the minority owners requested a buyout of their interests. The majority owners offered $10,000 per share, admitting this amount bore no relationship to the value of the company but saying it was what the company could afford to pay. However, the plaintiffs believed the company was worth $10 million and wanted $1.8 million for their shares.

Third-party investment proposal. At the end of November 2004, a global accounting software company outlined a "proposal investment" in the company. The defendants informed the plaintiffs that the proposed financing made it reasonable to buy out their interests for $500,000. In fact, the proposal valued the company at $5 million. The investor would infuse $500,000 in cash and obtain a 9.09 percent equity interest in a newly formed LLC. The investor reserved the right to make further cash infusions and thus increase its equity interest. The plaintiffs did not accept the offer and instead filed suit in the New Jersey Superior Court. The investor never exercised its option to invest further. Subsequently, the company merged with another company. In a premerger buyout proposal, it offered one plaintiff $350,000 and the other $262,500. The interests of all partners in the company were worth a total of $3.5 million.

The main issues at trial were: (1) whether there was oppression of the minority interest holders, (2) what precisely the plaintiffs' ownership interests in the company were, and (3) what the fair value of the two ownership interests was.

Both sides presented valuation experts. The plaintiffs' expert concluded that the company was worth $35.5 million. In contrast, the defendants' expert valued the company at $3.5 million. (The opinion does not give details on the calculations.)

Expert valuations too biased. The trial court found there was oppression, which translated into an award for the plaintiffs for attorney's fees and costs. It set the ownership interests at 10.45 percent for one plaintiff and 7.84 percent for the second. As to valuation, the court discredited both expert opinions and instead turned to the third-party "proposal investment" for information leading to a "more realistic value of the company." The experts' data, the court said, was "subject to the prejudices

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of the party experts." The $500,000 investment indicated that the value of the company prior to the investment was $5 million.

But, the trial court continued, that price represented "a non-marketable interest since the company was a non-publicly traded company." Even though "discounts generally should not be applied in … an oppressed shareholder action absent unusual or extraordinary circumstances," in this instance an upward adjustment was appropriate. "[T]he $5 million value derived from the … transaction which contains a marketability discount must be removed to reconstitute the fair value of the shares." Accordingly, the court added 35 percent and arrived at a total company value of $6.75 million.

At the same time, it denied the plaintiffs' request to adjust for a minority discount, which they claimed the offering price also included. This modification would "pay [the plaintiffs] for rights in the company that they do not enjoy."

Embedded minority discount or premium? Both sides challenged several of the trial court's findings at the appellate division. Regarding the valuation, the defendants made two arguments. First, the $5 million valuation implicit in the "proposal investment" did not include a minority discount. Based on their expert's calculation, the company's actual value was $3.5 million. The $1.5 million difference between the two values reflected the investor's willingness to pay more for other benefits, including a seat on the board of directors and a liquidation preference, than it would have paid for just an equity interest. Second, even if the market value of the company was $5 million, the trial court should have used a marketability discount to reduce the value to $3.25 million to adjust for the implied premium.

The plaintiffs also presented two objections. First, the lower court erred when it did not adjust for an embedded minority interest in the $5 million offering price. Second, the trial court made a mathematical error in adjusting for the implied marketability discount. The proper calculation required the court to divide $5 million by 65 because the offer only represented 65 percent of the company's total value. Accordingly, the total value was about $7.7 million.

At the start of its analysis, the appellate court pointed out that even though the trial court's factual findings in valuation disputes require deference from the reviewing court, no such deference applied to findings as to "what discounts or premiums the determination of fair value may include, or must exclude, since they are questions of law."

The appellate court went on to explain, "A majority discount adjusts for lack of control over the business entity, while a marketability discount adjusts for lack of liquidity in one's interest in an entity" (citing Balsamides v. Protameen Chemicals, 160 N.J. 352 (1999)). In terms of the minority discount, the court agreed with the defendants that the offering price did not contain a minority discount. The investor received benefits beyond an equity interest in the company, but the court said the offer also did not embed a premium for preferred membership in the LLC, as the defendants tried to claim.

As to the marketability discount adjustment, the appellate court agreed with the trial court that, generally speaking, this discount was inappropriate within the context of a dissenting shareholder action. But, the appellate court continued, in this case the trial court "utilized the marketability discount in valuing [the company], not in valuing the plaintiffs' particular interests." This was a significant distinction. "Discounting at the corporate level may be entirely appropriate if it is generally accepted in the financial community in valuing businesses" (citing Balsamides).

Considering that both experts applied a marketability discount of 35 percent in valuing the investor's offer, the trial court's adjustment was appropriate—even if it declined to adopt either expert's valuation of the company.

Lastly, the appellate court agreed with the plaintiffs that the lower court erred when it applied the discount factor to the company value. The fair value was $7.7 million. Considering one plaintiff's interest was 10.45 percent, his share in the company was worth about $804,000; given the other plaintiff's interest was 7.84 percent, his portion was valued at $603,000, the court concluded.

In Daubert Attack, Valuation Expert Portrayed as Mere Mouthpiece

Marine Travelift, Inc. v. Marine Lift Systems, Inc., 2013 U.S. Dist. LEXIS 91268 (June 28, 2013)

Valuation experts often build on someone else's assumptions to make reliable calculations. But can an expert simply evaluate and validate information from others without testing the underlying assumptions or doing an independent analysis? A recent lost profits case illustrates this issue.

The plaintiff, a manufacturer of marine hoist and industrial lift equipment, sued the defendant in federal court (E.D. Wis.) claiming it had breached the parties' distribution agreement and misappropriated trade secrets and confidential and proprietary information.

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The plaintiff retained an economist with 30 years of experience, significant academic research and teaching credentials as an independent expert on economic damages. His assignment was to opine on the "potential lost profits and damage to goodwill" the plaintiff was "likely" to incur in the future. This meant assessing the "principles and methods of forecasting" the plaintiff's CEO and CFO had used to calculate loss exposure and lost sales that ranged from $564,000 to $4.1 million.

Just a 'mouthpiece': The forecasts reflected a "reasonable, accurate and reliable methodology for assessing potential business damages," the expert said. He added that the plaintiff "also faces a significant risk of loss of its business goodwill."

He did not question any of the assumptions the executives used and did not outline any valuation for the claimed goodwill damages. He also did not investigate whether the plaintiff sustained actual damages, even though the alleged wrongdoing occurred 18 months previously.

In its Daubert motion, the defendant claimed the expert was simply there to serve as the plaintiff's "mouthpiece" and that his opinion lacked sufficient facts, data and independent analysis. The court agreed, calling his testimony irrelevant and unreliable. The expert only spoke to "potential business damages," the court stated with emphasis. Evidence that the plaintiff actually will suffer damages as a result of the alleged wrongful disclosure is relevant, but "evidence that it might suffer such a loss is not." As to reliability, he "offered no basis within his knowledge or experience" to support the executives' key assumptions, including a projected 26 percent loss exposure.

Finally, the court dismissed the plaintiff's argument that the expert had a right to rely on the executives' loss exposure calculations and sales projections because they themselves would testify as experts at trial (and, as such, submit to cross-examination). That was not the issue, the court said. Rather, the question was whether the expert could offer the executives' projections as his own opinion. Based on the facts, the court said "no."

Reliable or Obsolete? DE Chancery Scrutinizes Precrisis Projections

Towerview LLC v. Cox Radio, Inc., 2013 Del. Ch. LEXIS 139 (June 28, 2013)

Five years after the 2008 economic meltdown, observers look back with a good deal of hindsight. But when the Delaware Court of Chancery recently assessed the reliability of prerecession management projections for its discounted cash flow analysis (DCF), hindsight is precisely what it wanted to avoid.

After a radio broadcasting business merged into a wholly-owned subsidiary of its parent company, a group of shareholders, the petitioners, asked for a statutory appraisal.

To determine the fair value of their stock on the merger date (May 29, 2009), both sides presented experts. They both agreed that the DCF was the appropriate valuation method but clashed over the issue of how committed management was in May 2009 to long-range projections (LRP) that were done before the economic collapse. In fact, in the wake of the crisis in January 2009, management had produced another forecast for the year, which it updated again for each month leading up to the transaction. The May 20, 2009 forecast was the most recent one before the merger. This projection suggested a far less optimistic view of the future: Projected revenues were 16.8 percent lower and operating cash flow was 40.1 percent lower than the respective values in the 2009 LRP. Still, there were signs that management did not entirely distance itself from the LRP.

Cyclical or secular change? The petitioners' expert assumed that in early 2009, the industry and the company were in a cyclical slump from which they would—and would expect to—re-emerge. The steep 2008 recession would be followed by a steep recovery, and the company would return to the 2009 LRP after 18 months (i.e., in late 2011). Accordingly, he used the May 2009 forecast to project cash flows for 2009 and the 2009 LRP to project cash flows for 2010 through 2013.

In contrast, the company's expert assumed that, by the merger date, company management and radio industry observers realized that the industry was undergoing a "secular" change, which had begun before the 2008-2009 collapse. Management considered the 2009 LPR obsolete and did not expect a return to its financial projections. Therefore, the expert incorporated the May 2009 forecast for 2009 EBITDA and then estimated 2010-2013 by using the actual EBITDA compound annual growth rate (CAGR) that the company showed in the four years following the most recent 2000-2001 recession.

This approach, the court decided, was the correct analytical framework. Even though the court normally considered premerger management projections "an appropriate starting point from which to derive data in the appraisal context," here it was "wary" of accept-

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ing the argument that a valuation on the merger date "would anticipate a near-term return to even the 2009 LRP's 2011-2013 cash flow projections."

IRS Strains to Prove Goodwill in Like-Kind Exchange

Deseret Management Corp. v. United States, 2013 U.S. Claims LEXIS 987 (July 31, 2013)

"Use at your own risk" is the lesson a financial expert for the IRS learned when she used the discounted cash flow (DCF) method to bolster the agency's argument that the taxpayer was liable for appreciable goodwill related to a like-kind exchange.

Station swap: The plaintiff owned KZLA, the only country-music FM station in the Los Angeles market, but when the station kept underperforming in a fast-growing market, it agreed to a station swap with another communications company.

The exchange value of the assets was $185 million. The value of KZLA's tangible assets was approximately $3.4 million, and the value of all its intangible assets, excluding the station's FCC license and goodwill, was about $4.8 million. An appraiser calculated the value of the FCC license using the "residual fair market value" method—subtracting the value of the tangible and intangible assets from the $185 million exchange value and assigning the difference (the residual) to the FCC license. The appraiser assigned no value to goodwill claiming that: (1) legal precedent held that "broadcast stations do not possess any goodwill," and (2) KZLA, in particular, "does not possess any other traditional manifestations of goodwill." The license was worth nearly $176.8 million, the appraiser said.

Under I.R.C. Section 1031, a taxpayer may defer recognition of gain or loss from qualifying exchanges of like-kind property. But, under Regulation Section 1.1031(a)-2(c)(2), a business' goodwill is not of a like-kind to the goodwill of another business. Therefore, the nonrecognition provision does not apply. The IRS issued a deficiency notice claiming there was a goodwill value of $73.3 million on the transaction date. Ultimately, the plaintiff sued in the Court of Claims for a refund.

The court found indications of goodwill but required the IRS to show whether the goodwill was appreciable or negligible. The agency's expert tried to isolate the income attributable to the FCC license by performing a discounted cash flow (DCF) analysis of the station, treating it as a startup. She created projections for the revenues, operating cash flows, and net free cash flows that KZLA could reasonably be expected to achieve in the market based on past performance, market operating and financial benchmarks, as well as the performance of other radio stations in the Los Angeles market. Discounting the net free cash flow to present value, she then extracted the value for KZLA's license. She initially found it was worth $131.4 million, which left a residual value of goodwill of $45.4 million. After correcting for errors in her cash flow projections and working capital calculation, she lowered the amount to $36.5 million.

No goodwill: The plaintiff's rebuttal experts highlighted three errors that, if corrected, would increase the license value to $179.6 million, leaving no portion of the purchase price to assign to goodwill. The court agreed and in a detailed chart showed that the effect of the proposed adjustments was that there simply was nothing left for goodwill. "[T]the use of discount calculations to value goodwill represents a double-edged sword in that the numbers can demonstrate the presence or the absence of goodwill," the court concluded.

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