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Chancery Achieves Fair Value by Blending Three 'Imperfect Techniques'

In re DFC Global Corp.

A recent fair value decision from the Delaware Court of Chancery turned on the idea of uncertainty. Impending regulatory changes in key markets made it hard to predict the company's future performance. Shaky forecasts raised doubts about the reliability of the results that three different valuation methods generated. So, the court's solution was to blend the values.

The subject was a payday lending company that was headquartered in the United States but operated in 10 countries. Around the time of the transaction, the company experienced two pressure points: potentially tighter restrictions from regulatory authorities, especially in the U.S. and the United Kingdom and competition.

Because of concerns over regulatory change, management succession, and the company's high leverage, management began to explore a sale to a financial sponsor as early as 2012. It retained a financial advisor that reached out to many financial sponsors and a few strategic buyers. The future buyer, a private equity firm, came forward in fall 2013. The buyer knew of the uncertain regulatory environment in which the subject operated and wanted to take advantage of the company's vulnerability.

Initially, the buyer offered $12.16 per share. But, after management provided the buyer twice with EBITDA projections that were revised downward, the latter lowered its bid to $9.50 per share. The board approved the transaction on April 1, 2014 and the merger closed in June 2014.

A number of stockholders petitioned the Delaware Court of Chancery for a fair value determination. Both sides retained qualified valuators to make their case. The petitioners' expert based his valuation solely on the discounted cash flow method. The court commended him for also performing a multiples-based comparative company analysis even though he saw no reason to give any weight to it. The expert's DCF analysis yielded a value of $17.90 per share.

The company's (respondent's) expert relied on a DCF method that resulted in a $7.81 value per share and a multiples-based comparable company analysis that produced an $8.07-per-share value. Weighting the results equally, he determined a fair value of $7.94 per share. During litigation, the company also suggested the transaction price—$9.50 per share—was a reliable indicator of value. The petitioners objected.

The court noted the "wide gap" between the experts' DCF-derived values. Citing the Chancery's recent decision in In re Appraisal of Dell, the court pointed out that studies have shown that petitioners' experts on average produce a valuation that is 186 percent above the deal price, whereas respondents' experts arrive at a price that is 22 percent below the deal price.

In this case, the court decided to do its own DCF method by drawing on elements from both experts. For the final valuation, the court also considered the result of the multiples-based comparable company analysis and the deal price.

The court focused most of its valuation discussion on

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DCF input issues and paid particular attention to beta. "A relatively small change in beta can substantially affect WACC and, consequently, the outcome of a discounted cash flow model," the Chancellor noted. Here, the experts' theories on beta, including their views on the proper source of beta, the beta peer group, the beta measuring period, beta smoothing and beta unlevering, diverged significantly and resulted in very different valuations, the court observed.

For purposes of his comparable company analysis, the respondent's expert used six peer companies and the median of three multiples: market value of invested capital over 2014 estimated EBITDA, market value of invested capital over estimated 2015 EBITDA and market value of invested capital over last 12 months' EBITDA. Averaging the resulting valuations, the expert arrived at an $8.07-per-share price.

The court found the methodology reasonable, and it adopted the value resulting from it. It also found the deal price had a role to play in the final value determination considering the sales process had all the marks of an arm's-length transaction.

And yet, all of the valuation methods were "imperfect techniques," the court found. Their weakness ultimately came back to the same source: regulatory uncertainty. There was no knowing how the company would cope with the changes and whether it would remain viable, the court said.

This uncertainty "calls into question" the reliability of the company's projections underlying the experts' DCF models and, to some extent, the comparable company analysis, the court noted. The uncertainty also affected the sales process, although the buyer was aware of the company's "performance and uncertain outlook." These factors, in fact, "were at the core of [the buyer's] investment thesis to obtain assets with potential upside at a favorable price," the court said. It also noted that the buyer was a financial sponsor and was guided by achieving a certain internal rate of return rather than fair value.

At the same time, there was no doubt that all methods provided meaningful insight into the company's value, the Chancery found. Consequently, the court weighted the values derived from the different analyses equally to arrive at a $10.21-per-share fair value for the subject company.

Court Sets Aside Big Lost Profits Award Based on Bad Yardstick Analysis

Washington v. Kellwood Co. (Kellwood II)* and *Washington v. Kellwood Co. (Kellwood III)

After more than a decade of litigation, a damages case featuring an upstart sportswear company that put itself in league with the leading brand ended with a whimper. First, the court struck down a multimillion-dollar lost profits award, finding it was based on defective expert testimony. Later, it reconsidered its order for a new trial on lost value damages, finding pretrial proceedings showed the plaintiffs had no admissible financial evidence. A trial in that situation would be a waste of judicial resources, the court said.

The plaintiffs, the founder and his "Sunday Players" company, sued the defendant for breaching an exclusive licensing agreement to manufacture, market and promote sports apparel, specifically compression sportswear. The defendant allegedly told the plaintiff that MTV was interested in partnering with Sunday Players. An MTV sublicensing agreement would result in hundreds of millions in product sales. No deal between the defendant and MTV ever happened and the defendant abandoned its agreement with the plaintiffs. The defendant said it was unable to make a single sale even though it had pitched the Sunday Players brand to many large retailers and spent about $220,000 in marketing. The defense expert calculated that total sales made by the plaintiffs' sales team during the license agreement period were less than $150,000.

The plaintiffs' expert based his damages calculation on two approaches: a yardstick analysis and what he called a "Market Forecast Analysis." He then used the values from both analyses to calculate net sales, royalties and lost value of the Sunday Players brand, both for the license agreement's initial three-year term, as well as for a possible three-year renewal term.

Only the yardstick analysis survived a Daubert challenge. The expert used "Under Armour," the market leader in the compression sportswear industry as a benchmark, claiming it and Sunday Players sold similar products and were on a similar trajectory. Just as Under Armour experienced significant growth owing to its promotion agreement with ESPN, a deal

between the defendant and MTV would have led to similar success for Sunday Players. Ostensibly to account for increased competition in the compression apparel market, he reduced the comparative figure he derived from Under Armour's sales history by 50 percent.

The analysis triggered a harsh reproof from the defendant's expert, a leading valuator. The two brands were "so dissimilar as to render [the expert's] selection of Under Armour laughable," the defense said.

Noting that "expert testimony should not be rejected simply because the conclusions reached by the witness seem subjectively improbable," the court admitted the opinion. The testimony subsequently became the basis for the jury's $4.35 million lost profits and $500,000 lost business value awards.

In ruling on the defendant's post-trial challenges to the awards, the court (a different judge) agreed that the plaintiffs had failed to prove their "new and untested business" would have achieved the vast success their expert predicted, but for the defendant's breaches.

"The yardstick comparison can show the profits a company could have expected if it had maintained its market share; it cannot establish that a company without market share would have become an overnight success." The court dismissed the proposition that Sunday Players was comparable to the market leader as nothing more than "the entrepreneur's cheerful prognostications."

It explained why it earlier had admitted the very damages testimony it now rejected. Testimony that was admissible under Daubert "need not be sufficient to sustain a verdict." "Admissibility" and "sufficiency of scientific evidence" required different inquiries and involved different stakes, the court stated. While the expert opinion here was admissible, it was not a sufficient basis for the lost profits award.

The court acknowledged that the plaintiffs had suffered a loss of business value because of the defendant's breaches, but it found that, given a chance to prove their case in a new trial, the plaintiffs made it clear they "had no intention of pursuing a realistic damages award." In pretrial proceedings, they increased their loss claim from the $4.35 million the court had struck down to a range of $5 million to $140 million. At the same time, they could point to no evidence backing up their claim.

The court said it was "accelerating the inevitable" by closing the case and awarding the plaintiffs one dollar in nominal damages.

Tax Court Corrects Prior Valuation of LP Interest to Startling Result

Estate of Giustina v. Commissioner

In an estate tax dispute that has lasted for over five years, the Tax Court revalued the decedent's minority interest in an Oregon family business by order of the 9th Circuit Court of Appeals. The recalculation proved a boon to the taxpayer.

The Tax Court first valued the decedent's limited partner interest in a partnership that owned a timber company, including many acres of timberland, in 2011. At the time of the decedent's death, in 2005, the partnership had operated for 15 years. All limited partners were family members or trusts acting on behalf of a family member.

The Tax Court initially decided to value the LP interest by way of the discounted cash flow ("DCF") and net asset value ("NAV") methods. It gave a 75 percent weighting to the DCF-derived value and a 25 percent weighting to the NAV-derived value. The former represented the probability that the business would continue; the latter the possibility (albeit remote) that the partnership would dissolve and the assets would be liquidated. The Tax Court credited, but adjusted, the estate expert's cash flow calculation, including cutting the 3.5 percent company-specific risk premium that the estate's expert had proposed in half. A hypothetical buyer of the interest could limit the risk through diversification of assets, the Tax Court suggested.

The 9th Circuit Court of Appeals found that the Tax Court had made two clear errors that required remanding the case for a new value determination. In terms of the company-specific risk premium, the Tax Court failed to take into account how much wealth a potential buyer would need to affect a diversification, the 9th Circuit observed. And, considering how implausible it was that a buyer of the decedent's limited partner interest could achieve the dissolution of this long-term partnership, the Tax Court's giving any importance to the value of the assets was improper. The 9th Circuit ordered the Tax Court "to recalculate the value of the Estate based on the partnership's

value as a going concern."

The Tax Court's revised valuation adopted the estate expert's 3.5 percent company-specific risk premium and gave no weight at all to the assets of the company. As a result, the applicable discount rate for the DCF analysis increased from 16.25 to 18 percent. The corrections caused the value of the decedent's interest to drop from almost $27.5 million to about $14 million, the Tax Court found. It ordered the parties to recalculate the deficiency based on the revised valuation.

Court Deems Future Lost Profits Formula an Exercise in Speculation

Mattress Closeout Ctr. IV, LLC v. Panera, LLC

Courts are not looking to experts for creative ways to calculate damages. They want a calculation based on reasonable certainty. In a recent case, the court decided to throw out most of the plaintiff's damages claims before the case even went to trial because the expert worked off of untested client information and his formula for projecting future lost profits was based on plainly untenable assumptions.

The plaintiff was "the Marshalls or TJ Maxx of the mattress world." The defendant was a leading bakery-café chain. One of the plaintiff's four outlets experienced water leaking into its storeroom from the defendant's adjoining restaurant. It took the defendant a few months to make the necessary repairs, but ultimately the plaintiff did not suffer damage to its inventory and was not out of pocket for the repair work.

However, it wanted compensatory damages in excess of $100,000, as well as "exemplary damages" totaling $50,000. The exemplary damages were based on the defendant's allegedly "selfish and obnoxious conduct" and "repeated attempts at delay and its harassment of [the plaintiff]." The plaintiff retained a damages expert.

There was no basis for exemplary damages, the court said. They usually were only a remedy where the loss to a business was unquantifiable, as might be the case with loss of reputation or goodwill. Future lost profits and lost time of employees did not fit the category.

In terms of compensatory damages, the court found the plaintiff failed to show "a reasonable basis for its computation of damages for lost employee and lost principal's time." A recurring problem with the way in which the plaintiff's expert developed damages was his blind reliance on information the plaintiff store owner provided. For example, the owner told the expert to assume wasted employee time was 120 hours. During his deposition, the expert did not know whether this was time the employees spent in excess of their regular hours or time that was part of their workday. He had not reviewed employee time cards or payroll schedules to verify the claimed hours.

The court noted the expert's method for determining "lost principal's time" was even "sketchier." The expert assumed 150 lost hours because the owner told him to. However, during his deposition, the expert admitted in actuality the company incurred no additional costs for the 150 hours the owner claimed to have spent on the water leak.

The plaintiff wanted "future lost profits" for five years beyond the damages period. The plaintiff's expert said the calculation was based on a formula he had developed, which showed the number of repeat customers the company would lose going forward that it would have had but for the water leak issue. In determining lost income for future years, the expert compounded the number of lost customers but admitted there was no way of knowing whether this would be the number of lost customers in any given future year. It was just a "theory," he said.

The defendant contended the projected future losses were based on nothing but speculation and conjecture. The court agreed and dismissed this claim.

At trial, the plaintiff was only allowed to pursue recovery of damages for ordinary negligence and nuisance during the damages period, the court ruled.

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