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DCF Projections Failed to Reflect Target's Operative Reality, Chancery Says

ACP Master, Ltd. v. Sprint Corp.

In a big loss for shareholders objecting to a merger Sprint had orchestrated in order to obtain the remaining interest in a small telecommunications company in which Sprint had a controlling interest, the Delaware Court of Chancery declared the transaction fair, and, in the appraisal part of the litigation, credited the company expert's DCF analysis. The competing DCF value was based on wholly implausible projections that were never intended to reflect the target's operative reality, the court said. There was no mystery here about the reason for the huge gap separating the valuations. It came down to the choice of projections.

As part of a larger plan to team up with the Japanese telecommunications giant Softbank, Sprint was eager to acquire the minority interest in Clearwire, a small telecom that owned a large block of 2.5 GHZ spectrum and in which Sprint held a majority interest. Softbank wanted full access to Clearwire's spectrum.

Clearwire was interested in a merger with Sprint and formed a special committee. The parties agreed that Sprint would pay $2.97 per share for Clearwire's stock. The special committee's financial advisor performed a discounted cash flow analysis to value the company based on different scenarios. The first analysis, the "Single-Customer Case," assumed that Clearwire would only have one customer, Sprint. Under this assumption, Clearwire's value was no greater than $0.75 per share. Under the second scenario, the "Multicustomer Case," Clearwire's value exceeded the $2.97-per-share offer Sprint had made. However, the special committee and the financial advisor found this was an unlikely scenario given Clearwire's persistent failure to attract more customers. They agreed that $2.97 per share was fair to Clearwire's minority shareholders. Clearwire and Sprint signed a merger agreement based on this price.

Just then, a third party, DISH, intervened with a substantially higher bid to buy 100 percent of Clearwire's outstanding common stock. As the court put it, this offer "changed the negotiating landscape." DISH disappeared for a while, but large stockholders in Clearwire opposed the $2.97-per-share transaction.

To persuade Softbank to top any bid DISH made, Sprint created a presentation, the Full Build scenario, which outlined the cost to Sprint if it was unable to acquire Clearwire. Clearwire would be a stand-alone business and Sprint would use Clearwire's spectrum as a wholesale purchaser. As the court noted, Sprint created a full set of projections that assumed Sprint would end up paying Clearwire "staggering" amounts of money to access the latter's spectrum and would buy the same amount of spectrum regardless of whether it owned Clearwire or not.

Sprint ultimately acquired Clearwire for $5.00 per share. After the merger closed, the Sprint-Softbank transaction went through. A large Clearwire shareholder and related entities filed suit, claiming Sprint, aided by Softbank, had breached its fiduciary duties. The dissenters also filed a petition for statutory appraisal. The Delaware Court of Chancery consolidated the cases.

The court first found there was no breach of fiduciary duties even when one considered the transaction under the highest standard of scrutiny: entire fairness. According to the Chancery, the transaction occurred in two phases. The first phase concerned the dealings leading up to the $2.97-per-share agreement. The second phase began after DISH intervened and Sprint and Clearwire failed to get shareholder approval for the $2.97-per-share merger. Although the dissenting shareholders were able to point to instances in which Sprint and Softbank behaved unfairly vis-à-vis Clearwire in the first phase, these actions ultimately became meaningless as a result of DISH's higher bid. "The final merger consideration of $5.00 per share was

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a price that a seller, under all of the circumstances, could reasonably accept," the court said. Further, the evidence showed no one believed Clearwire was worth that much. Sprint agreed to pay the price because it expected massive synergies and wanted to avoid having DISH as a hostile minority investor.

In terms of the appraisal claim, the Chancery first noted that no one argued in favor of using the deal price. Both parties' experts relied on a DCF analysis to determine fair value. The dissenters' expert arrived at a value of $16.08 per share, whereas Clearwire's expert arrived at a $2.13-per-share price. The dissenters' expert used the Full Build scenario projections that Sprint had created for the purpose of convincing Softbank to go along with Sprint's plan to increase the offer to Clearwire. The court noted these were not the kind of forecasts that augured a reliable DCF analysis; Clearwire's management did not create them in the ordinary course of business and they did not represent Sprint's plans for Clearwire in the event the acquisition did not go through.

In contrast, Clearwire's expert used the Single-Customer Case with projections that company management created in the ordinary course of business that were regularly updated. These projections were a reliable indicator of Clearwire's reality at the time of the merger, the court said.

One other major disagreement between the experts concerned the valuation of Clearwire's unused spectrum. While Clearwire's expert found the net proceeds from the spectrum amounted to $1.98 billion, the dissenting shareholders' spectrum valuation expert arrived at a total value of $8.43 billion. The court rejected the latter valuation as speculative. It adopted in full the DCF analysis by Clearwire's expert and found that Clearwire's fair value was $2.13 per share.

Tax Court Introduces Formula to Value Donated Remainder Interest

RERI Holdings I, LLC v. Commissioner

In 2014, an odd charitable contribution case that centered on the value of a remainder in income-producing property surprised Tax Court observers because the court allowed it to go to trial regardless of the plainly defective appraisal summary that accompanied the deduction claim. Judge Halpern's decision, which included his formula for valuing the contested interest, gave real estate and business valuators much to chew on.

The petitioner in this convoluted tax shelter case was a partnership called RERI Holdings ("RERI"). During its short life, RERI donated an interest in another entity, Holdings, to a university. Holdings' only asset was a membership interest in yet another entity, Hawthorne, which, in turn, owned property that it leased to AT&T. Hawthorne acquired the property subject to a lease in early 2002 for $42.4 million. The initial lease term was for 15.5 years. AT&T had the option to renew the lease in successive five-year periods. An appraisal valued the property at $47 million as of August 2001.

In essence, there were two interests related to the property, the term-of-years interest ("TOYS") and the remainder, or successor member interest ("SMI"). The SMI interest, which was to become possessory in January 2021, was the focus of the tax dispute. RERI acquired the SMI for $2.95 million in March 2002 and assigned it to the university in August 2003. A September 2003 appraisal valued the fee interest in the property as of August 2003. The appraiser used present-value tables promulgated under the Internal Revenue Code's Section 7520 to arrive at an "investment value" for SMI. Section 7520 assures that the values of the present interest and future interest add up to the value of the property underlying the time-divided interests, without discounts. Based on this appraisal, RERI claimed a $33 million deduction for donating the SMI in its 2003 tax return. In December 2005, the university sold the SMI for $1.94 million.

The Internal Revenue Service, in a final partnership administrative adjustment ("FPAA"), initially argued the value of the contribution was $3.9 million. In a later amendment, the IRS claimed that RERI had no right to any deduction because the underlying transaction was a sham. Alternatively, the deduction should be limited to $1.94 million, the amount the university obtained when it sold the contributed property. RERI petitioned the Tax Court for review.

There were two major procedural issues, which the court decided in favor of the IRS. One, it found that the appraisal summary RERI had submitted left out vital information, that is, "donor's cost or other adjusted basis." RERI failed to meet the heightened substantiation requirement applicable to charitable contribution claims. This failure in itself justified "the full disallowance of its claimed deduction," the court said.

Moreover, Section 7520 did not apply because the holder of the SMI did not have "adequate protection" until the interest became possessory. Because the Section 7520 tables did not apply, the SMI's "actual fair market value" had to be determined.

The court said there were "three fundamental components" to the SMI valuation: (1) the projected cash flow from the property for 2021, when the SMI became possessory; (2) the expected growth rate in cash flows thereafter; and (3) the discount rate that applied to the post-2020 cash flows as of the valuation date, August 2003.

The court provided the following formula:

$$(2021\ CF/(r - g)) \times (1/(1 + r)^{17.33})$$

The first part determines the value of all remaining cash flows from the property by capitalizing projected 2021 cash flow into perpetuity at a rate equal to the excess of the discount rate over the growth rate. The second part is a discount factor that discounts the January 2021 value back 17.33 years to the date of the gift (August 2003).

The court's calculation drew on the testimony of the "three principal experts," one for RERI and two for the IRS. Even though the experts' approaches varied somewhat, their conclusions could be expressed in terms of the formula, the court said.

The fair market value for the SMI as of the date of the gift was just below $3.5 million, the court concluded. Considering this valuation and the $33 million claimed deduction, the court found there was a gross valuation misstatement. Moreover, it decided RERI did not have a reasonable cause defense. In sum, the Tax Court disallowed the claimed deduction in its entirety and ruled that the gross valuation misstatement penalty applied.

Delaware Supreme Court Disses Chancery's Blending of Valuation Methods

DFC Global Corp. v. Muirfield Value Partners, L.P.

The Delaware Supreme Court overturned a 2016 ruling by the Delaware Chancery Court that had blended the results of three valuation techniques to arrive at fair value. Chief Justice Strine, who once headed the Chancery, wrote a harsh critique replete with lots of advice to his successor, Chancellor Bouchard, on how to do a valuation.

The contested merger involved a global payday lending company that faced regulatory uncertainty in key markets and fierce competition. A private equity firm acquired the company. The chancellor, who handled the appraisal proceeding, performed a discounted cash flow ("DCF") analysis and also used the outcomes of the multiples-based comparable company analysis and the transaction price in calculating fair value. He weighted the results equally.

Post-trial, the company asked the court to correct an error related to the working capital figures in the Chancellor's DCF analysis. In response, the dissenters wanted an adjustment to the perpetuity growth rate based on their expert's affidavit that there needed to be a "codependent … and directionally consistent relationship" between the projected working capital in the DCF and the perpetuity growth rate. The court made both adjustments and achieved a fair value that was slightly higher than the original one.

The company appealed the decision with the Delaware Supreme Court. It asked the high court to create a judicial presumption, applicable in appraisal proceedings that provides that, when the merger that triggered the lawsuit was an arm's-length transaction, the merger consideration was the best indicator of fair value.

The Supreme Court declined to craft a bright-line rule. But it strongly agreed with the company that the Chancery's adjusted DCF analysis was highly problematic and that the weighting of the results of the three methods was not supported by the record of the case or by basic economic principles. "Market prices," the Supreme Court said, "are typically viewed superior to other valuation techniques because, unlike, e.g., a single person's discounted cash flow model, the market price should distill the collective judgment of the many based on all the publicly available information about a given company and the value of its shares."

The Supreme Court remanded, directing the chancellor to reassess the earlier valuation.

Expert's Fair Market Value Analysis Aligns with Applicable Healthcare Law

United States ex rel. Lutz v. Berkeley Heartlab, Inc.

A group of defendants faced accusations of healthcare law violations and launched a *Daubert* challenge to the opposing expert's fair market value ("FMV") analysis. The analysis centered on fees paid to physicians for blood processing services. A primary objection by the defense was that the expert used the wrong definition of FMV and her analysis produced "absurd results." The court found the expert's FMV analysis was logical and reliable. The court also dismissed objections to the expert's commercial reasonableness testimony.

Various whistleblowers alleged that a group of defendants had violated the Anti-Kickback Statute ("AKS") and False Claims Act ("FCA"). The government filed its complaint in intervention. In broad strokes, the government alleged that a number of labs put a kickback scheme in place under which labs would pay physicians and physician groups for referrals for large panels of blood tests, many of them unnecessary. The illegal payments were disguised as "processing and handling fees" ("P&H fees").

The instant decision focused on the BlueWave defendants. BlueWave was an entity that functioned as the marketing arm of two implicated labs. As a result of BlueWave's sales efforts, the defendants received millions of dollars in reimbursement from Medicare and other federal government healthcare programs.

The government's expert testified about the FMV of

the contested P&H services. The expert was a CPA with extensive experience in the healthcare arena. She had served as a consultant to the government in a variety of Medicare fraud cases. She said that for her FMV analysis she relied on the ASA's Business Valuation Standards and the AICPA's Standards for Valuation Services. She used a cost approach that considered factors such as the time needed to perform the work, the type of personnel performing the tasks, labor costs for the tasks, the office space needed to perform the tasks and the equipment and supplies required to perform them. The expert concluded that the business arrangement between the laboratories and physicians was designed to "take into account" the value and volume of referrals. Also, the fee arrangements in the instant case were not commercially reasonable without including the value of the referrals.

The court dismissed the defendants' argument that the expert lacked experience in the lab industry and therefore was unable to express an opinion on the FMV of transactions executed pursuant to laboratory agreements.

The defendants' main argument was that the FMV analysis was unreliable. The expert used a definition of FMV that was found in the Stark Law, which dealt with physician self-referral and which required the exclusion from consideration of the volume and value of referrals. However, the government here did not allege Stark Law violations. The defendants also claimed the expert relied on the personal services safe harbor provision of the AKS even though the defendants had not pled this exception and even though compliance with the provision was not mandatory to show compliance with the AKS.

The court was not receptive to the arguments. It said that including the value and volume of referrals in the calculation of the FMV of the contested P&H services "would defeat the purpose of an analysis designed to determine whether payments to physicians in this case were higher than the FMV for services actually performed and so may have disguised remuneration intended to induce referrals."

The court noted that case law concerned with the appropriate FMV standard in AKS cases says that FMV in this context may differ from traditional economic valuation formulas that might account for potential revenue from future referrals. Because the AKS prohibits any inducement for the referrals, the value attached to the referrals had to be excluded from the calculation, the court said.

The court also rejected the claim that the expert had ignored other valuation methodologies, noting the cost approach was an accepted methodology for calculating FMV and there was no requirement to use two or three separate approaches.

The defendants claimed the expert's commercial reasonableness opinion was irrelevant because commercial reasonableness was not a requirement under the AKS.

The court found the opinion was relevant to the government's claim that the contested fees were not commercially reasonable absent the value of the referrals, which was relevant to showing the defendants' intent to use the fees as inducement for future referrals and as a rebuttal to the defendants' claim that they had sound business reasons for entering into the fee arrangements. Also, the opinion was relevant in terms of countering the defendants' advice of counsel defense, which relied on letters from counsel that indicated the fees were FMV, commercially reasonable and complied with the AKS's personal service safe harbor provision.

Both the expert's FMV and commercial reasonableness opinions were admissible under *Daubert,* the court concluded.

New Edition of Gary Trugman's Book Now Available

Long considered one of the books on business valuation, Gary Trugman's *Understanding Business Valuation: A Practical Guide to Valuing Small- to Medium-Sized Businesses* is now available in its 5th edition. What stands out in this book is Gary's informal, easy-to-read style that draws on his real-world experience to make technical and complex topics easy to understand.

In addition to revisions to existing material and examples, there's a new chapter on valuing stock options, preferred stock, debt, and startup ventures. There's also a new discussion of economic obsolescence, "an issue that arises regularly but is not necessarily addressed by the valuation analyst," writes Trugman.

When you purchase the book, you will get access to a special webpage that contains an index of all articles from *Business Valuation Update* and an index of all cases in *BVLaw,* among other features.

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