Willamette Management Associates

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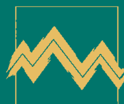
Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Transaction-Related Board Advisory Services



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Insights

Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates.

Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Forethoughts

This Insights issue focuses on merger and acquisition ("M&A") transaction-related services and other board advisory services. Specifically, this issue focuses on the issues that a company board of directors would likely encounter in making transaction-related decisions. The board, in its duty to maximize shareholder value, should consider advice from legal counsel and financial advisers to both limit liability and mitigate shareholder grievances.

In this Insights issue, we are extremely pleased to include discussions authored by prominent experts in the financial advisory and transaction services professions. These discussions should help our readers understand the complexities of the legal and valuation issues involved in transaction-related decisions.

This Insights issue discusses both best practices and company board considerations related to fairness opinions, solvency opinions, transaction earnout provisions, post-closing purchase price adjustments, and pre-transaction due diligence procedures. This Insights issue also addresses the M&A considerations related to an ESOP sponsor company stock purchase transaction.

Willamette Management Associates analysts provide transaction-related valuation and financial opinion services to boards of directors and to private company owners. In addition, Willamette Management Associates analysts provide forensic analysis and testifying expert services to legal counsel involved in transaction-related litigation.

About the Editors

Timothy J. Meinhart

Timothy J. Meinhart is a managing director in our Chicago office. In addition to his work on all types of valuation and forensic analysis engagements, Tim is also the leader of the firm's shareholder litigation valuation services practice.

Tim has spent the majority of his 30-year career providing valuation consulting, economic analysis, and transaction advisory services. These services include performing the following types of valuation and economic analyses: business and succession planning valuations, acquisition purchase price allocation valuations, asset impairment analyses, restricted stock valuations, blockage discount analyses, reasonableness of compensation analyses, restructuring and reorganization analyses, transfer price analyses, merger and acquisition valuations, fairness opinions, economic damages analyses, income-producing property valuations, and employee stock ownership plan ("ESOP") sponsor company stock valuations.

Tim is an accredited senior appraiser of the American Society of Appraisers ("ASA"), accredited in business valuation. He is past president of the ASA Chicago chapter. He was elected for two terms on the ASA Business Valuation Committee. He was appointed to the Business Valuation Committee Education Subcommittee and the Technical Topics Subcommittee, and he also served on the ASA Board of Examiners for the business valuation discipline. Tim is the past president and a current director of the Business Valuation Association of Chicago. Since 2011, Tim has served on the valuation committee of the editorial advisory board for the *Trusts & Estates* professional journal.

Kevin M. Zanni

Kevin M. Zanni is a managing director in our Chicago office, and he has enjoyed working at Willamette for more than 13 years of his 20-year valuation career. Kevin specializes in providing valuation and financial advisory opinions for both transaction-related matters and dispute resolution matters. His work involves the analysis of publicly traded businesses and private businesses—including close corporations, partnerships, limited liability companies, professional sports franchises, professional practices, and public utilities.

Kevin has prepared valuation and economic analyses for the following purposes: tax planning and compliance (ad valorem, income, gift, and estate), forensic analysis and dispute resolution, financial accounting and public reporting, transaction planning (acquisition, divestiture, liquidation, and reorganization), fiduciary compliance, and management information and strategic planning. Kevin's practice also includes intangible asset damages analysis related to breach of contract claims and tort claims.

Kevin is an accredited senior appraiser of the ASA, a certified valuation analyst, a certified business appraiser, a certified fraud examiner, and is a certified in entity and intangibles valuation credential holder. He is a past president of the Chicago chapter of the ASA, and a past president of the Business Valuation Association of Chicago. Kevin recently served the American Institute of Certified Public Accountants ("AICPA") as part of a taskforce to develop a bridging document between the AICPA valuation standards and the IFRS valuation standards.

Thought Leadership Discussion

How Solvency Opinions May Reduce the Risk of Fraudulent Transfer Exposure in Leveraged Transactions

Michael F. Holbein, Esq.

A constructive fraudulent transfer occurs where the transferor receives less than "reasonably equivalent value" in exchange for the transfer and the transferor is either (1) insolvent on the date of such transfer; (2) engaged in a business or transaction for which any property remaining with the transferor has unreasonably small capital; or (3) intended to incur, or believed it would incur, debts that would be beyond its ability to repay as such debts matured. A constructive fraudulent transfer may be avoided under the U.S. Bankruptcy Code and applicable state law. Leveraged transactions, in particular, give rise to constructive fraudulent transfer risk. An independent, third-party solvency analysis—prepared at the time of the leveraged transaction—can be useful in defending against such a fraudulent transfer claim.

Introduction

It is not atypical for leveraged transactions to be attacked years after the fact when one of the parties to the transaction later files for bankruptcy protection. In lawsuits brought by trustees, debtors-in-possession, and, in some cases, creditors' committees, a judicial determination that the transaction constituted a fraudulent transfer can result in buyouts being undone, spin-offs being unspun, and intercompany guaranties being avoided.

In these circumstances, a contemporaneously prepared, independent, third-party expert solvency analysis can be a bulwark against a catastrophic financial loss.

To appreciate why, first, it is necessary to understand (1) what an avoidable fraudulent transfer is and (2) how certain transactions can give rise to such a transfer. Second, it is important to know what to look for in a solvency opinion and why such an opinion matters. This discussion covers each of these two topics.

Fraudulent Transfers (and Obligations)

Fraudulent transfer lawsuits usually, though not always, arise in the context of a bankruptcy case.[1] The U.S. Bankruptcy Code specifically provides a mechanism for the avoidance of fraudulent transfers, and it also allows for the pursuit of fraudulent transfer claims available to creditors under state law.

The Bankruptcy Code Fraudulent Transfer Statute

Section 548 of the Bankruptcy Code provides for the avoidance of fraudulent transfers and obligations. At the outset, it is important to remember that, in addition to fraudulent transfers, fraudulently incurred obligations are also avoidable.

The conversations around these transactions are almost exclusively, if only superficially, limited to fraudulent "transfers." Therefore, this discussion employs the same convention—unless the transaction being discussed specifically involves the potentially fraudulent incurrence of an obligation. Nonetheless, the discussion regarding "transfers" applies to "obligations" as well. In this regard, it may be helpful to think of an obligation simply as the transfer of a promise to pay or to perform.

The Bankruptcy Code divides fraudulent transfers into two categories, which are addressed in Sections 548(a)(1)(A) and (B), respectively. The former transfers are typically referred to as "actual" fraudulent transfers. And, the latter transfers are typically referred to as "constructive" fraudulent transfers. However, these two terms are not found anywhere in the Bankruptcy Code.

Actual fraudulent transfers are those transfers "made . . . with actual intent to hinder, delay, or defraud" a creditor.[2]

Intent is found in certain "badges of fraud," derived from case law and borrowed from state statutes. Solvency opinions do not usually play a large role in insulating parties from actual fraud—the best defense here is to avoid fraudulent, or apparently fraudulent, conduct. Therefore, this discussion does not discuss issues related to the avoidance of actual fraudulent transfers in any detail.

Constructive fraudulent transfers are transfers made where:

- the transferor/debtor-to-be voluntarily or involuntarily received less than "reasonably equivalent value" in exchange for the transfer and
- one of three conditions existed.

A transfer is fraudulent if there was no reasonably equivalent value and the transferor was insolvent on the date of such transfer.[3]

Here, an entity is deemed "insolvent" when the sum of all the entity's debts is greater than the sum of all of the entity's property.[4] This analysis is typically called the "balance sheet test."

Alternatively, a transfer is fraudulent if (1) there was no reasonably equivalent value and (2) the transferor was "engaged in a business or transaction, or was about to be engaged in a business or transaction, for which any property remaining with the [transferor] was an unreasonably small capital" (i.e., the transferor was undercapitalized).[5] This analysis is typically called the "unreasonably small capital test" or the "capital adequacy test."

Finally, a transfer is fraudulent if (1) there was no reasonably equivalent value and (2) the transferor "intended to incur, or believed [it] would incur, debts that would be beyond [its] ability to repay as such debts matured."[6] This analysis is typically called the "cash flow test."

A trustee, debtor-in-possession, or, in certain circumstances, a creditors' committee may sue to avoid any of the above-described transfers if made within two years prior to the bankruptcy filing.[7]

This two-year period is referred to as the "look back" or "reach back" period. Such suits have to be brought within two years from the date of the bankruptcy filing.

Once a transfer is avoided under Section 548, it is automatically preserved for the benefit of the estate under Section 551 of the Bankruptcy Code.[8]

In addition, what was transferred, or its value, may be recovered under Bankruptcy Code Section 550. It can be recovered from any of the following:

- The initial transferee,
- Any entity for whose benefit the transfer was made
- Any mediate or intermediate transferee of the initial transferee[9]

State Fraudulent Transfer Laws

In addition to the Bankruptcy Code, states have laws that allow for the avoidance of fraudulent transfers.[10]

The trustee, or trustee equivalent, can employ the "strong arm" powers provided in Section 544 of the Bankruptcy Code to assert these state law causes of action.[11]

The most typical of these state laws, adopted by 43 states in some form or another, is the Uniform Fraudulent Transfer Act ("UFTA"). The UFTA was amended in 2014, and it was renamed the Uniform Voidable Transactions Act ("UVTA"). Like the Bankruptcy Code, the UVTA divides these transactions into two categories.

However, unlike the Bankruptcy Code, the distinction is not between constructive fraud and

actual fraud. Rather, the UVTA separates these two types of transactions into:

1. those transfers that can be avoided by creditors in existence at the time the transfers were made and
2. those transfers that can be avoided by present and future creditors.[12]

Nonetheless, the terms actual fraud and constructive fraud are often still used in the context of the UVTA.[13]

The transactions voidable under the UVTA by creditors in existence at the time of the transaction include those transfers made for less than reasonably equivalent value while the debtor was insolvent (i.e., the first type of constructive fraudulent transfer discussed above).[14]

The UVTA defines insolvency the same as the Bankruptcy Code. That is, when the sum of the entity's debts is greater than the sum of the entity's assets at fair valuation. However, the UVTA adds a presumption of insolvency where the transferor is generally not paying debts as they become due.[15]

Transactions voidable by present and future creditors include actual fraudulent transfers[16] as well as the other two types of "constructive" fraudulent transfers described in the Bankruptcy Code.

Using nearly identical language as the Bankruptcy Code, the UVTA defines the latter two types of transactions as transfers made for less than reasonably equivalent value while the transferor:

- "was engaged, or about to be engaged, in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction"[17] or
- "intended to incur, or believed or reasonably should have believed it would incur, debts beyond [its] ability to pay as they came due."[18]

Just as with avoidance actions filed under Bankruptcy Code Section 548, the trustee, or the trustee equivalent, has two years from the date of the filing of the bankruptcy case to initiate suit. However, the lookback period under the UVTA is four years, twice as long as the lookback period under the Bankruptcy Code.

Once avoided under Section 544 and state law, the transfers are preserved and recoverable under Sections 551 and 550 of the Bankruptcy Code, respectively.

Transactions Giving Rise to Potential Fraudulent Transfer

Whenever something is given—like the transfer of money or property, the grant of a security interest, or a promise to pay or perform—for less than adequate consideration, the potential for a constructive fraudulent transfer exists. As such, any number of commercial transactions can give rise to fraudulent-transfer risk.

Let's consider the following three transactional examples: a leveraged buyout, a spin-off, and an enterprise loan.

- The leveraged buyout: In a typical leveraged buyout, a target company is acquired with borrowed money (the leverage), and the target company's assets are used to secure the loan.

  In other words, the target company gives something of value (a security interest in its assets) and gets nothing in return. This is because the money goes to the acquiring entity, not the target company, to fund the purchase price.

  If the pledge of security is accompanied by a guarantee from the target company, and it often is, the potential fraudulent transaction is compounded. This is because the target company will have incurred an obligation, the loan guarantee, for nothing in return. This presents fraudulent transfer risk.
- The spin-off: In certain restructuring transactions, a parent company may wish to spin off a business unit.

First, the parent will usually transfer its assets into a subsidiary, often created for the sole purpose of the spin-off. The subsidiary usually finances this acquisition.

Second, the parent will sell or distribute its shares in the subsidiary, completely divesting itself of ownership of the now spun-off company. There are a multitude of legitimate business reasons for a parent to spin off a subsidiary, all in service of maximizing shareholder value.

But if financial distress follows and leads to bankruptcy for either the parent or the spun-off company, the transaction will likely come under scrutiny.

Often, the transaction is lopsided. For example, the spun-off company may assume the parent's debt or borrow too much to purchase the assets. Or, the parent may receive inadequate consideration for the assets transferred. This occurrence presents fraudulent transfer risk.

- The enterprise loan: It is routine for corporate families to utilize large loan structures where funds are distributed by the lender, usually on a draw, either to the subsidiaries directly or to the parent and then by the parent amongst the subsidiaries. The subsidiaries are co-obligors or guarantors under the loan agreement.

  Often, a lockbox and sweep arrangement pulls cash from the subsidiaries daily.

  If certain subsidiaries are underperforming and their affiliates are co-obligating or guarantying, while subsequently repaying their own debts without receiving any true upside, there is fraudulent transfer risk.

The typical characteristic of all of these transactions is the potential disparity between what was given and what was received.

Put differently, a transfer may be made for less than reasonably equivalent value in exchange.

Ultimately, in the ensuing fraudulent transfer litigation, experts will be called on to answer the question: What were the thing given and the thing received actually worth?

But this is only half of a constructive fraudulent transfer claim. The other half—insolvency, undercapitalization, or cash flow deficits—also requires expert testimony. In that regard, a solvency opinion can be thought of as expert testimony for use in case of future litigation.

The Solvency Opinion

To be most effective (i.e., to have the greatest evidentiary weight), a solvency opinion is performed by an independent third-party analyst, typically one with experience in the particular industry. The solvency opinion is based on independently obtained or verified information and should not be outcome-driven.

The analyst should not be incentivized to opine in favor of solvency. This independence will lend the opinion credibility and provide a possible edge over an opinion prepared specifically for litigation.

Solvency opinions generally include analyses that mirror the "constructive" fraud provisions of the Bankruptcy Code and the UVTA—a balance sheet analysis, an adequacy-of-capital analysis, and a cash flow analysis.

Solvency opinions may also include an analysis of market capitalization (the number of shares outstanding multiplied by the price per share). Internal information is often verified against publicly available information, and all analysis assumptions are subject to update and revision in order to account for market changes and manipulation.

Balance Sheet Test

A balance-sheet test in a solvency opinion is designed to answer in advance whether the debtor meets the Bankruptcy Code definition of insolvent. In other words, do its liabilities exceed the value of its assets at fair valuation? The question often is reframed in reverse as—Is the debtor solvent?

In valuing the debtor's assets, valuation analysts generally rely on the going-concern premise of value rather than on the liquidation premise of value as the measure of highest and best use. Contingent and disputed debts are often weighted based on the likelihood of payment.[19]

Cash Flow Test

A cash flow test is designed to determine whether the debtor will be able to pay its debts, including any debts with the associated transaction, as they come due. Not coincidentally, it mirrors the fraudulent transfer analysis in the Bankruptcy Code and the UVTA.

It is important to note that cash flow can often be positively affected by restricting cash outflow with new debt and deferring payment on the transaction debt. Failure to account for this manipulation can signal an outcome-driven opinion. Inevitably, where cash flow is an issue, capitalization is as well.

Capital Adequacy Test

A capital-adequacy test is designed to determine whether the debtor can endure future business fluctuations. This analysis often includes stress testing against various scenarios likely to have an impact on the debtor's business.

This stress test analysis is designed to satisfy the fraudulent transfer inquiry into potential undercapitalization.

Summary and Conclusion

The second prong of the fraudulent transfer analysis (whether it is the solvency analysis, the cash flow analysis, or the capitalization analysis) can often be overlooked by fraudulent transfer plaintiffs. This is often the case because plaintiffs are more focused on the nuance issues of value, which serve as the starting point (i.e., the first prong) for determining whether a claim exists.

Most often, the parties entering into transactions like those described above are financially sound at the time of the transaction. However, given the four-year state law look-back period, it is typical for litigation to ensue years after the transaction if the debtor experiences financial difficulties.

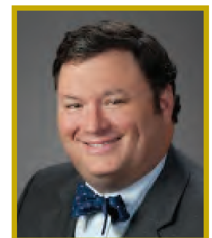
In some of these litigations, the plaintiff's expert—with the benefit of hindsight—will opine that the debtor was in financial distress long before anyone could have reasonably known.

An independent, third-party solvency analysis—an analysis that was prepared contemporaneously with the transaction—can provide an invaluable tool to counter such a claim.

Notes:

1. Creditors may assert state law fraudulent transfer claims where no bankruptcy has been filed. However, once a bankruptcy case is filed, most courts view the claim as property of the bankruptcy estate and prohibit suits by individual creditors.
2. 11 U.S.C. § 548(a)(1)(A).
3. 11 U.S.C. § 548(a)(1)(B)(ii)(I).
4. 11 U.S.C. § 101(32)(A).
5. 11 U.S.C. § 548(a)(1)(B)(ii)(II).
6. 11 U.S.C. § 548(a)(1)(B)(ii)(III).
7. 11 U.S.C. § 548(a)(1).
8. 11 U.S.C. § 551.
9. 11 U.S.C. § 550(a).
10. Alaska, Kentucky, Louisiana, Maryland, South Carolina, and Virginia have not adopted the UFTA or updated UVTA and instead have different statutes or a patchwork of common law providing for the avoidance of fraudulent transfers. The differences between these laws, though interesting, is beyond the scope of this discussion.
11. 11 U.S.C. § 544(b)(1).
12. UVTA, § 4, "Transfer or Obligation Avoidable as to Present or Future Creditor"; § 5 "Transfer or Obligation Avoidable as to Present Creditor."
13. One of the reasons given for the renaming accomplished by the 2014 amendment (from "Fraudulent" to "Voidable") was to address the inconsistent use of the term "fraudulent" with respect to constructive fraud, which doesn't qualify as fraud under any other understanding of the concept. See UVTA, Prefatory Note. No substantive change was intended by the change in terminology. Id. This is not unlike the change in terminology that accompanied the 1984 adoption of the UFTA in replacement of the Uniform Fraudulent Conveyance Act. There, the change was meant to recognize the applicability of the Act to transfers of realty and personal property. To the drafters, the term "conveyance" apparently connoted a transfer restricted to personal property. See UFTA, Prefatory Note.
14. UVTA, § 5(a). This category also includes transfers made to insiders in repayment of antecedent debt while the transferor was insolvent and where the insider had reason to know about the transferor's insolvency. UVTA, § 5(b). This is similar to insider preference avoidance found in Section 547 of the Bankruptcy Code; the difference being that the preference avoidance statute in the Code does not include a scienter (i.e., knowledge) requirement.
15. UVTA, § 2(a) and (b).
16. UVTA, § 4(a)(1). To show intent, the UVTA includes a nonexclusive list of "badges of fraud." UVTA, § 4(b).
17. UVTA, § 4(a)(2)(i).
18. UVTA, § 4(a)(2)(ii).
19. Contingent debt describes financial liabilities that are not yet, and may never become, due. Instead, the debtor's obligation to pay is predicated on a triggering event (e.g., a guaranty). A disputed debt is usually fixed in amount, the debtor simply contests its obligation to pay. Caution should be taken when weighting contingent and disputed debts. The bankruptcy court will also consider expert analysis rendered with the benefit of hindsight.

Michael F. Holbein is a partner at Arnall Golden Gregory LLP and a member of that firm's Bankruptcy, Creditors' Rights & Financial Restructuring practice. A bankruptcy litigator, Michael defends and prosecutes matters for trustees, financial institutions, and trade creditors at both the trial and appellate levels. Over the span of his career, he has defended and prosecuted numerous complex, multi-million-dollar fraudulent transfer lawsuits.



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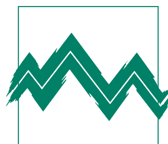

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Financial Considerations for Boards and Trustees in ESOP Sponsor Company Sale Transactions

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Merger and acquisition ("M&A") transactions are often highly anticipated and sometimes highly controversial events for companies in both the public market and the private market. Companies commit significant time and resources to sourcing and structuring the appropriate deal. The presence of an employee stock ownership plan ("ESOP") at the target company adds a layer of complexity to the M&A transaction. As a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"), the ESOP trustee has an important role to perform with respect to reviewing a proposed transaction. This discussion focuses on the roles of the sponsor company board and the ESOP trustee when a sponsor company sale is being considered. This discussion also focuses on the role of the trustees' financial adviser in reviewing the financial aspects of the proposed M&A transaction.

Introduction

The sale of a company that sponsors an employee stock ownership plan ("ESOP") typically requires additional due diligence—relative to a non-ESOP sponsor company transaction—in order to ensure that the transaction is fair to ESOP participants. The sale of an ESOP sponsor company requires special procedures and expertise in order to navigate the ESOP trust shareholder requirements to effect a successful company sale.

The Employee Retirement Income Security Act of 1974 ("ERISA") provides that ESOP trusts are managed by trustees who have fiduciary duties to:

1. the plan,
2. its participants, and
3. its beneficiaries.

In order for an ESOP sponsor company to be sold, the ESOP must receive no less than "adequate consideration" for its company stock. This requirement means that any sale transaction has to be considered prudent and financially fair:

1. to the plan,
2. to its participants, and
3. to its beneficiaries.

The ESOP trustee assesses the proposed sale transaction and determines if the terms of the proposed transaction are in the best interest of the ESOP. The trustee typically retains an independent financial adviser and legal counsel to assist it with the transaction.

The ESOP trustee typically employs these financial and legal advisers:

1. to determine the fairness of any proposed transaction,
2. to conduct financial and legal diligence with respect to the ESOP sponsor company, and

3. to ensure that the transaction is consistent with all applicable laws.

In order to determine if a proposed sale transaction is fair to the ESOP from a financial point of view, the trustee and its financial advisers should perform financial due diligence of the sponsor company. The financial due diligence involves estimating the fair market value of the sponsor company overall and of the company shares held by the ESOP. The financial adviser fairness analysis compares (1) the proceeds that the ESOP will receive as part of the proposed transaction to (2) the fair market value of the ESOP ownership interest.

The advisers should then present their findings to the trustee. The trustee will make a final determination whether to:

1. accept the proposed offer,
2. reject the proposed offer, or
3. counteroffer with different terms and conditions.

This discussion focuses on the following topics:

- Overview of the sale process for an ESOP sponsor company
- The role of the ESOP trustee in reviewing the proposed sponsor company sale transaction
- The role of the trustee's financial adviser in reviewing the proposed sponsor company sale transaction

The Sponsor Company Sale Process

The sale process often begins with a potential acquirer submitting a letter of intent to the subject sponsor company's board of directors. Even when an ESOP owns 100 percent of the outstanding stock of the sponsor company, the board of directors is usually the first to receive and consider a proposed transaction.

In other cases, the board may hire a financial adviser to actively solicit bids to acquire the sponsor company. The reasons for selling a sponsor company can vary quite a bit. However, whether the proposal is an unsolicited tender offer or a solicited purchase offer, the first step in the sale process is typically a board-level function.

For a smoother transaction process, it is helpful for the board of directors to notify the ESOP trustee of the proposed sponsor company sale transaction at the earliest possible time. The sponsor company board should consider the ESOP trustee as its partner. And, the sponsor company board should make certain that the trustee has all of the information it needs to perform a thorough analysis of the proposed transaction.

The board has a responsibility to:

1. protect the assets of the company and
2. ensure that the shareholders receive the highest return on their investment.

In this capacity, the board should evaluate any and all bona fide sponsor company purchase offers. The board may hire a financial adviser to:

1. solicit bids for the sponsor company,
2. assist with negotiating and structuring the proposed transaction, and/or
3. provide a fairness opinion related to the proposed transaction.

In circumstances where the board relies on information from the trustee's financial adviser, there is the potential for additional complexity. The trustee's financial adviser must remain independent and cannot work directly for the sponsor

company. However, it is possible for the board to be allowed to rely on the work of the trustee's financial adviser.

When considering the work of the trustee's financial adviser, the board should be mindful that the duties of the trustee's financial adviser extend only to the trustee and the ESOP—and not to the board. Therefore, complexity may arise due to the fact that the ESOP trustee's financial adviser solely acts as the adviser of the ESOP trustee.

To the extent that the board objectives and incentives are aligned with those of the ESOP, this adviser duty does not pose significant potential conflicts. However, if the two parties' motivations become misaligned, then this arrangement could present a conflict of interest.

Potential conflicts may range from information sharing conflicts and inefficiencies in the negotiation process to a failure of fiduciary responsibilities. In order to meet their respective fiduciary duties throughout the process, all parties should be aware of their responsibilities—and of whose interests they serve.

In most sponsor companies, should the board pursue an offer to sell, the company board typically negotiates the terms of the offer. However, the board and the ESOP trustee (and the trustee's advisers) should communicate early and often during the negotiation process.

Misalignment between the goals and objectives of the board and of the trustee should to be addressed early in the process. If this issue is ignored by the board, the potential offer may be jeopardized through internal squabbling which may appear to a potential buyer as indicating that a transaction is doubtful.

Even though the board may take the lead in the negotiations, the ESOP trustee has the final say in approving a transaction[1] on behalf of the ESOP.

Once a bona fide purchase offer is received by the sponsor company board, the offer should promptly be submitted to the ESOP trustee for review.

Role of the ESOP Trustee

The trustee has a fiduciary responsibility solely to the plan participants and the plan beneficiaries. Each ESOP trust is governed by a trust document that specifies the duties and responsibilities of the ESOP trustee.

The ESOP trustee will follow the terms of the plan documents to the extent that the plan terms are consistent with ERISA. In general, the ESOP trustee has exclusive authority and discretion over the management of plan assets.[2]

ERISA Sections 404(a)(1)(A) and 404(a)(1)(B) describe the exclusive benefit rule and the prudent man rule for fiduciaries of ERISA plans, respectively.

The ERISA exclusive benefit rule requires a fiduciary (the ESOP trustee) to act solely in the interest of the plan participants and beneficiaries for the exclusive purposes of providing benefits to participants and their beneficiaries and of defraying reasonable expenses of administering the plan.[3]

The exclusive benefit rule requires the fiduciary to have "an eye single to the interests of the participants and beneficiaries."[4]

The ERISA prudent man rule requires a fiduciary (the ESOP trustee) to approach its duties with respect to a plan "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

The ERISA fiduciary is expected to act as a prudent expert would under similar circumstances, accounting for all relevant substantive factors as they appeared at the time without the benefit of hindsight. This standard "is not of a layperson, but rather of a prudent fiduciary with experience dealing with a similar enterprise."[5]

This ESOP trustee duty is more expansive than the general common law duty of trustees. This is because it imposes a duty greater than a reasonably prudent person—it requires that the trustee be experienced with such matters, leading many to refer to this standard as the "reasonably prudent expert standard."

The U.S. Department of Labor ("DOL") and certain courts have characterized the requisite level of fiduciary prudence under ERISA as both substantive prudence and procedural prudence. Substantive prudence refers to the merits of the decision made by the fiduciary, and procedural prudence addresses the process through which the fiduciary reaches its decision.

In the absence of a conflict of interest that would impair the fiduciary's independent judgment, the fiduciary prudence requirement is satisfied by applying substantive prudence and procedural prudence.[6]

In the context of a sponsor company sale transaction, once the board of directors recommends an offer to the shareholders, the ESOP trustee should evaluate the offer to determine whether:

1. the offer maximizes the value of the plan assets,
2. it is prudent for the ESOP to enter into the transaction, and
3. the transaction is fair to the ESOP from a relative point of view.

In order to fulfill its procedural prudence obligation, the trustee typically retains legal counsel and an independent financial adviser. These advisers assist the trustee in reviewing the legal and financial aspects of a proposed sponsor company stock purchase transaction.

The retention of advisers does not absolve the ESOP trustee of its liability in the subject transaction. The trustee is expected to exercise its own judgment, considering the advice of outside advisers. With help from its advisers, the role of the trustee is to negotiate on behalf of the ESOP trust.

The trustee should consider all viable alternatives to the proposed sale transaction in order to determine if the proposed sale transaction maximizes the value of plan assets. Such alternatives may include considering a public offering or simply rejecting the transaction. The trustee may decide that it is prudent to solicit proposals from other potential buyers.

Finally, the ESOP trustee will have to determine if the proposed transaction is prudent. In doing so, the ESOP trustee should determine if a prudent man with experience in such matters would sell the sponsor company under the proposed terms.

Prudence is a matter of judgment, but the ESOP trustee has a responsibility to ensure that the transaction is fair:

1. to the trust,
2. to its participants, and
3. to its beneficiaries.

Special care should be taken to ensure the proposed transaction meets this prudence standard, as the DOL may require that the trustee demonstrate the prudence of the transaction after the fact.

Government-imposed penalties for violation by a fiduciary of the prudence standard can be severe. Therefore, it is especially important for the ESOP trustee to use qualified advisers based on experience, knowledge, and qualifications rather than simply on the price they charge for their services.

In a sponsor company sale transaction, the ESOP trustee may be required to accept voting direction from the plan participants with respect to their allocated shares. In this case, the ESOP trustee may want to ensure that the sponsor company makes full disclosure to the participants of all the appropriate information concerning the offer. The ESOP trustee may also want to arrange for the confidential tallying of the participant directions.

The ESOP Trustee's Financial Adviser

The ESOP trustee's independent financial adviser is often asked to provide a fairness opinion to the ESOP trustee. The fairness opinion should state whether or not:

1. the ESOP trust is receiving adequate consideration and
2. the transaction is fair to the ESOP from a financial point of view.

This fair market value determination should be arrived at through a good faith process whereby the ESOP trustees and fiduciaries review all relevant information, study all reports from their advisers, and make informed, well-thought-out decisions, giving themselves sufficient time for reflection.

This determination of fair market value should comply with both Internal Revenue Service and DOL regulations.

The financial adviser typically seeks to educate the ESOP trustee on all financial aspects of the transaction. This education process is accomplished primarily, but not exclusively, by a fairness opinion and the fairness analysis. The ESOP trustee may ask the financial adviser to consider the return to the ESOP of alternatives to the proposed transaction, such as the long-term value to the ESOP if the transaction was rejected and business continued as usual.

The consideration of synergies is typically not required for a transaction to meet the adequate consideration threshold. However, it may be appropriate to consider potential synergies to assist the ESOP trustee in negotiating the best price possible. This is because the trustee's role is to maximize the value of plan assets (in this case, to maximize the sponsor company sale transaction consideration to the ESOP).

The Transaction Fairness Opinion

A fairness opinion is the opinion of a financial adviser as to whether the prospective transaction is fair from a financial point of view. A fairness opinion is frequently provided for merger, acquisition, divestiture, recapitalization, or reorganization transactions. The fairness opinion solely reflects the fairness of the proposed transaction to a specific party or transaction participant.

A fairness opinion relates to the price and the structure of the proposed transaction from a financial perspective. That is, the fairness opinion does not opine on the process that was followed to establish the transaction terms and conditions or the legal aspects of the transaction.

The transactional fairness opinion in a proposed sale of the sponsor company provides the financial adviser's opinion to the ESOP trustee with respect to the following:

- The financial fairness of the proposed transaction terms and conditions to the ESOP
- The fairness of the proposed deal structure to the ESOP
- The fairness of the proposed purchase price to the ESOP

The transactional fairness opinion is an important procedural tool. It provides the ESOP trustee with important information regarding various financial and valuation aspects of the proposed sale transaction. With this information, the ESOP trustee may be able to negotiate more effectively on behalf of the ESOP participants.

The transactional fairness opinion is also an important legal tool. It provides evidence that the ESOP trustee used reasonable business judgment in the evaluation and assessment of the proposed sale transaction.

The primary deliverable by the independent financial adviser to the ESOP trustee is the fairness opinion letter. The financial adviser often provides a presentation to the trustee outlining the fairness analysis.

The ESOP trustee should read this presentation carefully and ask relevant questions of the adviser to better understand the assumptions and comparisons used in the analysis. The trustee should assure itself that it understands the analysis and that the assumptions applied by the adviser were reasonable under the circumstances.

Adequate Consideration

In the context of a fairness opinion performed for the sale of an ESOP sponsor company, fairness is defined as not receiving less than "adequate consideration" under ERISA Section 3(18)(B).

Adequate consideration is defined in ERISA Section 3(18). The first clause of this section discusses adequate consideration for a "security for which there is a generally recognized market," which is typically not applicable for private company transactions.

ERISA Section 3(18)(B) defines adequate consideration for private company securities as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the [U.S. Secretary of Labor.]"[7]

On May 17, 1988, the DOL issued the "Proposed Regulation Relating to the Definition of Adequate Consideration" (the "DOL Proposed Regulation") to further define the term "adequate consideration."

Although the DOL Proposed Regulation was never made into law, trustees and independent financial advisers often consider the DOL Proposed Regulation when assessing ESOP sponsor company stock transactions.

The DOL Proposed Regulation defines fair market value as "the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset."[8]

The "good faith" component of ERISA Section 3(18)(B) requires two factors.

First, good faith requires a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation.

Second, the fiduciary performing the valuation should itself be independent to all parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent to all parties to the transaction (other than the plan).[9]

If the financial adviser determines that the sale transaction proceeds represent adequate consideration to the ESOP, then the transaction is considered to meet the "absolute" fairness threshold.

Relative Fairness

The trustee's financial adviser may also be asked to determine the "relative" fairness of the transaction to ESOP participants. It is possible for a transaction to be fair in the aggregate (i.e., the total price is fair to all shareholders) but still be unfair to certain owners (i.e., the ESOP participants).

The financial adviser analyzes the transaction proceeds to all shareholders and any deal incentives for the sponsor company board to determine whether the transaction is fair to the ESOP on a relative basis.

In instances where the ESOP is not the sole shareholder, different forms of consideration may be offered to the various parties to the sponsor company sale transaction. When different forms of consideration are offered, it may be appropriate for the financial adviser to perform an internal rate of return ("IRR") analysis for the transaction participants. The relative IRRs can affect whether the proposed transaction is fair to the ESOP from a financial point of view.

In a sale transaction, the ESOP trustee may prefer to receive cash proceeds as of the transaction closing date to begin winding down the ESOP trust. The ESOP trustee may negotiate to receive cash consideration up front rather than participate in an earn-out or other form of contingent consideration.

Additional transaction considerations and incentives that the financial adviser may review as part of the relative fairness analysis include, but are not limited to, rollover equity, management compensation plans, and transaction bonuses.

With regard to management compensation plans, the ESOP trustee should be assured that the terms of such programs:

1. are reasonable and
2. do not unduly affect the proceeds that would be received by the ESOP.

If the terms of the deal do not properly account for these differences, it is possible that the deal may be fair to some shareholders of the sponsor company but not to other shareholders of the selling sponsor company. Disclosing these differences is not the same thing as accounting for these differences.

It is not required that the ESOP receive exactly the same economic return as other parties in the transaction. However, it is prudent for the ESOP trustee to consider:

1. what is the ESOP's return relative to the returns to all stakeholders and
2. whether the ESOP's—and the other parties'—returns are fair relative to the risks taken.

Transaction-Specific Analysis Considerations

A fairness analysis for the sale of the sponsor company involves an opinion on the fair market value of the sponsor company equity. The financial adviser estimates the fair market value of the proceeds received by the ESOP if other than cash, especially in the case where the acquiring company's stock will be exchanged for the sponsor company shares held in the ESOP.

The following factors may be considered by the financial adviser (1) as part of the fairness analysis and/or (2) to assist the trustee in assessing the proposed transaction:[10]

- Is the sale transaction a strategic acquisition, financial acquisition, or management buy-out (which has its own special considerations)?
- What are the overall terms and structure of the sale transaction?
- What are the income tax implications of the transaction?
- Are there any earn-outs or synthetic equity plans?
- How much of the transaction sale proceeds will be held in escrow and for what purpose(s)?
- How will the transaction affect the board and any key employees; that is, are there any noncompete, nonsolicitation agreements, employment agreements, or termination agreements?

- Is there an "internal" loan (i.e., a loan between the ESOP and the sponsor company), and, if so, how will this affect the distribution of the transaction sale proceeds to ESOP participants?
- What are the ESOP participant voting and disclosure requirements?
- Are there any other transaction considerations that may affect value or terms?

The financial adviser should provide the ESOP trustee with enough information to make an informed decision with respect to the financial aspects of the proposed transaction.

If the transaction requires a pass-through vote of the ESOP participants, then the financial adviser may be asked to share its analysis directly with the ESOP participants. The objective of this procedure is to educate the ESOP participants on the financial aspects of the proposed transaction.

Summary and Conclusion

In addition to the standard board level due diligence that is performed as part of any merger or acquisition transaction, the sale of an ESOP sponsor company includes certain requirements to ensure that the ESOP participants receive adequate consideration in the proposed transaction.

If the appropriate procedures are undertaken, the presence of an ESOP trustee can be beneficial to completing a successful sale transaction. There are numerous considerations for the trustee and the trustee's financial adviser when considering the financial benefits to ESOP participants of a proposed sponsor company sale transaction.

There is typically much more involved in reviewing the financial aspects of a sponsor company sale transaction than just assessing whether the proposed purchase price is greater than fair market value.

A thorough analysis of the transaction consideration and terms performed by a financial adviser—and encompassed in a fairness opinion analysis—should give the ESOP trustee confidence in its decision to accept, reject, or further negotiate the proposed sponsor company sale transaction.

Notes:

1. The trustee typically has a fiduciary duty for approving a stock purchase transaction. An asset purchase transaction involves a pass-through vote to the ESOP participants.
2. See ERISA Section 403(a). There are two caveats to the ESOP trustee's exclusive authority and discretion over the management of plan assets. First, the ESOP trustee may be "directed" by another named fiduciary according to the plan documents and not contrary to provisions of the ERISA. Second, the ESOP trustee may delegate the management of certain plan assets to an investment manager. The ESOP trustee typically has exclusive authority when assessing a proposed ESOP employer stock purchase transaction.
3. ERISA Section 404(a)(1)(A).
4. David Ackerman, Questions and Answers on the Duties of ESOP Fiduciaries (Oakland, CA: National Center for Employee Ownership, 2008), 32.
5. Ibid., 46.
6. Ibid., 55.
7. ERISA Section 3(18)(B).
8. DOL Proposed Regulation Section 2510.3-18(B)(2).
9. Ibid., Section 3(18)(B)(3)(ii).
10. See "Fairness from a Financial Point of View: Financial Advisory to the ESOP Trustee in a Sponsor Company Sale Transaction" by Terry G. Whitehead, CPA, featured in the Willamette Management Associates Spring 2020 *Insights* edition for a specific discussion of the financial adviser's analysis with respect to a proposed transaction.

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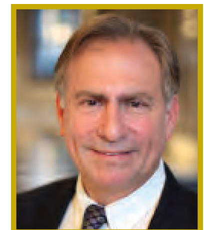

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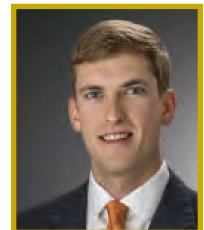

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Willamette Management Associates provides specialized financial advisory services for ESOP sponsor companies and other closely held corporations. Willamette Management Associates is recognized as a thought leader among business valuation, forensic analysis, and financial opinion firms. Since the passage of ERISA in 1974, we have provided financial advisory services to ESOP trustees, to other ESOP professional advisers, and to ESOP sponsor companies in virtually every industry and profession.

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Best Practices Discussion

Disputes and Litigation in Merger and Acquisition Transactions

Stockton De Laria and F. Dean Driskell III, CPA

Merger and acquisition ("M&A") transactions are often complex, and such transactions can result in a dispute between the buyer and the seller. Two of the more frequently disputed components of M&A transactions involve (1) transaction price earnout provisions and (2) post-closing purchase price adjustments. This discussion addresses (1) the advantages and disadvantages of various M&A transaction structures, (2) typical types of earnout provision and post-closing price adjustment disputes, and (3) transaction structuring and transaction procedures to minimize the likelihood of M&A transaction disputes and litigation.

Introduction

It would be an unusual day to open the *Wall Street Journal* (or more likely click the WSJ icon on your tablet or laptop)—or tune into your favorite business talk show—and not read or hear a story about a dispute involving participants in a merger and acquisition ("M&A") transaction.

Such disputes often lead to lengthy and costly litigation. Such disputes typically involve disagreements over (1) the price paid (or the value received) for the M&A transaction, (2) various transaction price earnout provisions, or (3) some other small detail hidden in one of the hundreds of pages of the transaction purchase agreement.

The standard practices of confidential settlements and nondisclosure agreements often preclude analysts from determining the actual cost of litigation in these transactions.[1] However, a quick look at the largest law firms in the United States provides some perspective on the legal resources focused on M&A transactions.

Data from the Am Law 100 shows that it is not unusual for a larger law firm to have over 500 partners and associates focused on M&A. In fact, several Am Law firms have more than 650 lawyers assigned to their M&A practice group.[2]

Legal representation is a necessary expense for the transacting parties, especially during the document drafting and the transaction negotiation phases. However, costly post-transaction litigation should be avoided.

While buyers and sellers often utilize insurance to offset a portion of the cost of disputes, disagreements between the parties do occur. And, such disagreement may lead to lengthy and disruptive arbitrations and litigation. This discussion highlights possible considerations for transactional parties with a focus on preventing future disputes.

An M&A transaction typically begins when the buyer approaches the seller—and, ideally, ends when the seller receives funds and the deal is closed. This period could take anywhere from a few months to several years.

It is important to draft, negotiate, and ultimately agree upon the specific terms of the transaction before close. If one party is unhappy after the transaction, it may lead to litigation—the terms may fall

under rigorous and expensive scrutiny. Transaction participants—and transaction advisers—should understand how companies end up in these predicaments. This discussion starts at the beginning with transaction structuring and negotiation.

This discussion considers the advantages and the disadvantages of three typical M&A transaction structures:

1. Asset purchase transactions
2. Stock purchase transactions
3. Mergers

Next, this discussion considers typical disputes in M&A transactions, more specifically, earnout provision and post-closing price adjustment provision disputes.

Earnout provisions provide contingency compensation to the sellers of the target company after the close of the transaction. Post-closing price adjustment provisions address changes in the assets and liabilities of the target company between:

1. the initial agreement on price and
2. the close of the transaction.[3]

This discussion summarizes many of the typical earnout provision and post-closing price adjustment disputes. Additionally, this discussion describes disputes over changes in account valuations, representations and warranties, material adverse changes, and issues of control.

Finally, this discussion recommends procedures that may be performed to minimize the risk of litigation in M&A transactions. These recommendations include mutually beneficial provisions and drafting considerations for accounting standards and for asset value calculations.

Asset Purchase Transactions

In an asset purchase transaction, the buyer purchases working capital accounts, tangible property, intangible property, and intangible value in the nature of goodwill. In addition, the buyer assumes agreed-upon liabilities. The seller receives the transaction compensation and retains ownership of the existing legal entity.[4]

Tangible property may include assets such as machinery, equipment, and real estate. Intangible property may include intellectual property and human capital. Agreed-upon liabilities may include accounts payable and notes payable. Goodwill may be considered the amount paid by the buyer over and above the value of the working capital, tangible assets (net of liabilities), and identified intangible assets.

An asset purchase transaction may be advantageous from the buyer's perspective. However, both parties still have several advantages and disadvantages to consider before entering into such a transaction.

Exhibit 1 provides a list of the primary advantages and disadvantages of an asset purchase transaction structure.

Exhibit 2 provides a simplified diagram of a typical asset purchase transaction.

From the buyer's perspective, one of the more apparent benefits of an asset purchase transaction is the selective assumption of liabilities. Generally, the buyer negotiates to assume a narrow list of liabilities within the ordinary course of business and broadly excludes any other obligations.[5]

For example, a buyer may assume the accounts payable and the liabilities associated with assignable contracts, but the buyer may exclude litigation-related and unidentifiable liabilities. The ability to carve out liabilities may save the buyer time and money while conducting due diligence.

Asset purchase transactions also have favorable income tax implications for the buyer. Generally, both parties agree on a purchase price allocation into seven identified asset classes, as required by Internal Revenue Code Section 1060.[6] This purchase price allocation agreement typically establishes both the income taxes to be paid by the seller and the new asset tax basis for the buyer.

The buyer may step up the depreciable basis of the acquired tangible assets and may amortize the acquired goodwill on a straight-line basis over 15 years.[7] The depreciation and amortization increase future tax deductions and decrease future taxable income. The resulting income tax savings may allow the buyer to generate more cash flow from the assets post-acquisition. These depreciation and amortization deductions enable the buyer to recoup a large portion of the purchase price from the government.

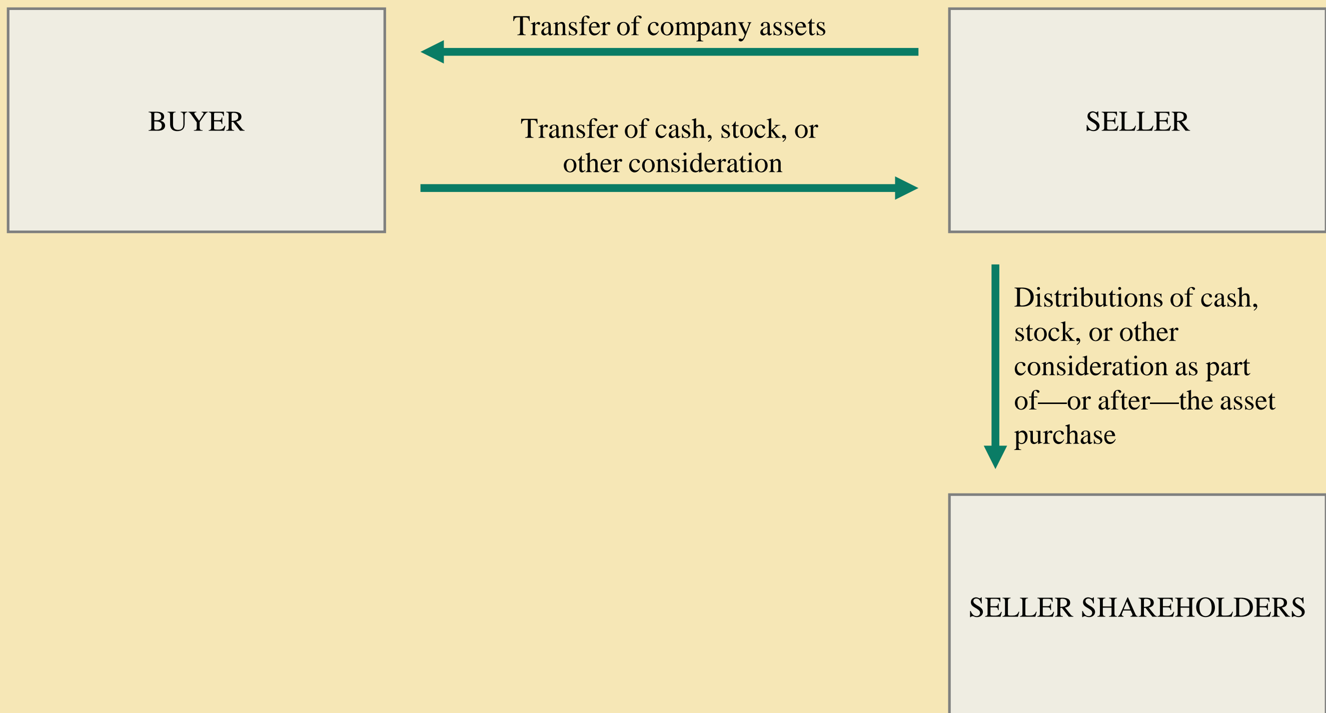
Further, an asset purchase transaction may allow the buyer to bypass the target's noncontrolling shareholders—because the target entity remains intact. Finally, the buyer may elect to forego any unfavorable existing employment agreements and selectively retain employees.[8]

The primary disadvantage to the buyer is that the seller often demands a higher transaction purchase price. The buyer may have to renegotiate vendor,

Exhibit 1
Asset Sale Transaction Structure
Transaction Structure Advantages and Disadvantages

ASSET PURCHASE TRANSACTION CONSIDERATIONS		
	BUYER	**SELLER**
TRANSACTION STRUCTURE ADVANTAGES	• Income tax benefit: Step-up in the depreciable basis of acquired tangible assets • Income tax benefit: Amortization of the acquired intangible assets • Selective assumption of liabilities • Due diligence may be less costly • Noncontrolling shareholders have less price negotiating power • Selective retention of company employees	• Stronger price negotiation position for a higher transaction sale price
TRANSACTION STRUCTURE DISADVANTAGES	• Weaker price negotiating position • May need to renegotiate vendor, supplier, and employment contracts • May need to retitle all of the transferred assets	• Income tax burden: Double taxation • May need to liquidate any residual assets • Retention of many recorded and all contingent liabilities • Responsibility to terminate leases and other contracts

Exhibit 2
Asset Sale Transaction Structure
Simplified Transaction Structure Diagram



supplier, and employment contracts as well as retitle the purchased assets. But all these issues may be worth the price premium paid by the buyer due to (1) the income tax benefit and (2) the avoidance of contingent and unknown liabilities.

From the seller's perspective, the only substantial advantage is a strong price negotiation position. The seller may leverage the multitude of benefits for the buyer (1) to secure a higher purchase price or (2) to negotiate a favorable carve out of liabilities and a favorable purchase price allocation.[9]

Upon completion of the transaction, the primary disadvantage to the seller is a higher income tax liability. The seller of a C corporation typically faces double taxation at the entity and owner level.[10]

The agreed-upon allocation of the sale price determines any gain recognized by the seller. The target company pays federal and state income tax on the gain; then, the shareholders pay taxes on the distribution of the sale proceeds to the individual shareholders. Tax pass-through entities—such as S corporations—may avoid double-taxation issues and may be more willing to enter an asset purchase transaction.[11]

Finally, if assets or obligations remain with the target company, the sellers may be unable to walk away until they wind down the company's legal entity. Assets on the target company's balance sheet may need to be managed or liquidated. Liabilities may need to be paid off—either from the proceeds of the sale or from income-generating assets. And existing leases, contracts, and employee agreements may need to be renegotiated or terminated.[12]

Stock Purchase Transactions

From an income tax perspective only, a stock purchase transaction is often structured as either a Section 368 tax-free exchange or a Section 338 election (where the sale of stock is treated—for income tax purposes only—as a sale of assets). Both structures accomplish the same goal of transferring ownership of a corporate entity without changing the ownership of the underlying assets and liabilities. However, a Section 338 election treats the transaction as a sale of stock for legal purposes and as a sale of assets for federal income tax purposes.[13] Both types of income tax structures have advantages and disadvantages for the buyer and the seller.

Exhibit 3 provides a list of the primary advantages and disadvantages of an asset transaction.

Exhibit 4 provides a simplified diagram of a typical stock purchase transaction structure.

In a tax-free exchange stock transaction (e.g., the typical cash-for-stock or stock-for-stock exchange), the seller may benefit from a lower income tax liability and from the retention of fewer contingent and unknown liabilities. The sale of the corporation stock does not create a taxable gain or loss at the target company level. Instead, both C and S corporation shareholders incur capital gains on the sale of their stock.[14] Any disadvantage to the corporation stock seller is the likely discount to the transaction sales price for any potentially unknown liabilities.

"In a stock purchase transaction (compared to an asset purchase transaction), the buyer will primarily benefit from simplicity."

In a stock purchase transaction (compared to an asset purchase transaction), the buyer will primarily benefit from simplicity. Since the buyer purchases the stock—and not the individual assets of the corporation—the assets do not need to be revalued or retitled. Typically, any existing contracts with the corporation, such as nonassignable licenses and permits, remain intact. In some jurisdictions, the buyer may avoid transfer taxes because the legal title of the asset remains with the corporation.

There are also several disadvantages to the buyer for structuring an M&A transaction as a stock purchase. The buyer would not receive a step-up in the tax basis of the individual acquired assets. Such assets transfer at a carryover tax basis.[15] Essentially, the buyer cannot benefit from the higher depreciation and amortization deductions that decrease the future tax expense in an asset purchase transaction.

The buyer generally assumes all liabilities unless the seller agrees to take back or pay off any existing liabilities. The buyer may inherit future unknown liabilities such as lawsuits, environmental concerns, employee issues, or other liabilities that carry over with the corporation—unless such liabilities are mitigated in the representations, warranties, and indemnifications agreements.[16]

The buyer may also have to deal with complicated securities laws associated with the acquisition of a corporation with many shareholders.[17] The level of shareholder support required to pass the deal will depend on the transaction structure and the jurisdiction. Noncontrolling shareholders that do not want to sell may lengthen the process and increase the purchase price.[18]

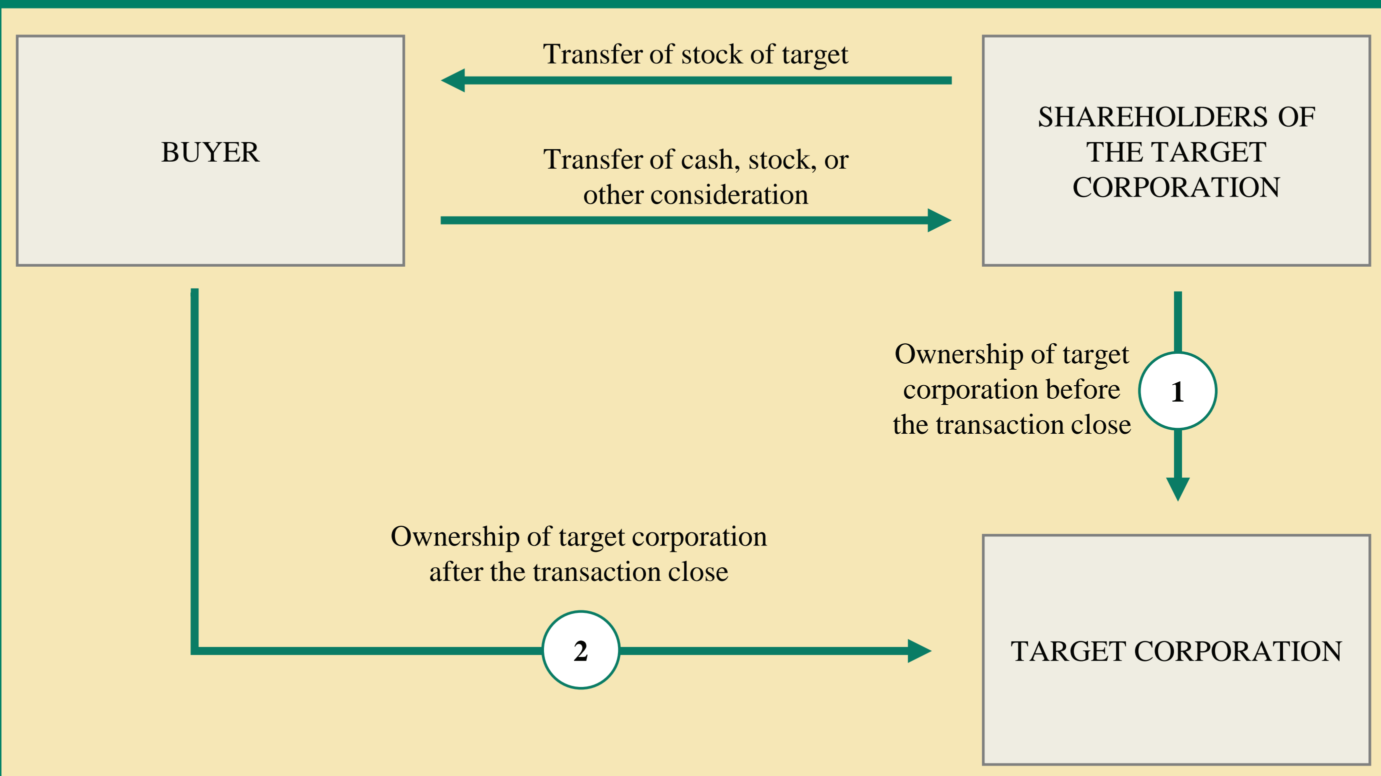
Finally, the buyer is not able to claim amortization tax deductions in a stock purchase structure.

In 1982, the United States Congress enacted Internal Revenue Code Section 338. A Section 338

Exhibit 3
Stock Purchase Transaction Structure
Transaction Structure Advantages and Disadvantages

STOCK PURCHASE TRANSACTION CONSIDERATIONS		
	TO THE BUYER	**TO THE SELLER**
TRANSACTION STRUCTURE ADVANTAGES	• No need to revalue and retitle the transferred assets • Assumption of all licenses and permits • May avoid transfer taxes in some jurisdictions • Simplified structure	• No entity-level taxable gain • Fewer contingent and unknown liabilities
TRANSACTION STRUCTURE DISADVANTAGES	• No step-up in the depreciable tax basis of acquired tangible assets • No tax amortization of acquired goodwill • Assumes all liabilities unless the parties agree otherwise • Potential for future lawsuits • Requires compliance with state securities laws	• Pricing in the transferred liabilities may lower the corporation sale price

Exhibit 4
Stock Sale Transaction Structure
Simplified Transaction Structure Diagram



tax election allows the buyer to treat the stock purchase as an asset purchase for federal income tax purposes.[19] The main downside to a Section 338 election is that it could increase the seller's income tax burden. This is because both the corporation level and the shareholder level are taxed. The Section 338 election only makes economic sense if the present value of future income tax savings exceeds the immediate income tax cost of the election.[20]

Accordingly, for a C corporation seller, a Section 338 election only makes sense in rare instances. Section 338 includes two separate elections: Section 338(g) and Section 338(h)(10). The Section 338(g) election only applies to a C corporation and it is made unilaterally by the acquirer after the transaction. The Section 338(h)(10) election is made jointly by the buyer and the seller before the transaction.[21]

Merger Transactions

The third M&A transaction structure is the merger. A statutory merger consolidates two or more corporations that are distinct legal entities into a single legal new or surviving entity that holds the combined assets and liabilities of the original companies.[22]

Generally, the acquired company receives cash, stock in the surviving company, or a combination of the two for compensation. Statutory mergers fall under the state law that governs the parties in the transaction.[23]

The buyer may prefer a merger structure because it only requires the majority consent of target shareholders. In other words, noncontrolling shareholders (1) may be forced into the merger and (2) may be required to sell their equity at fair value.[24]

Additionally, the buyer may be able to complete the merger without using any cash. Further, the buyer may avoid the costly and time-consuming revaluing and retitling that is involved in an asset purchase transaction.

Exhibit 5 provides a list of the primary advantages and disadvantages of a merger transactions.

Exhibit 6 provides a simplified diagram of a typical merger transaction structure.

Exhibit 7 provides a simplified diagram of a triangular-type merger transaction.

In contrast to the merger transaction advantages, merger transactions also present several disadvantages to the buyer. The buyer may need to create a new corporate structure or subsidiary, depending on the type of merger. The buyer also assumes all liabilities, known and unknown, which increases deal-related risk. Finally, the buyer may need an assortment of third-party consents to remedy anti-assignment provisions.[25]

A seller may benefit from a merger transaction structure because the stock compensation allows the seller to reap the future benefit of a successful, merged entity. Noncontrolling shareholders usually do not have the power to block the merger. However, the target company shareholders have the benefit

Exhibit 5
Merger Transaction Structure
Transaction Structure Advantages and Disadvantages

MERGER TRANSACTION CONSIDERATIONS		
	TO THE BUYER	TO THE SELLER
TRANSACTION STRUCTURE ADVANTAGES	• Usually requires majority consent of the target company shareholders • Possibility of a cashless transaction • Avoidance of revaluing and retitling the transferred assets • Tax treatment as a tax-free reorganization	• Equity compensation tied to the future success of the buyer • Dissenting shareholder appraisal rights • Potential income tax treatment
TRANSACTION STRUCTURE DISADVANTAGES	• May need to create a new corporate structure or subsidiary • Assumption of all of the liabilities • Third-party consents may be required • Requirement for federal, state, and regulatory filings	• Noncontrolling shareholders usually lack the power to block the merger • Potential income tax treatment • Requirement for federal, state, and regulatory filings

Exhibit 6
Merger Transaction Structure
Simplified Transaction Structure Diagram

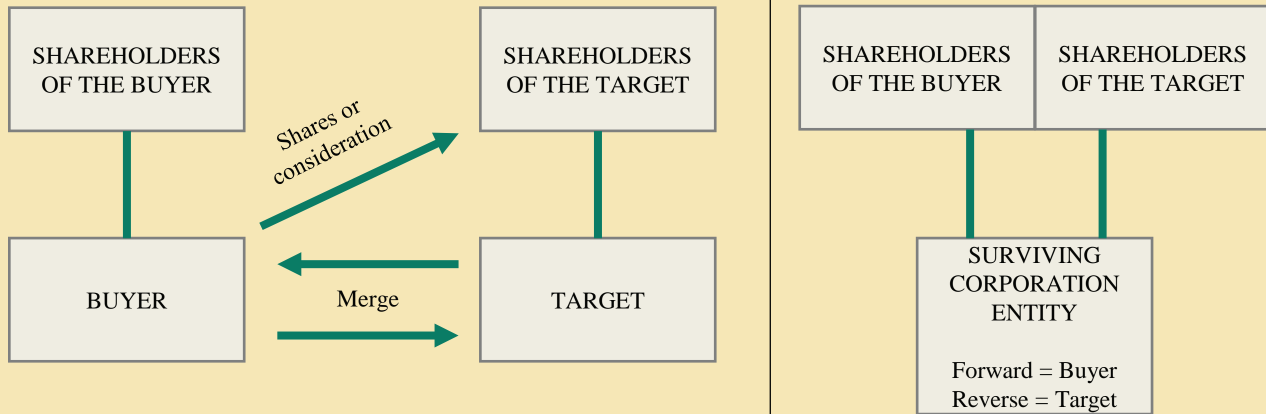
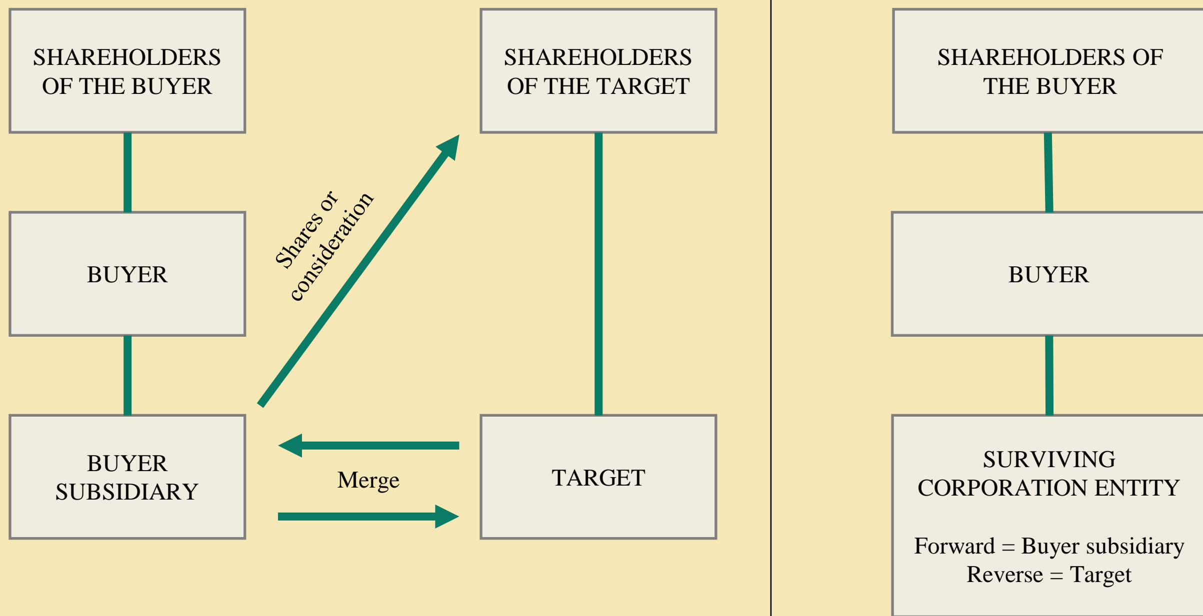


Exhibit 7
Triangular Merger Transaction Structure
Simplified Transaction Structure Diagram



of dissenting shareholder appraisal rights—that is, the right to receive the appraised fair value of their shares.

While this shareholder right provides a clear way out for noncontrolling shareholders who do not wish to sell, it also could lead to disputes regarding the "fair value" of the target corporation shares.[26]

Regarding the income tax treatment and the paperwork involved, there are both advantages and disadvantages to the buyer and the seller. Mergers could have an income tax treatment similar to an asset purchase, a stock purchase, or even a tax-free reorganization.[27]

Both transaction parties also have to fulfill the federal, state, and regulatory filing requirements, which may result in high legal costs.

Transaction Process and Timing

Much of the analysis related to the transaction structure discussed above occurs after a tentative "go/no-go" decision is made by the buyer and the seller. After considering all of the strategic, financial, regulatory, and risk issues, the parties determine whether or not to move forward.

If both parties are a "go," the next procedures generally involve performing due diligence, negotiating a definitive agreement, and executing the transaction.[28]

Exhibit 8 provides a simplified diagram of the four phases of a typical merger and acquisition transaction profile.

During the valuation process, the buyer determines a range of fair values for the transaction. These values may include scenarios that may or may not consider post-merger synergies.

Some merger synergies may consist of the elimination of duplicative functions (such as accounting or human resources). In contrast, other merger synergies include more speculative items, such as increased margins due to decreased competition.

The due diligence process often takes place concurrently with the valuation analysis. The purpose of due diligence, from the buyer's perspective, is to understand the details of the operational and financial aspects of the target corporation. Areas of inquiry during due diligence may be extensive and include the following considerations:

- Financial—Financial statements, audits, EBITDA (earnings before interest, taxes, depreciation, and amortization) calculations, GAAP considerations, risk of cash flow, unrecorded accounts, off-balance-sheet assets and liabilities

Exhibit 8
Four Phases of a Typical Merger and Acquisition Transaction

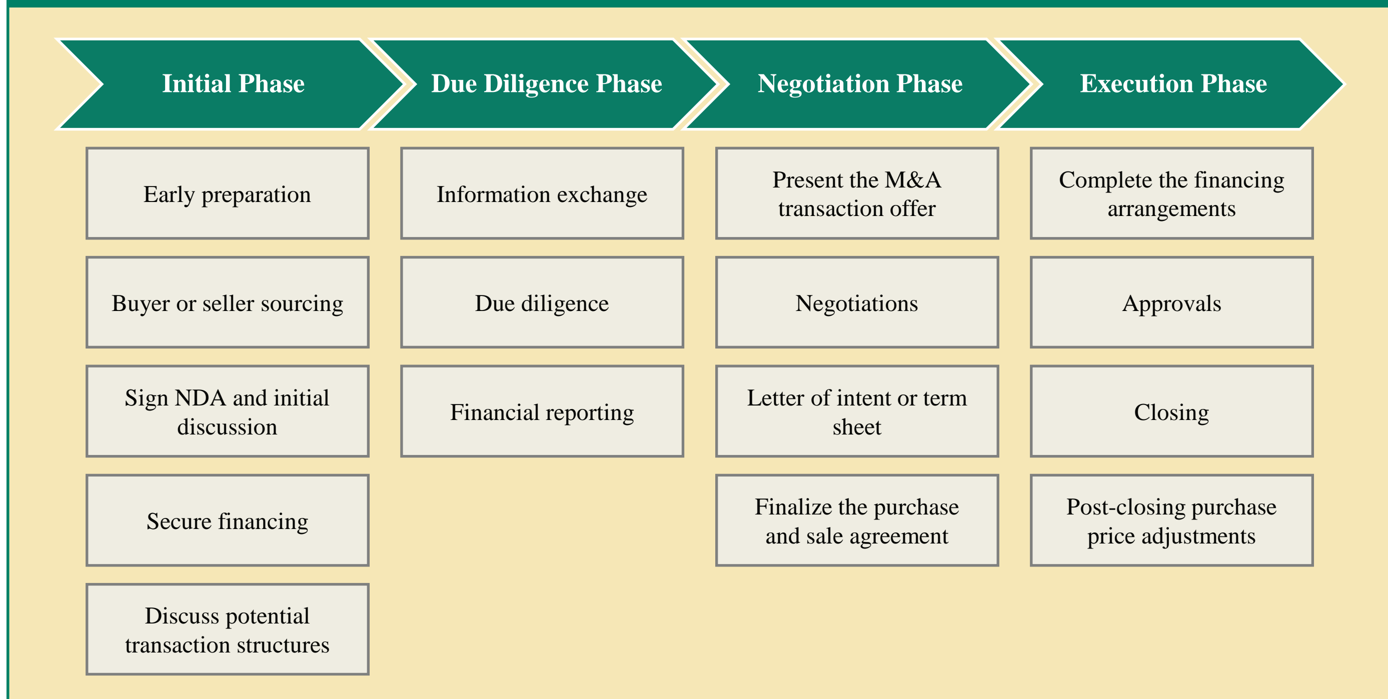


Exhibit 9
Hypothetical Example of a Transaction Earnout Provision

SIMPLE EARNOUT EXAMPLE:

BigCo recently bought SmallCo using an earnout. Based on the historical financials for SmallCo, the buyer was confident that SmallCo could achieve $15,000,000 in sales the next year at a 10 percent EBITDA margin. However, the seller strongly believed that SmallCo would be able to achieve $16,000,000 in sales the next year at the same 10 percent EBITDA margin. Both parties agreed that 6.0x EBITDA was a fair valuation multiple for SmallCo. The different sales assumptions created a $600,000 difference in value of SmallCo. BigCo agreed that the seller should have the opportunity to earn the additional value. Initially, the seller wanted to earn the additional consideration in proportion to the sales generated next year in excess of $15,000,000 up to $16,000,000. The buyer disagreed with a sales milestone fearing that the seller would increase sales without regard to profitability. The buyer suggested the earnout be tied proportionally to the EBITDA for next year in excess of $1,500,000 up to $1,600,000. The seller was concerned over the buyer's ability to manage the financials to minimize an earnout tied to EBITDA. The parties compromised by tying the earnout to gross profit. The seller had the opportunity to earn a sliding percentage of $600,000 proportional to the gross profits generated in excess of $5,250,000 up to $5,600,000 for the next fiscal year.

VALUATION PROJECTIONS		
	Seller	Buyer
Revenue	16,000	15,000
Gross Profit	5,600	5,250
Gross Margin	*35%*	*35%*
EBITDA	1,600	1,500
EBITDA Margin	*10%*	*10%*
EBITDA Multiple	6.0	6.0
Target Value	**9,600**	**9,000**

EARNOUT DECISION

$$\$600{,}000 \times \frac{Gross\ Profit\ for\ next\ FY - \$5{,}250{,}000}{350{,}000}$$

- Intellectual property—Assessment of patents, trademarks, copyrights, trade secrets, customer lists
- Customers/contracts—Concentration and quality of customers, agreements, and contracts
- Litigation—Pending litigation, contingent liabilities
- Tax issues—Litigation, disputes, aggressive positions
- Regulatory issues—Governmental disputes, compliance issues
- Insurance—Analysis of insurance agreements
- Corporate—Legal, board issues, corporate structure
- Environmental—Unrecorded liabilities, contingent liabilities, area of concern
- Related-party issues—Family members, affiliated entities, controlling parties

The next procedures in the M&A process are the negotiation of the price and the detailed written purchase agreement. In this process, both the buyer and the seller attempt to maximize their self-interests and minimize risks. For the buyer, this means reducing the cash paid at closing. Generally, the seller wants to collect all of the sale proceeds up front.

To bridge the gap between the cash wants of the buyer and the seller, some type of earnout payment may be offered. An earnout payment is additional future compensation paid to the sellers of the target company after the transaction close date.

Generally, any earnout payment depends on the company meeting specific predetermined targets in the periods following the sale. Earnout agreements have become popular in middle market, private company M&A transactions. However, both buyers and sellers should beware that these agreements frequently end in disputes and litigation.[29]

Finally, once a purchase price is determined and the purchase agreement signed, there is typically a balance sheet of the acquired entity prepared by the seller as of the agreement date. Due to the passage of time between the agreement date and the transaction close date, most M&A transaction agreements include a mechanism to adjust the purchase price after closing. The adjustment will account for the change in balance sheet accounts. Such adjustments are referred to as "post-closing adjustments."

As with earnout agreements, post-closing price adjustments are often disputed, subject to opportunistic behavior, and frequently litigated.

Earnout Provisions

Earnout provisions are popular, especially with private equity buyers who wish to retain the previous

management. For example, a buyer may propose annual earnout payments (1) for each year that key management personnel stay in place or (2) for meeting specific employee retention or customer retention goals.

There are other reasons why earnout provisions are used in M&A transactions. Earnouts may bridge valuation opinion or profitability projection differences between the buyer and the seller.

For instance, Exhibit 9 provides a simplified hypothetical example of an earnout provision.

While an earnout provision seems like a perfect compromise to bridge any valuation gap, the sellers may want to consider (1) whether the buyer is offering the earnout as an opportunity to capitalize on future performance or (2) whether the buyer is trying to undercut the current fair value by leaving a portion of the total consideration to chance.

An earnout provision can be tied to nearly any target or metric that affects the likelihood of a payout. The parties should take care before entering into an earnout agreement.

The Delaware Court of Chancery commented on the tendency of earnouts to lead to disputes saying:

> disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. . . . But since value is frequently debatable, and the causes of underperformance equally so, an earnout often converts today's disagreement over price into tomorrow's litigation over the outcome.[30]

There are several types of disputes that may result from earnout agreements. First, earnout metrics and targets are often disputed either informally or through arbitration or litigation. A partial list of such metrics includes gross revenue, gross profit margin, working capital, EBITDA, adjusted EBITDA, earnings before interest and taxes ("EBIT"), revenue growth, employee retention percentage, profit per customer, regulatory approvals, units sold, and the like.[31]

Even financial metrics such as working capital and EBITDA may be interpreted and calculated differently. For example, is cash on hand included in working capital? Are changes in revenue recognition policies consistent across periods?

Buyers and sellers should consider the following ways to minimize disputes over earnout metrics and the targets in an earnout agreement:

- Metrics should be clearly defined in the earnout agreement—along with specific examples of the earnout calculations.
- Earnout formulas are preferable to narrative text. For example, the illustrative earnout formula (Q2 20xx EBITDA – $2.5 million) × 5 percent is clear and concise.
- Define even the typical financial terms and include historical examples. For example, EBITDA is defined as earnings before interest, taxes, depreciation, and amortization. It may be important to be specific about other noncash items, if applicable.
- Agree on how to account for restructuring and integration expenses. These expenses may be significant and may drive down EBITDA and other metrics in early post-transaction periods.

Second, vague language in the earnout agreement often leads to disputes. It is typical for the agreement to state that financial targets should be calculated "in accordance with generally accepted accounting principles ("GAAP")." Alone and without context, this language can present problems.

Generally, GAAP does not require one method but instead provides guidance to the accounting practitioner. Two completely different accounting methods may be consistent with GAAP—but may also generate significantly different calculations.[32]

Additionally, a savvy buyer may change the target company's GAAP accounting post transaction to its benefit, creating inconsistent treatment. This can lead to additional questions, such as the following:

- Does the earnout agreement require consistency?
- Would the buyer or the seller have enough information to know if the calculations were inconsistent?

Consistency with GAAP can be problematic. This is because alternative calculations can all be consistent with GAAP.

The following suggestions may clarify the language in earnout agreements and help to avoid post-transaction disputes:

- Define the relevant accounting policies used by the corporation at the time of the agreement. For example, define and show examples of revenue recognition and account valuation policies and procedures.
- Include in the agreement that the buyer will continue to use "consistent" GAAP through

Exhibit 10
Transaction Purchase Price Adjustments
The Net Working Capital Adjustment
Illustrative Examples of Price Adjustments

Actual Net Working Capital at Close	$	1,200,000	Actual Net Working Capital at Close	$	800,000
Target Net Working Capital	$	1,000,000	Target Net Working Capital	$	1,000,000
Excess Net Working Capital	$	200,000	Shortfall in Net Working Capital	$	(200,000)
Buyer Pays to the Seller $200,000			**Seller Pays to the Buyer $200,000**		

the earnout period. Exceptions to this policy should be agreed to by both parties.

Third, the length of the earnout agreement may be problematic for either the buyer or the seller. Generally, earnouts range from 12 months to three years. However, it is not unusual to see longer or shorter earnout periods.[33]

Longer earnout periods tend to run into problems with the integration into the buyer's other companies and changes in accounting methods and principles. For example, the buyer may integrate the target company into existing businesses or other acquisitions and eliminate separate financial statements for the original entity.

In addition, both accounting guidance and GAAP change frequently. Such changes can lead to a change in the earnout calculation. Certain accounting and GAAP changes may have a material impact on the earnout calculations.

Shorter earnout periods have issues with "just missed" targets.[34] For example, if the seller was due a significant earnout payment for reaching a $10 million EBITDA milestone in the first quarter after the sale, but EBITDA totaled only $9.9 million, then the seller may argue that actions by the buyer precluded reaching the target.

Providing an extended earnout period to meet targets or including pro-rate payments for targets in the earnout agreement may minimize the likelihood of transaction disputes.

Finally, the purchase should be structured where the seller receives an up-front contribution for the value of the target company at the closing date. Any earnout provision should award future performance.[35]

Deferring too much of the purchase price to future periods may leave the seller feeling cheated and may lead to disputes and expensive litigation.

The parties may also develop a dispute resolution plan and include the details of such a plan in the earnout agreement. One way to minimize dispute costs is to seek the assistance of a forensic accountant. The forensic accountant may assist in putting together the plan and be the first line of defense in any initial dispute.

Post-Closing Purchase Price Adjustments

A majority of private-company M&A transactions include a mechanism to adjust the purchase price on a post-closing basis. Such adjustments are performed through post-closing purchase price adjustments. Such post-closing adjustments range from simple to complex.

Perhaps the most typical purchase price adjustment relates to changes in net working capital ("NWC"). However, price adjustments due to income, expense, assets, liabilities, and net assets also occur in M&A transactions.

NWC is the difference between current assets and current liabilities and measures the short-term liquidity of the company.[36] Generally, NWC disputes between buyers and sellers focus on whether (1) a particular account should be included or (2) a specific account is accurately measured. Such determinations are typically based on GAAP.

The primary purpose of such purchase price adjustments is to protect the buyer from fluctuations or changes in the target company's financial condition from the time the purchase price is agreed upon to the time of closing. The NWC adjustment is often included in the purchase agreement to ensure that the transacting parties (1) arrive at an agreed upon purchase price and (2) are not negatively affected by changes in working capital.

Generally, the parties establish a targeted level of working capital in the purchase agreement. This target NWC is used as the basis for the adjustment at the close. As seen in the example below, the buyer

would generally pay the seller if NWC is greater than the target NWC. When actual NWC is lower than the target NWC, the seller generally pays the buyer.[37]

Exhibit 10 provides a simplified example of a net working capital purchase price adjustment.

Negotiating the terms and other aspects of any purchase price adjustments is important to avoid disputes. For the NWC example above, the determination of target NWC is important, and it may have a significant impact on the final purchase price.[38]

Whether the purchase price adjustments include provisions for NWC, net assets, or other metrics, the buyer and the seller should agree in principle on both the definition and the calculation of these items. Generally, it is helpful to include examples of the calculations and historical information in the purchase and sale agreement. This procedure mitigates some of the potential misunderstandings between the parties, and it provides more consistent treatment between periods.

The parties should agree on the manner of calculating NWC. The buyer will often prefer calculations in accordance with GAAP, whereas the seller will often prefer to maintain the target's previous practices for calculating NWC.[39]

As with earnout agreements, accounting principles and estimates may significantly affect purchase price adjustments. The buyer and the seller should agree to exclude changes in accounting principles that may occur during the transaction period for post-closing adjustment purposes. This agreement may eliminate one party using changes in accounting rules to harm the other.

Accounting estimates can be important to post-closing adjustment measurement. A list of potential accounting estimates affecting post-closing price adjustments includes the following:

- Inventory valuations
- Allowance for doubtful accounts
- Contingent liabilities
- Accruals

The accounting profession provides significant guidance on inventory valuation methods, but it leaves many of the decisions to the practitioner. FIFO (first-in, first-out), LIFO (last-in, first-out), and WAC (weighted average cost) are all inventory valuation methods acceptable under GAAP. Each inventory valuation method may produce different cost of sales for the target company.

In addition, the write-off of unusable or obsolete inventory may be used to manipulate the adjustments. The buyer and the seller should agree to consistent accounting treatment, and any changes to the accounting principles or asset write-offs should be agreed to by both the buyer and the seller.[40]

The allowance for doubtful accounts is the amount of the accounts receivable balance that is estimated to be uncollectible. Generally, this amount is based on a historical percentage of accounts receivable. As with inventory valuation, the buyer and the seller should agree to consistent treatment. Both parties should approve any variation to the historical calculation of net accounts receivable and any specific (material) write-offs.

The accounting treatment for contingent liabilities is somewhat subjective. For example, an expense is accrued (1) if the liability is probable and (2) if the expense can be estimated. Warranties and litigation are types of contingent liabilities, and both are difficult to estimate. The buyer and the seller should reach a consensus on how to treat contingent liabilities before the transaction close.

Accruals typically contain some type of estimate, and estimates are subjective in nature. Disputed accruals may include estimates for bonus compensation, pension obligations, legal fees, litigation costs, remediation, and tax expense.[41] The buyer and the seller should agree in advance on all relevant accruals. This procedure minimizes the likelihood of disputes.

Other potential disputes involving post-closing adjustments include the following:[42]

- Cross border accounting—Transactions across borders with different accounting and tax regulations may complicate post-closing adjustments. The implementation of the International Financial Reporting Standards minimized differences in accounting for public companies, but accounting treatments may significantly differ across borders for private entities.
- Interim versus year-end reporting—Many companies make adjusting and valuation-type entries to the books and records only at the end of fiscal quarters or years. Therefore, without adjustments or updates, balance sheet or NWC calculations at interim dates may be incomplete or inaccurate.
- Subsequent events—Unanticipated events occurring after the agreement date and before the close date may have a significant impact on the closing balance sheet or NWC calculations. For example, a global pandemic like COVID-19 may hinder a company's ability to collect accounts receivable.
- Materiality—The buyer and the seller may argue that a post-closing adjustment dispute is immaterial to the transaction. Generally,

courts and arbitrators disregard the materiality argument unless there are specific dollar amounts or thresholds specified in the purchase agreement. The reasoning is that the proposed adjustment (usually) causes a dollar for dollar adjustment in the purchase price, and any additional dollars are material to both the buyer and the seller.

Risk-averse buyers and sellers typically consider cross-border accounting, interim versus year-end financial reports, subsequent events, and materiality when drafting the purchase agreement. Specific language and examples contained in the agreement may minimize the risk of transactional disputes.

Finally, as with the earnout provisions, the buyer and the seller should avoid the boilerplate GAAP language. GAAP rarely requires specific accounting treatment and generally leaves the final decision on the application to the experience and judgment of the practitioner. The buyer and the seller should agree to consistent GAAP unless both parties agree to changes.

Other M&A Disputes

In addition to the earnout provisions and the post-closing price adjustment disputes discussed above, representations and warranties and material adverse change disputes also occur in M&A transactions.

The purchase agreement often contains a lengthy list of promises made by the seller to the buyer. These are known as the representations and warranties clauses. If breached by the seller, such clauses may allow the buyer to recover escrow funds or provide a basis for the buyer to sue for damages. Examples of potential representations and warranties include the following:

- Accuracy of financial statements—Any error or omission in the financial statements, regardless of materiality, may be a basis for representations and warranties claims.
- Undisclosed litigation—All potential litigation should be disclosed, including unfiled matters, and filed matters where management believes there is little chance of success.
- Undisclosed liabilities—Unpaid bills, litigation settlements, environmental claims, and so forth.
- Legality—Is the corporation properly formed? Are the articles of incorporation and other documents in good order? Is the corporation legally allowed to do business? Are the employees legally authorized to work? Are other documents in good order? Are there any tax or financial statement audit inquiries?
- Status of inventory—Is the inventory salable, obsolete, legal? Are the cost components correct? Are the inventory counts accurate and up to date?
- Employee benefits—Have employee tax withholding deposits been made? Are benefits records accurate, including vacation, sick, and comp time accruals?

The intention of each representations and warranties clause included in the purchase agreement is to protect—and provide potential remedies to—the buyer. The seller should carefully understand the representations and warranties and ensure that some immaterial amount or lack of disclosure does not lead to a dispute.

Material adverse change ("MAC") provisions are often used in purchase agreements to allow buyers to terminate M&A transactions should a significant (and material) impact to the company occur.[43] As with representations and warranties, MACs primarily protect the buyer and may be damaging to the seller.

Generally, MACs are used as negotiating tools by both the buyer and the seller. For example, in the Microsoft and LinkedIn acquisition in 2016, LinkedIn included the following exceptions to the MAC clause that would not qualify as a MAC:[44]

- Changes in general economic conditions
- Changes in conditions in the financial markets, credit markets or capital markets
- General changes in conditions in the industries in which the company and its subsidiaries conduct business, changes in regulatory, legislative or political conditions
- Any geopolitical conditions, the outbreak of hostilities, acts of war, sabotage, terrorism or military actions
- Earthquakes, hurricanes, tsunamis, tornados, floods, mudslides, wildfires or other natural disasters and weather conditions
- Changes in proposed changes in GAAP
- Changes in the price or trading volume of the company's common stock
- Any failure, in and of itself, by the company and its subsidiaries to meet any public estimates or expectations of

the company's revenue, earnings and other financial performance or results of operations for any period

- Any transaction litigation

Interestingly, there is no mention of a pandemic in the above list of exclusions.

Resolving Disputes

The best procedure to avoid disputes and costly litigation in an M&A transaction is to think through the potentially contentious issues while negotiating the transaction. Once the agreement is signed, the earnout period begins, and the parties make the post-closing adjustments, it is difficult to resolve issues without expensive third-party involvement.

Leaving the negotiation and drafting of the purchase agreement to the lawyers is not always a best practice. The involvement of forensic accountants can provide the perspective of a party that understands the company's financial position.

If a dispute is unavoidable, there are several procedures to potentially resolve the dispute in a cost-effective manner.

First, consider a confidential conversation with the opposing party. Sometimes a resolution may be reached without moving to mediation, arbitration, or litigation.

Second, consider seeking a neutral forensic accountant to review the transaction and the related earnout and post-closing adjustment issues. Often a neutral third-party accountant can explain terms and expectations to one party that the other party cannot. By this point, if both sides of the dispute have "dug in" and find it difficult to move from their stated position, an unbiased accountant may be able to bridge the communication gap.

Third, attempt a mediation resolution. A day with a mediator is typically much less expensive and time-consuming than arbitration. Involving the finance people on both sides may be one strategy with mediation. Often the finance teams can work through issues that the company executives and lawyers cannot.

Finally, if arbitration is warranted and an accounting firm is engaged, it may be advantageous to limit the scope of the arbitrator to the items of dispute and specify the ranges of potential changes to the earnout or the purchase price. This process generally focuses the efforts of the arbitrator, minimizes time and cost, and avoids opening up new areas of inquiry.

Summary and Conclusion

In today's operating environment, post-transaction litigation occurs often. However, such litigation may be avoidable if the transacting parties take extra care before a transaction is closed. An understanding of the motivations behind specific deal structures—such as asset transactions, stock transactions, and mergers—and an understanding of clauses that are particularly vulnerable to dispute—such as earnouts and purchase price adjustments—may positively influence the manner and magnitude to which the transacting parties address deal clauses in the negotiation and drafting stages.

By having such a high-level understanding, the transacting parties may know where to focus legal resources and may ultimately lower the possibility of a future dispute.

Notes:

1. Chubb reported in 2018 that the average settlement cost with the insurance company for M&A claims was $4.5 million for the years 2012 through 2016.
2. "Rising Volume and Cost of Securities Class Action Lawsuits is a Growing Tax on U.S. Business, Chubb Data Reveals," Chubb, accessed June 30, 2020, https://news.chubb.com/2018-07-10-Rising-Volume-and-Cost-of-Securities-Class-Action-Lawsuits-is-a-Growing-Tax-on-U-S-Business-Chubb-Data-Reveals.
3. Robert F Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor City, NJ: Valuation Products and Services, 2019), 966–967.
4. Some courts can rule an asset transaction as a de facto merger, and as such, attach all rights and liabilities of a merger to the original deal. The four general exceptions are "(1) the successor expressly or impliedly assumes the liability of the predecessor, (2) the transaction is a de facto merger or consolidation, (3) the successor is a mere continuation of the predecessor, or (4) the transaction is a fraudulent effort to avoid liabilities of the predecessor." Glenn West, "An Asset Purchase That Wasn't – Beware the De Facto Merger Doctrine in Distressed M&A," Weil, Gotshal & Manges LLP, May 4, 2020, https://www.jdsupra.com/legalnews/an-asset-purchase-that-wasn-t-beware-11698/.
5. "Asset Purchase vs Stock Purchase," Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/deals/asset-purchase-vs-stock-purchase/.
6. Internal Revenue Code Section 1060 mandates that the buyer and seller allocate the purchase price of the assets using the residual method to the asset classes in order of cash, actively traded personal property, receivables and assets marked-to-market, inventory or stock-in-trade,

other tangible property, intangibles other than goodwill and going-concern value, and goodwill and going-concern value. The parties individually report the allocation using Internal Revenue Service Form 8594.

7. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
8. Ibid., 7.
9. Ibid.
10. Lemuel Lim, "Basic Structures in Mergers and Acquisitions (M&A): Different Ways to Acquire a Small Business," Genesis Law Firm, PLLC, accessed June 30, 2020, https://www.genesislawfirm.com/asset-acquisition-stock-purchase-and-merger-structures.
11. David Boatwright and Agnes Gesiko, "Tax Strategies For Selling Your Company," Latham & Watkins LLP, accessed June 30, 2020, https://www.lw.com/upload/pubcontent/pdf/pub1311_1.pdf.
12. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
13. "Section 338 Elections," macabus, accessed June 30, 2020, https://macabacus.com/taxes/section338.
14. David Boatwright and Agnes Gesiko, "Tax Strategies For Selling Your Company," Latham & Watkins LLP, accessed June 30, 2020, https://www.lw.com/upload/pubcontent/_pdf/pub1311_1.pdf.
15. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
16. "Asset Sale vs. Stock Sale: What's The Difference?," Mariner Capital Advisors, https://marinercapitaladvisors.com/resources/asset-sale-vs-stock-sale-whats-the-difference/.
17. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
18. Majority shareholders can compensate noncontrolling shareholders for their support in what is known as a side payment. The IRS and U.S. Tax Court have historically held differing views on the treatment of side payment as either unrelated or related to the underlying transaction.
19. "Section 338," Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/accounting/section-338/
20. "Section 338 Elections," macabus, accessed June 30, 2020, https://macabacus.com/taxes/section338.
21. Ibid., 21.
22. "Outline of Legal Aspects of Mergers and Acquisition in the United States," no. 15 (September 2003): 1–8.
23. Ibid., 23.
24. Ibid.
25. "Outline of Legal Aspects of Mergers and Acquisition in the United States": 1–8.
26. Ibid., 27.
27. Boatwright and Gesiko, "Tax Strategies For Selling Your Company."
28. Lemuel J. Lim, "Overview of M&A Process," Genesis Law Firm, PLLC, accessed June 30, 2020, https://www.genesislawfirm.com/overview-merger-acquisition.
29. Reilly and Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, 966–967.
30. Airborne Health, Inc. v. Squid Soap, LP. 984 A.2d 126, 132 (Del. Ch. 2009) quoted in Kevin R. Shannon and Michael K Reilly, "Post-Closing Earnouts in M&A Transactions: Avoiding Common Disputes," *Deal Points: The Newsletter* (Winter 2011).
31. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, *Litigation Services Handbook: The Role of the Financial Expert*, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), Chapter 24, 1–36.
32. Ibid., 33.
33. Ibid.
34. Ibid.
35. Ibid.
36. Current assets include cash, cash equivalents, short-term investments, receivables, inventory, and prepaid expenses. Current liabilities include payable, accrued expenses, and the current portion of long-term debt.
37. Reilly and Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, 966.
38. George Haramaras, "Post-Acquisition Disputes: Working Capital Adjustments and Working Capital Disputes," *Willamette Management Associates Insights*, (Spring 2019): 44–50.
39. Ibid., 40.
40. Ibid.
41. Weil, Lentz, and Evans, *Litigation Services Handbook: The Role of the Financial Expert*, Chapter 24, 1–36.
42. Ibid., 43.
43. Ibid., (n 43).
44. "Material Adverse Change: The ABCs of MACs," Wall Street Prep, accessed June 30, 2020, https://www.wallstreetprep.com/knowledge/material-adverse-change-mac/.

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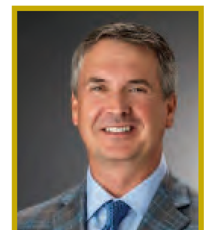
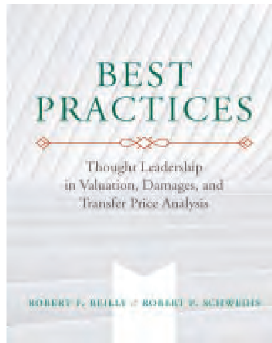
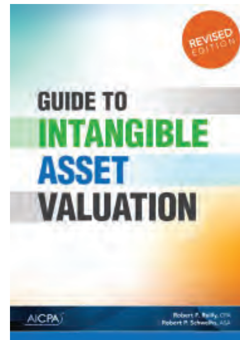
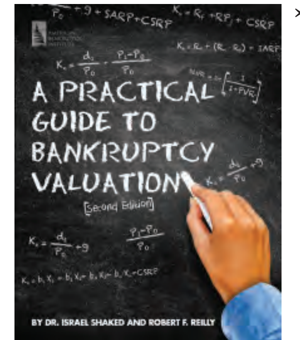


Valuation Textbooks Authored by Robert Reilly and Robert Schweihs







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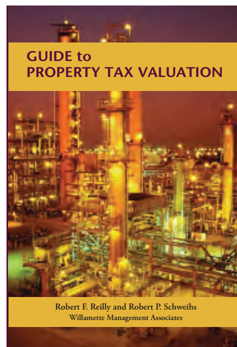

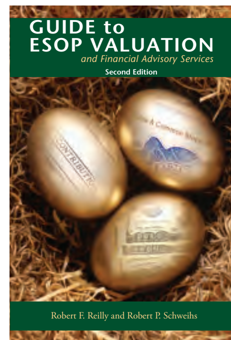

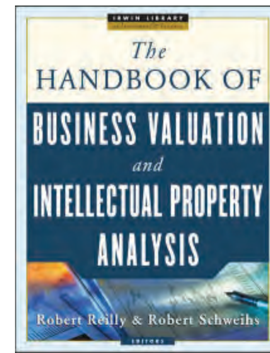

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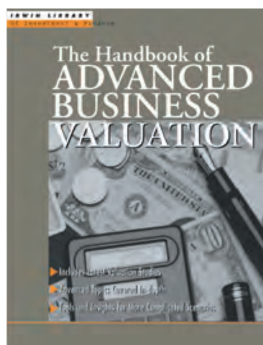

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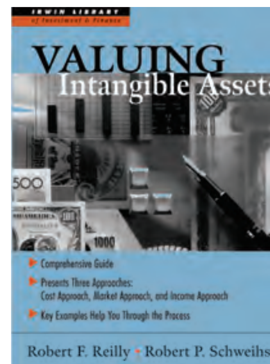

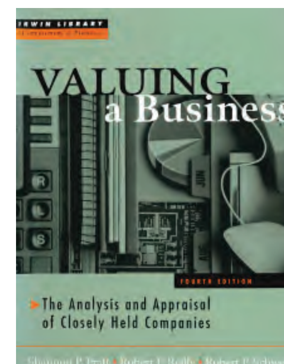

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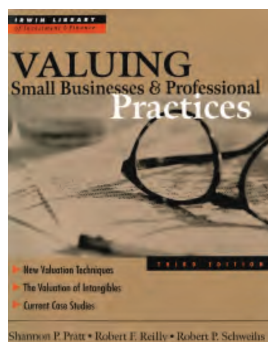

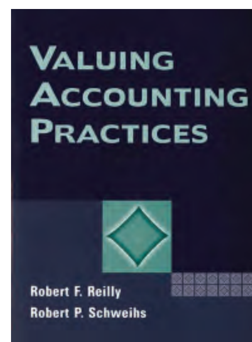

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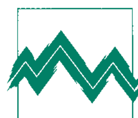

Willamette Management Associates

The Roles of the Investment Banker and the Valuation Analyst in M&A Transactions and Litigation

Samuel S. Nicholls

Valuation analysts ("analysts") are often retained to provide testifying expert services in disputes related to merger and acquisition ("M&A") transactions. Such analysts may also provide transaction fairness opinions as part of the M&A deal process. This discussion focuses on the roles of the investment banker and the valuation analyst—both during the M&A transaction and after the M&A transaction. This discussion also considers flaws in the M&A process and, particularly, in the transaction fairness opinion that can lead to post-transaction shareholder litigation. Lastly, this discussion considers how various courts have viewed the fairness of certain M&A transactions that suffered from a flawed process.

Introduction

As illustrated by recent Delaware Chancery Court and Delaware Supreme Court decisions on shareholder appraisal rights, merger and acquisition ("M&A") disputes often include elements of breach of fiduciary duty by the target company's board of directors or its special committee. Such alleged breaches often relate to the board's oversight of the M&A deal process. These disputes may also involve allegations of proxy violations related to inadequate disclosure of material information that investors should have been provided in order to make an informed decision when casting their votes.

In litigation, the parties to the lawsuit each typically retain a valuation analyst to estimate the fair value of the target company stock and to provide expert testimony.

Investment bankers and valuation analysts may also be retained to provide a fairness opinion related to a pending M&A transaction. A fairness opinion is a determination of whether or not the transaction consideration paid to the target's shareholders is fair from a financial point of view.

This discussion focuses on the following topics:

- The differences in the roles of the valuation analyst and the investment banker
- Events that can lead to M&A disputes and examples of when a court decided that the M&A deal process was flawed
- The typical fairness opinion process performed by the investment banker
- The use of management-prepared financial projections and examples of when these financial projections were accepted or rejected by a court
- The role of the investment bank in M&A transactions

The Roles of the Valuation Analyst and the Investment Banker

This discussion focuses on the roles of the independent valuation analyst and the investment banker under two circumstances. The first is the role of

each party in preparing a fairness opinion for an M&A transaction. The second is the role each party serves in preparing valuation opinions to used in post-transaction shareholder disputes.

Fairness Opinions for M&A Transactions

Valuation analysts are often retained to provide fairness opinions for private company M&A transactions. Rather than retain an investment banker, many private companies either retain a business broker or conduct the transaction with in-house staff. Many private companies may also be owned by private equity firms that have M&A expertise.

In instances where the private company is experienced in negotiating M&A transactions, the company may be capable of handling the deal process, especially if it was already approached by a potential acquirer. In those circumstances, only a fairness opinion may be needed for a particular transaction. If that is the case, the transaction financial advisory fees may be much less than what an investment banker would charge to provide both investment banking services and a fairness opinion.

Valuation analysts are not advocates for either the potential acquirer or the target company. Consequently, analysts do not accept contingency or performance-based fees. Instead, fees are typically based on an agreed-upon budget or standard hourly rates. And, such fees are usually lower than the success-based fees charged by investment bankers.

Since valuation analysts are not advocates, the role of the analyst is usually confined to providing a professional opinion regarding the fairness of the proposed or agreed-upon transaction consideration. The fairness opinion typically consists of a written opinion that may be accompanied by a financial analysis that concludes a range of value. The business valuation approaches (i.e., income approach, market approach, and asset-based approach) applied by the analyst are often the same approaches applied by the investment banker.

Unlike the investment banker, the development and the reporting of the analyst's valuation analysis typically complies with promulgated professional standards. These promulgated standards may include the Statement on Standards for Valuation Services or the International Valuation Standards.

In some cases, publicly traded companies, or private companies that are targets of a public company acquisition, may retain an investment banker to provide M&A advisory services. This retention may relate to a myriad of factors which may include mitigating litigation risk and the need for certain investment-banker-provided services. These services may include managing the deal process, soliciting bids, and negotiating the terms of the transaction.

Valuation analysts, on the other hand, generally do not provide such services, due in part to their inability to charge success fees which otherwise may undermine the analyst's independence. An additional explanation of the role of the investment banker in M&A is presented later in this discussion.

Valuation Opinions for Disputed Transactions

When a valuation analyst is retained as a testifying expert in a disputed M&A transaction, the work product typically consists of a written valuation expert report with exhibits. The valuation expert report and exhibits may be more comprehensive than either (1) the investment banker's work presented in the proxy materials or (2) the investment banker's materials presented to the board of directors or the special committee.

Settlement discussions may occur in the litigation after the exchange of expert reports. If a settlement is not reached after the exchange of expert reports, each expert may be asked to analyze the work of the opposing expert—and to prepare a rebuttal report. Rebuttal reports respond to the analyses, inputs, and opinions of the expert hired by the counterparty to the litigation.

Following the issuance of rebuttal reports, each expert may be allowed to respond to the rebuttals prepared by the other expert. If a settlement still has not been reached, then deposition testimony, and potentially trial testimony, will proceed.

There may be differences in the valuation inputs selected by valuation analysts serving as experts in litigation versus those selected by investment bankers retained for M&A. Among these differences is the valuation date. The valuation date applied by the valuation analyst may be the date the subject transaction closed. The valuation date applied by the investment bankers may be the date the transaction was approved by the board of directors. Due to the passage of time between the two valuation dates, there may be differences in the valuation variables applied by the investment banker versus the valuation variables applied by the valuation analyst.

Some of these differences, such as the present value discount rate, may be material. That may be the case if the target company's market capitalization from one date to the other leads to a material difference in the debt to equity ratio used for calculating the weighted average cost of capital.

Another difference is the quality of the analysis and the work product. The investment banker's work product may be produced by bankers who do

not have technical training in valuation practices and standards. This lack of valuation training may lead to unsupported judgments.

As an example, an investment banker's selected cost of debt (for the weighted average cost of capital calculation) may lack support. The banker may ask one of the bank's fixed-income traders or credit analysts what rate they would charge to the target company. In contrast, the analyst may estimate a cost of debt based on an extensive analysis of market-based yields of guideline debt securities.

The valuation analyst may also estimate a weighted average market-based yield if the target company has diverse business units with different credit profiles and different costs of capital.

Investment banks are not typically retained to prepare expert analyses and expert reports—or to provide expert testimony—in connection with shareholder disputes that arise from M&A litigation. However, the banker may be required to testify as a fact witness if the bank provided advisory work and/or a fairness opinion in the disputed M&A transaction.

Events That May Lead to M&A Disputes

Some observers believe that a robust pre-signing market check may result in a higher final bid than otherwise. Some observers believe that a post-signing, go-shop period yields little transaction pricing benefit.

This is because any new bidder in a go-shop period has a ticking clock to submit a higher bid. That new bidder often lacks the necessary time to conduct the same level of due diligence that was conducted by earlier bidders.

Deal processes may be considered as flawed if there appears to be too much reliance on a go-shop period—rather than the pre-signing period—to extract the highest price. This was one area of dispute in the *In re Appraisal of Dell Inc.* judicial decision.[1]

Legal counsel sometimes find it challenging to identify flaws in the deal process prior to the litigation discovery procedure. This is because proxy statements do not always provide sufficient detail about the deal process.

To avert disputes, sometimes proxies provide a detailed time line of all discussions. The level of disclosure may be an area of contention between counsel who represent entities involved in a transaction and counsel who represent shareholder plaintiffs.

The following discussion summarizes several judicial decisions where the court determined that the M&A deal process was flawed.

Blueblade Capital Opportunities LLC v. Norcraft Companies, Inc.[2]

- The deal price was previously rejected as too low by the target's board of directors.
- The chief executive officer seemed more interested in obtaining post-merger employment and in receiving payment under a tax receivable agreement than in securing the highest price for the shareholders.
- There was no robust, pre-signing market check. No other pre-signing bidders were sought by the board of directors or by the board's financial adviser.
- The stock was thinly traded, which made the efficient (or semi-efficient) market theory less relevant.
- The go-shop period was fruitless due to the existence of a sizable break-up fee, an unlimited right to match any higher offer, and the right of the suitor to begin tendering shares during the go-shop period.

City of Miami General Employees' and Sanitation Employees' Retirement Trust v. C&J Energy Services, Inc.[3]

- C&J Energy Services, Inc. ("C&J"), did not engage in any market check prior to agreeing to merge with Nabors Industries Ltd.
- The C&J board of directors delegated the primary responsibility for negotiations to its chief executive officer.
- No special committee was formed, and four members of the C&J board of directors were guaranteed five-year terms with the merged entity.
- The court enjoined the shareholder vote for another 30 days to further attempt to solicit interest from other bidders. This judicial order was premised on the lack of other bidders emerging during the five months following announcement of the deal. There was no judicial ruling on the fairness of the merger price.

Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.[4]

- The merger was not the product of a robust sale process. The transaction was undertaken at the insistence of the Snyder family, which controlled both Farmers & Merchants Bancorp of Western Pennsylvania, Inc. ("F&M"), and NexTier

Bank N.A. ("NexTier"), and stood on both sides of the transaction. No other bidders for F&M were considered.

- The transaction was not conditioned on obtaining the approval of a majority of the minority of F&M stockholders.
- Two of the three members of the special committee had business ties with the Snyders.
- F&M engaged Ambassador Financial Group as its financial adviser, but only to "render an opinion as to the fairness of the exchange ratio that would be proposed by [FinPro] to the NexTier board."

Flawed Deal Process and Investment Banker Fee Structure

Sometimes the terms of the investment banker compensation can give rise to a flawed deal process. In an article published in the *Harvard Law Review*, Guhan Subramanian cites one example of a properly structured fee arrangement and one example of an improperly structured fee arrangement for a target company's investment banker. The investment banker usually receives an incentive fee based on the final deal price.

In the properly structured fee arrangement example, Subramanian cites Merrill Lynch serving as financial adviser to the Sports Authority, Inc., during its leveraged buyout.[5]

The fee was the sum of 0.50 percent of the purchase price up to a price of $36.00 per share and an additional 2 percent above $36.00 per share. The acquirer initially offered $34.00 per share, but Merrill Lynch then negotiated a higher price of $37.25 per share, thereby collecting 2 percent of the incremental $1.25 per share.

In the improperly structured fee arrangement example, Subramanian cites Evercore serving as financial adviser to Dell Inc. during its leveraged buyout.

Evercore received a monthly retainer fee of $400,000, a flat fee of $1.5 million for the fairness opinion, and a fee equal to 0.75 percent of the difference between the initial bid during the pre-signing phase and any subsequent higher bid Evercore could obtain during the go-shop period.

This structure gave Evercore the incentive, if it opted to do so, to minimize the negotiated price during the pre-signing phase so as to widen the difference between the pre-signing price and any higher price during the go-shop period, upon which the 0.75 percent contingency fee was based.

Considerations with Regard to the Fairness Analyses

In many transactions, the investment banker presentation to the special committee or to the entire board of directors—often referred to as the "banker book"—is not required to be disclosed to investors. However, in a merger dispute, the discovery process often reveals both the final banker book and any prior drafts. Differences between drafts and the final analysis may be justified, but these differences may also raise questions.

It is typical for the target company and its suitor to revise financial projections during the deal process. In these situations, it is often the latest set of financial projections, prior to the signing of the deal, that are relied upon by both the financial adviser and—if the transaction is litigated—by the courts.

Occasionally, the valuation inputs used by the investment banker in the fairness opinion analysis may be challenged by the financial expert retained by a shareholder plaintiff.

The following list presents some of the potential disagreements with respect to the selected valuation inputs:

- Justification for the selected beta—If the target company was publicly traded, there may be a question as to why the investment banker selected a beta based on either comparable or guideline publicly traded companies—rather than the target company's own beta. The time horizon for the selected beta (i.e., one-year, two-year, five-year) may also be a question. Statistical analysis is often conducted to support—or rebut—a selected beta.
- Target capital structure—The capital structure used by the investment banker may be questioned. For example, the investment banker may select the capital structure on the industry-based capital structure at the time the deal was approved. In contrast, another analyst may base the analysis on the target company's actual capital structure as of the unaffected date.
- Long-term growth rate—Investment bankers and valuation analysts may disagree about the expected long-term growth rate. Whether the expected long-term growth rate should reflect only inflationary growth or include real growth may be debated. International exposure can be a factor that influences the expected long-term growth rate. Another factor may be the target company's recent and anticipated trends for

market penetration and market share.

- Financial projections—If the M&A transaction is disputed, the parties may question whether the investment banker—or the analyst—adjusted management's financial projections and, if so, what was the basis for making such an adjustment.
- Selection of comparable or guideline companies and transactions—The investment banker and the analyst may disagree on the companies that should be considered in a market approach analysis. In litigation, the court has the final say on which, if any, of the guideline companies are appropriate.

Use of Management-Prepared Financial Projections

It is generally accepted that the target company's management is in best position to prepare company financial projections. This is particularly true if the target company regularly prepares financial projections during its annual planning process. This conclusion is based on the belief that nobody knows the company better than its own management.

A special committee formed for the purpose of overseeing the deal process and negotiating deal terms with a potential acquirer may amend the financial projections. This may occur when (1) the special committee concludes that the financial projections are either optimistic or pessimistic or (2) multiple sets of financial projections are prepared that are contingent on various scenarios.

The target company's board of directors is responsible to obtain the best possible price. There may be occasions when the company financial projections may be too optimistic—in order to achieve that goal. In these situations, financial projection revisions may be made by the special committee or by the investment banker at the direction of the special committee.

Alternatively, there may be occasions when the target company's financial projections are too downward-biased. There may be parties who are more focused on choosing the deal at any price than on preparing credible financial projections.

Examples of when parties are driven to complete the deal may include (1) a chief executive officer who has negotiated a higher pay package during the deal process to remain with the merged company or (2) an executive of the suitor who also has a board seat with the target company or a close relationship with some of the target's executives.

The investment bank serving as financial adviser to a target company's board of directors may assist in making or revising financial projections. This may occur when the target company is not well versed in making projections. The target company management may provide financial projections based on generally accepted accounting principles ("GAAP"). The banker may convert the GAAP-based net income projections to cash flow projections in order to develop a discounted cash flow valuation.

When provided with multiple financial projections, the analyst rendering the fairness opinion may apply judgment in determining the reliability of each financial projection.

The following discussion summarizes several judicial decisions where financial projections were an issue in the dispute.

Judicial Rejection of Management Financial Projections

- *In re Appraisal of PetSmart Inc.*—Vice Chancellor Slights of the Delaware Chancery Court noted that financial projections in prior cases were found to be unreliable when "the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, where the projections were created for the purpose of obtaining benefits outside

the company's ordinary course business, where the projections were inconsistent with a corporation's recent performance, or where the company had a poor history of meetings its projections."[6]

The Chancery Court also observed that the company management had no history of creating financial projections beyond short-term earnings guidance.

Judicial Acceptance of Management Financial Projections

- *Cede & Co. v. Technicolor, Inc.*—Chancellor Chandler of the Chancery Court accepted the company financial projections and rejected the petitioner expert's alteration of those projections, writing that, "When management projections are made in the ordinary course of business, they are generally deemed reliable."[7]

  The judicial opinion also noted that the subject company management had a very good track record of meeting earnings guidance (i.e., financial projections).

Judicial Rejection of Third-Party Financial Projections

- *In re Radiology Assocs., Inc.*—The Chancery Court rejected the petitioners' valuation analysis because the prospective financial inputs were too speculative. The Chancery Court reached this conclusion due to the fact that the company management neither created the financial projections nor gave any guidance to the third party that created the projections.[8]

Judicial Acceptance of Second Set of Projections

- *Delaware Open MRI Radiology v. Kessler*—Vice Chancellor Strine of the Chancery Court opined about the fairness opinion's exclusion of financial projections that were based on the company's expansion plans: "In essence, when the court determines that the company's business plan as of the merger included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value"[9] as a going concern (also citing *Cede & Co. v. Technicolor*, 684 A.2d 289 at 298-99, and *Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d 206 at 222 (Del. 2005)).

- *In re United States Cellular Operating Company*—Vice Chancellor Parsons of the Chancery Court concluded that financial projections should include reasonably anticipated capital expenditures, stating that "This is not a situation where projecting capital expenditures to account for conversion to 2.5G and 3G is speculative. Industry reports included such expenditures and the Companies themselves 'anticipated' it. Therefore, Harris should have incorporated the effects of this expected capital improvement in his projections."[10]

  The judicial decision also noted that, under other circumstances, the court "should avoid, however, speculative costs that are not part of the company's operative reality" (citing *Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549, 552 (Del. 2000)).

  This decision notes that the company management had no prior experience with preparing long-term financial projections. The fairness opinion was rendered by a firm that worked alongside management developing a set of projections. The financial projections were based on such factors as anticipated subscriber growth driven by population growth and market penetration and customer churn.

  Consequently, the two testifying experts in this dispute had no financial projections prepared solely by company management. Instead, the testifying experts had financial projections that were created by the investment bank with the assistance of company management. Both testifying experts applied these financial projections as a starting point and made their own adjustments to the financial projections.

Judicial Rejection of Second Set of Projections

- *In re PLX Technology Inc. Shareholders Litigation*—Vice Chancellor Laster of the Chancery Court rejected the use of a second set of financial projections that were based on growth initiatives. The Chancery Court reached this decision despite the financial projections having been prepared in the ordinary course of business.

  In reaching its decision, the Chancery Court reasoned that, "to achieve even higher growth rates, particularly in 2017 and 2018, the December 2013 Projections contemplated a third layer of future revenue.

It depended on PLX introducing a new line of 'outside the box' products that would use the ExpressFabric technology to connect components located in different computers, such as the multiple servers in a server rack. To succeed with this line of business, PLX would have to enter the hardware market and compete with incumbent players like Cisco."[11]

- *In re Micromet, Inc. Shareholders Litigation* —The Chancery Court addressed the claim that the board had breached its fiduciary duty of disclosure by failing to disclose certain financial projections that were ultimately not relied upon for the fairness opinion. The Chancery Court stated, "Similarly, I find that Micromet was not required to disclose the 'Upside Case' projections that Micromet's management provided to Goldman. Again, these projections were not relied upon by Goldman in its fairness opinion and at least some of the directors found the projections to be unreliable and overly optimistic."[12]

The Role of the Investment Bank in M&A

The investment bank's role in M&A transactions may vary based on many factors. The following discussion summarizes some of these factors.

- Were the wheels already set in motion when the investment bank was hired, and was an acquirer nearly decided upon?

  If so, the investment banker's role may be confined to managing the rest of the deal process and providing a fairness opinion. Sometimes, when the overture is from a strategic acquirer, the target company already knows the suitor company well.

  In this case, the investment banker will be used more as a sounding board and as a reality check:

  1. to provide confirmatory analysis and
  2. to evaluate the risk and reward of competing offers.

  When the investment bankers are more involved than this, they may make introductions to other potential suitors. These introductions are not always with the intent of a merger at the outset, but may lead to merger discussions later.

- Was the target company desirous of being acquired, and has it already been approached by a suitor company?

  If the client intends to be sold and no suitors have been identified, or they have but discussions have not commenced, then the investment banker's role will be far more extensive.

  Investment bankers will evaluate bids. This is referred to as buyer qualification. Buyer qualification may involve determining whether the bidders are:

  1. experienced with making acquisitions, which can affect the speed of the deal process;
  2. a good strategic fit, which may lead to a higher bid; and
  3. including contingencies in their offer.

  During the due diligence process, the target company's investment banker may weed out bidders who may be "phishing." This is a term used for companies that have no intention of making the acquisition, but rather just want access to competitive information.

  One procedure for rooting out this type of potential suitor is monitoring the data room for how long they spend on particular documents, such as the customer lists, and how little time they spend on other documents that an acquirer would ordinarily want to inspect.

- Is there a need to accelerate the completion of the transaction?

  This factor can be a consideration when deciding whether to conduct an auction or more of a targeted, high-level solicitation. The more entities poking around in the virtual data room, the longer it takes to complete a transaction.

  From the perspective of the acquirer, information technology infrastructure is usually a big part of post-merger integration. Achieving synergies depends on the success of post-merger integration.

- Is the best strategic fit with one or two companies, or is a more competitive bidding process best?

  It is said that the auction process often produces the highest price. However, there are other important considerations, such as the length of the deal process, which may be longer for an auction.

  During that time, unforeseen economic events could lead to a lower stock price and a lower resulting takeout price.

The more bidders that are involved, the higher the risk that the negotiations will be leaked to the public. This could lead to a higher stock price of the target company (if publicly traded) and spook suitors.

A longer sales process can lead to employees resigning out of fear of losing their jobs. This could also kill a deal, because part of the value of any company is its employees.

Another risk is that leaks can stoke fear in a company's suppliers and customers that their treatment under the merged entity will not be the same.

- Is the target company or the suitor company experienced with M&A?

  If management is inexperienced, the investment bank will need to spend much more time coaching management, being more involved with negotiations, and assisting with making financial projections.

- Is the investment banker hired to explore multiple strategic options other than just being acquired?

  One example of alternative strategic options is a company with significant real estate that could conduct sale/leasebacks to extract untapped value. This may be a viable strategy if the value of those assets is underappreciated by the financial markets.

  An investment bank may explore the value of joint ventures or other arrangements, as an alternative to a sale of the company, if it was hired to evaluate multiple strategic options.

- Are private equity funds potential acquirers?

  Every private equity fund has a target internal rate of return ("IRR"). Knowing that IRR, the banker can model five to six years of cash flow projections (a typical investment holding period for a private equity company M&A transaction), make an assumption about an appropriate exit multiple, and backsolve for the acquisition price and implied pricing multiple that would allow the fund to achieve its targeted IRR.

  Such an analysis would help the target company:

  1. to estimate the price that the private equity fund may be willing to pay and
  2. to compare that price to offers made by strategic buyers.

- Are one or more of the final bidders insisting on a stock-for-stock transaction?

  If so, the investment bank will evaluate both the target company and the acquirer company. Such an analysis requires another set of financial projections.

  The range of value of both the target company and the acquirer company will be used to determine the exchange ratio, or if an exchange ratio has already been agreed upon in principle, to determine if the exchange ratio is fair.

  Because the acquirer's stock is its currency with which it will pay the merger consideration, the banker will assess whether the acquirer—and the resulting merged company—is a solid long-term investment.

  Consideration of projected post-merger synergies may also be important. This is because the target company's shareholders will hopefully benefit from these synergies.

- How is the cultural fit, and how difficult will post-acquisition integration be?

  Investment bankers retained by the acquirer company rather than the target company may also assist with identifying pitfalls to post-acquisition integration. Examples include the cultural fit, which is a human resources matter.

  Some companies have a "coat and tie" culture while others are more informal. Some have a policy of extending employee bonuses while others do not.

  Organizational charts and employees reporting to one versus several higher level executives can differ as well. For example, the target company may have a simple structure where each employee reports to only one superior.

  In contrast, the acquirer may have its employees report to multiple higher level executives. Ignoring the cultural fit can lead to employee defections after the merger.

- How much of the synergies are included in the acquisition price premium offered by the preferred bidder?

  The highest bid is not always the best bid. The acquirer company will usually pay a price premium that is less than projected synergies (which is a reasonable posture because otherwise there is no value to the deal for the acquirer).

  The principle that fair value equals the deal price less some portion of synergies was addressed in *Verition v. Aruba*.[13] There

was no auction process, controlled sale, or targeted high-level solicitation. Instead, there was a closed negotiation (i.e., one bidder).

While the Delaware Supreme Court ruled that this was not an issue, it addressed and rejected the Court of Chancery's ruling that fair value was equal to the unaffected market price of the target stock. Instead, it ruled that fair value (for arm's-length transactions disputed in appraisal rights cases) was equal to the deal price less a portion of synergies.

In reaching this conclusion, the Delaware Supreme Court pointed to a study that found sellers typically collected an average of 31 percent of expected synergies. However, this percentage varied widely due to transaction value being a matter of negotiations and the number of bidders and their aggressiveness.

The Delaware Supreme Court ruled that fair value was 22 percent below the deal price and 12 percent above the unaffected market price.

Notably, the Delaware Supreme Court did address the issues of synergies sometimes not being achieved and that acquirers usually negotiate a deal price premium that does not include all anticipated synergies.

Summary and Conclusion

Investment bankers are often retained to provide a variety of M&A services—in addition to issuing a fairness opinion. Some of these M&A services may include managing the deal process, soliciting bids, making introductions, evaluating bids and then best offers, and assisting with deal negotiations.

Valuation analysts are also qualified to render fairness opinions. Furthermore, analysts are able to retain their independence because their services are not provided on a contingent fee basis.

M&A transactions may have a flawed deal process that eventually leads to costly shareholder inappropriate litigation. Some of these flaws may result from the fee structure for the investment bank. Retaining a valuation analyst is one way to evaluate the fairness of a particular transaction and potentially avoid future shareholder litigation.

Notes:

1. In re Appraisal of Dell Inc., C.A. No. 9322-VCL, 2016 WL 3186538 at *38-49 (Del. Ch. May 31, 2016). Numerous academic papers were cited to support the credence that the go-shop period following the pre-signing phase rarely results in topping bids. In general, most transaction price competition occurs before the deal is accepted in principle One footnote in the Dell opinion cited the following quote from M&A attorney Martin Lipton during an interview of Mr. Lipton by one of the expert witnesses in this matter, Professor Guhan Subramanian: "The ability to bring somebody into a situation [pre-signing phase] is far more important than the extra dollar a share at the back end [go-shop phase]. At the front end, you're probably talking about 50%. At the back end, you're talking about 1 or 2 percent."
2. C.A. No. 11184-VCS, 2018 WL 3602940 (Del. Ch. July 27, 2018), opinion by Vice Chancellor Slights; synopsis from Jill B. Louis and Rashida Stevens, "Chancery Court Cites Flawed Process in its Resort to Traditional Valuation Methodology," *The National Law Review* (September 6, 2018).
3. C.A. No. 9980-CB, 2018 WL 508583 (Del. Ch. Jan. 23, 2018); synopsis from Yaron Nili, "Delaware Court Preliminarily Enjoins Merger Due to Flawed Sales Process," *Harvard Law School Forum on Corporate Governance* (December 7, 2014).
4. C.A. No. 10589-CB, 2016 WL 6651411 (Del. Ch. Nov. 10, 2016).
5. Guhan Subramanian, "Deal Process in Management Buyouts," *Harvard Law Review* (December 2016): 41.
6. In re Appraisal of PetSmart, Inc., Consol. C.A. No. 10782-VCS, 2017 WL 2303599 at *32 (Del. Ch. May 26, 2017).
7. Cede & Co. v. Technicolor, Inc., C.A. No. 7129, 2002 WL 23700218 at *7 (Del Ch. (Dec. 31, 2003, revised July 9, 2004), citing In re Radiology Assocs., Inc. Litig., 611 A.2d 485, 490-91 (Del. Ch. 1991).
8. In re Radiology Assocs., Inc. Litig., 611 A.2d 485, 490-91 (Del. Ch. 1991).
9. Delaware Open MRI Radiology v. Kessler, 898 A.2d 290 (Del. Ch. 2006), endnote no. 51.
10. In re U.S. Cellular Operating Co., No. Civ.A 18696-NC, 2005 WL 43994 at *37 (Del. Ch. Jan. 6, 2005).
11. In re PLX Technology Inc. Stockholders Litigation, C.A. No. 9880-VCL, 2018 WL 5018353 at *52 (Del. Ch. Oct. 16, 2018).
12. C.A. No. 7197-VCP, 2012 WL 681785 at *13 (Del Ch. Feb. 29, 2012).
13. Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 210 A.3d 128 (Del. 2019).

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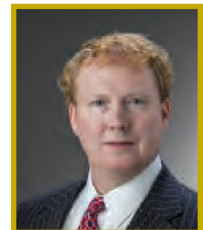


Financial Adviser Due Diligence Related to Financial Information Used in a Fairness Opinion Analysis

Timothy J. Meinhart

Financial advisers prepare fairness opinions related to a variety of different transactions. An often overlooked component of the fairness opinion analysis is the due diligence process that financial advisers conduct with respect to the target company historical financial information ("HFI") and prospective financial information ("PFI"). It is only after performing sufficient due diligence that the financial adviser can apply the appropriate methods and procedures to opine on the fairness of a particular transaction. This discussion summarizes the typical due diligence that a financial adviser conducts on the target company's HFI and PFI when the adviser renders a fairness opinion.

Introduction

In nearly every transaction involving a publicly traded company, the company board of directors requests that its financial adviser prepare a fairness opinion. The objective of requesting such an opinion is to ensure that the pending transaction is fair to the company shareholders from a financial point of view.

Fairness opinions may also be sought by the boards of private companies when the shareholders of the private company include a broad group of individuals (or entities) who do not necessarily have direct representation on the board of directors. In both cases, the board of directors relies on its financial adviser to provide independent, unbiased, and objective advice on the fairness of the price—and the terms—of the pending transaction.

At the heart of any fairness opinion is (1) the target company historical financial information—or HFI—and (2) the target company prospective financial information—or PFI. In preparing its fairness opinion, the financial adviser typically conducts substantial due diligence on the target company from both a historical perspective and a forward-looking prospective.

In conducting this due diligence, the financial adviser may find it necessary to adjust the target company HFI in order to provide a more meaningful presentation of the company historical financial performance.

As part of its work, the financial adviser also typically conducts due diligence on the company PFI that is incorporated in the fairness opinion analysis.

This discussion focuses on the typical due diligence procedures related to a target company's HFI and PFI. Also, this discussion provides insight into typical normalization adjustments that a financial adviser may make to the HFI when preparing a fairness opinion.

Understanding the Basis of a Fairness Opinion Analysis

Most fairness opinion analyses include various methods and procedures to analyze the following:

1. The target company stock or the target company assets that are the subject of the proposed transaction
2. The consideration that will be paid in the proposed transaction
3. The structure and the terms of the proposed transaction

Furthermore, most fairness opinion analyses include one or more valuation methods. The application of these valuation methods results in a range of value for the subject company stock or the subject company assets. While the fairness opinion analysis is not a valuation of the target business or its shareholder equity per se, the analysis often mirrors that of a typical business valuation engagement.

For example, in a typical business valuation engagement, a profitable, going-concern operating company is often valued by applying a combination of market approach valuation methods and income approach valuation methods.

The market approach valuation methods that are typically applied include (1) the guideline publicly traded company method and (2) the guideline merged and acquired company method.[1]

The income approach valuation methods that are typically applied include (1) the discounted cash flow method and (2) the direct capitalization method.

However, unlike a typical business valuation engagement, where the valuation analyst's objective may be to arrive at a pinpoint estimate of the subject company stock value or the subject company asset value, a fairness opinion analysis usually results in a relevant range of value for the subject stock or the subject assets.

Regardless of the valuation procedures and methods applied, the reliability of the fairness opinion analysis often is a function of the reliability of the subject company historical and prospective financial data that were used in the fairness opinion analysis.

For example, the value indications derived from the application of the guideline merged and acquired company method are typically based on the application of market pricing multiples of recently acquired guideline companies to the normalized HFI of the target company.

The value indications derived from the application of either the discounted cash flow method or the direct capitalization method are based on the application of required rates of return to the PFI of the target company.

And, the value indications derived from the guideline publicly traded company method are typically based on the application of publicly traded company market pricing multiples to both the normalized HFI and the PFI of the subject company.

In each of these instances, the financial adviser needs to use credible financial data for the subject company to arrive at a credible range of values. In other words, the fairness opinion analysis is only as reliable as the subject company financial data upon which the analysis was based.

HFI Due Diligence Procedures

The initial phase of most fairness opinion analyses involves a thorough analysis of the target company historical financial performance. In the course of this work, the financial adviser typically analyzes the target company's performance over several historical periods.

The following question is often raised by users of fairness opinions: Why does the adviser need to conduct an analysis of the target company's HFI when the company's current value is simply the present value of its expected financial performance?

The short answer to this question is that a proper analysis of the target company historical performance can provide insight on:

1. how the company has performed over periods of changing business conditions and
2. the company income-producing and cash-flow-producing capacity.

Often, the end goal of the historical analysis is to arrive at a reliable annual "run rate" of the company revenue; net income; earnings before interest, taxes, depreciation, and amortization ("EBITDA"); or some other measure of cash flow.

In some instances, HFI, when credibly measured and normalized, may be a superior measure of a company's financial performance and capacity than its PFI. This conclusion is especially true if there is a fair degree of uncertainly embedded in the PFI.

A thorough review of the company HFI is also often necessary to bridge any gap that may exist between a target company's historical financial performance and its prospective financial performance.

In the course of rendering a fairness opinion, it is not uncommon for the opinion provider to observe growth and profitability trends in a target company's HFI that are substantially different than the trends observed in the same company's PFI. In other words, the company historical growth rates, profit margins, and the rates of return may be quite different than the company projected growth rates, profit margins, and rates of return.

In these cases, an analysis and normalization of the target company HFI—along with a review of the company PFI, as presented later in this discussion—is helpful in providing a link between a company's past financial performance and its prospective financial performance.

An analysis and normalization of the target company HFI may also be helpful in explaining certain trends that appear in the PFI. Nonetheless, there are instances where a company's HFI—even after adjustment and normalization—may not provide an explanation for the observed trends in the company's future financial performance.

There are many reasons why this result may be the case.

One reason why a company's HFI may not explain the projected trends in its PFI is that a company's financial performance will usually change as it enters a different stage of its lifecycle. Most business entities move through different lifecycle stages. In broad terms, these stages include a start-up stage, a growth stage, a mature stage, and a decline stage.

In the start-up stage and the growth stage, a business typically has significant capital investment, high revenue growth, and increasing profitability. In the mature stage, the same business typically has a predictable and stable level of capital investment, relatively low revenue growth, and stable profit margins. In the decline stage, the same business typically has low capital investment, declining revenue, and stable to declining margins.

To the extent a target company is in the process of gradually moving from one business life cycle stage to another, the financial adviser should expect to see a noticeable difference between its historical financial performance and its projected financial performance. In this instance, the financial adviser should not expect historical financial performance to necessarily be representative of future financial performance.

Another reason why a company's HFI many not explain trends in its PFI is that a company's financial performance will usually change throughout the economic cycle. The U.S. economy—and the economies of other developed nations—are cyclical in nature. In other words, economic booms do not last indefinitely nor do economic recessions.

While the length of economic cycles have varied over time, many of the more recent economic cycles have been, on average, five to six years. If a target company is highly sensitive to changes in economic conditions, the financial adviser should expect that sensitivity to be revealed in the company reported financial performance over time.

Furthermore, certain companies' business prospects may be more sensitive to changes in economic activity than others.

For example, companies that operate as retailers of grocery products generally report stable financial performance during both good and bad economic periods. On the other hand, companies that are in the business of the exploration and production ("E&P") of crude oil and natural gas are highly sensitive to changes in economic conditions.

When analyzing the HFI of the grocery retailer, the financial adviser would generally expect to see relatively stable financial performance over the long term.

Barring any plans the target company may have for expansion or contraction, this stable historical financial performance may provide a reasonable basis for:

1. estimating the company value based on its current financial fundamentals and
2. analyzing the reasonableness of the company's PFI.

Analyzing the HFI of the E&P company would typically be much more difficult. Changes in commodity prices, availability of drilling infrastructure, and availability of labor are just three factors that could severely affect an E&P company's financial performance.

Even after normalizing the HFI, the financial adviser may conclude that, given the cyclicality of the business, basing an analysis on the company's most current financial performance would either grossly overvalue or grossly undervalue the company assets.

As a target company moves throughout the economic cycle, it is important for the financial adviser to understand how changes in economic activity have affected the company's historical financial performance. Furthermore, these changes in economic activity may provide a reasonable explanation of why a company's HFI may not be indicative of the same company's PFI.

Industry-specific changes may be another reason why a company's HFI may not explain trends in its PFI. Generally, more rapid industry-specific changes yield greater variation in historical financial performance results. Industry-specific changes may encompass factors such as the competitive landscape, market penetration, new product development, and technological obsolescence.

The mobile phone market is a current example where each of these factors come into play. And, an analysis of the leading mobile phone manufactur-

ers would reveal historical financial performance that may not necessarily be representative of future financial performance expectations.

In situations such as this, the financial adviser needs to evaluate whether an analysis based on historical financial performance would result in a meaningful value conclusion—given the speed of change in a company's particular industry.

One of the primary reasons for analyzing a target company's HFI is to develop a reliable level of revenue, earnings, or cash flow that can be used by the financial adviser in its fairness opinion analysis. In the case of a mature company that operates in a mature industry that is not susceptible to large industry-specific changes, the HFI may provide a reasonable basis for estimating a company's value and evaluating its PFI.

Alternatively, if a target company is in a stage of growth or decline and operates in an industry that is subject to constant and rapid change, the company HFI, while informative, may not be particularly useful in estimating the company value or understanding its PFI.

HFI Normalization Adjustments

While conducting its due diligence, a financial adviser often applies normalization adjustments to the subject company HFI. Most users of fairness opinions who are familiar with these types of adjustments focus solely on adjustments to historical company expenses.

However, normalization adjustments are not limited to necessary changes in the company expenses. The financial adviser may determine that it is also appropriate to adjust a company's historical income and, in some cases, its revenue.

The normalization adjustments to revenue, income, and expenses are intended to produce a normalized level of revenue, earnings, and cash flow that could be used by the financial adviser in its fairness opinion analysis.

Whether analyzing a company's historical income or historical expenses, normalization adjustments are generally characterized as either nonrecurring items or extraordinary items. However, in many cases, there is an element of overlap between the two descriptions. As a result, these terms are used interchangeably throughout this discussion.

In terms of a historical revenue and income analysis, a company may report nonrecurring/extraordinary revenue or income from a variety of difference sources.

For example, a company may report gains on the sale of assets or business divisions, and, in some instances, these gains may be substantial. To the extent these gains are not expected to recur, the financial adviser may reduce the company income in each applicable year for the amount of the gains to arrive at a more realistic picture of the company's income-producing capacity.

Other more typical examples of nonrecurring/extraordinary revenue or income that may require a normalization adjustment include the following:

- Revenue or income associated with nonrecurring or extraordinary litigation judgments or settlements
- Revenue or income associated with one-time insurance settlements
- Extraordinary customer revenue associated with one-time contracts or orders
- Interest and dividend income associated with cash and investments that are not directly used in the company operations

When evaluating potential normalization adjustments to company revenue or income, the financial adviser also considers that certain nonrecurring or extraordinary revenue/income for one company may not be considered nonrecurring or extraordinary for another company.

For example, gains that are realized through the sale of company assets may be viewed as nonrecurring for a company such as a manufacturer or distributor that rarely sells any of it fixed assets. However, gains realized by a commercial bank through the routine sale its loan and investment assets would not necessarily be treated as nonrecurring income, especially in instances where the bank is conducting sale transactions on an annual basis.

In terms of historical expense analysis, a financial adviser may identify during his or her due diligence that various historical expenses are either nonrecurring or extraordinary in nature.

Some of the more typical examples of nonrecurring or extraordinary expenses that may require a normalization adjustment include the following:

- Expenses associated with nonrecurring or extraordinary litigation
- Losses on the sale of assets or business divisions
- Nonrecurring restructuring charges
- Asset impairment charges
- Severance-related expenses

As is the case with an analysis of revenue and income, the financial adviser should use care when evaluating whether a historical expense is

nonrecurring or extraordinary. In situations where the financial adviser determines such an adjustment should be made, the subject expense is added to company income to restate the company profitability on a normalized basis.

One fault in many fairness opinion analyses is to treat recurring expenses as nonrecurring expenses. In doing so, the adviser runs the risk of overstating normalized earnings and potentially jeopardizing the reliability of its fairness opinion analysis.

Also, the financial adviser should decide whether its objective is to normalize the company's generally accepted accounting principles ("GAAP") earnings or some other measure of non-GAAP earnings.

In the typical case, where the financial adviser's objective is to estimate a normalized level of non-GAAP earnings, such as EBITDA, it may be necessary to make normalizing adjustments for most, if not all, noncash expenses reported on the income statement.

While these expenses may be neither nonrecurring nor extraordinary, normalizing adjustments may still be needed to arrive at the desired measurement of normalized earnings.

Another area of potential controversy when reviewing and normalizing HFI may be the financial adviser's treatment of expenses such as stock-based compensation ("SBC") expense. Some financial advisers have a tendency to adjust earnings for the entire amount of SBC expense.

The typical rationale for doing so is that a normalization adjustment should be made for SBC expense because it is a noncash expense. However, other financial advisers may consider other important factors in addition to whether the expense is a cash expense or a noncash expense.

In the case of SBC expense, the financial adviser may also consider the dilutive effect of awarding SBC to employees and whether the target company intends to continue the practice of awarding SBC compensation in the future. SBC expense is just one of many examples of expenses that may be treated differently by different financial advisers.

When deciding whether to make normalization adjustments to the HFI of the target company, the financial adviser may also consider the nature of the transaction that is the subject of the fairness opinion.

If the target company is private and the subject of a management buyout, it may be appropriate to evaluate the company's historical financial performance under the current stewardship. This may be particularly true if the buyout group is not anticipating major changes in how the company will operate post transaction.

However, in the case of a transaction involving a strategic buyer, the financial adviser may consider various assumptions regarding how the target company revenue may increase and/or the target company expenses may decrease as a result of being acquired by a larger industry participant.

These assumptions may guide the financial adviser in determining which normalization adjustments may (or may not) be appropriate for the subject analysis.

The financial adviser has a fair degree of discretion in deciding what revenue, income, and expenses are nonrecurring or extraordinary in nature. The general rule of thumb is that any income or expense that is reported by the company on an annual basis, in the normal course of business, is usually considered to be a recurring item.

As previously discussed, various valuation methods that a financial adviser may apply in the fairness opinion analysis may be based on the historical financial fundamentals of the target company. It is only after conducting sufficient due diligence on the target company HFI that the adviser can use the HFI within valuation methods and arrive at a reliable range of values for the target company.

Due Diligence Related to PFI

While it is often debated how much due diligence needs to be conducted on a target company's HFI when preparing a fairness opinion analysis, there tends to be less debate about how much due diligence should be conducted on the target company's PFI.

Most financial advisers agree that there should be an adequate level of due diligence performed on the target company PFI that would give the financial adviser comfort in relying on the prospective information. This is especially true if the information is an important component of the fairness opinion analysis, which is often the case when a discounted cash flow analysis is applied by the financial adviser.

In spite of the agreed-upon need for adequate due diligence, financial advisers typically include standard language in their fairness opinions that disclaims responsibility for the accuracy of the PFI.

While the language may vary from adviser to adviser, the disclaimer language will usually include statements such as the following:

- The financial adviser relied on, and assumed the accuracy and completeness of, all information that was provided to the adviser, including any PFI.
- The financial adviser has not independently verified any information provided by the

client, or its accuracy or completeness, and has no obligation to undertake any such independent verification.

- The financial adviser relied on financial analyses and forecasts provided to it by the client, and in doing so, has assumed that the analysis and forecasts have been reasonably prepared, based on assumptions reflecting the best currently available estimates and judgments by management as to the expected future results of operations and financial condition of the company.
- The financial adviser expresses no views or opinions regarding the financial analyses and forecasts provided to it by the client or the assumptions on which the analyses and forecasts were based.

While the tone of the above-described language would suggest the financial adviser intends to perform little, if any, due diligence on the PFI, the opposite tends to be true in most cases. The primary objectives of the financial adviser in analyzing the PFI is to understand the following:

1. How the PFI was prepared
2. The assumptions upon which the PFI is based
3. The overall reliability of the PFI

There are several questions that financial advisers raise when conducting due diligence on PFI that will be used within a fairness opinion analysis. The following discussion summarizes some of the typical financial adviser questions.

- Does the company routinely prepare PFI?

  Some companies routinely prepare PFI as part of their annual budgeting process. However, many companies do not. In general, a financial adviser has a higher degree of confidence in PFI that was prepared by a management team that routinely prepares such information than in PFI prepared by company management that is not experienced in preparing such information.

  Likewise, a financial adviser will generally conduct more due diligence on PFI that was prepared by a company that is new to the budgeting process than on PFI that was prepared by a company with a long track record of providing reliable prospective data.

- Under what circumstances was the PFI prepared?

  In asking this question, the financial adviser is attempting to learn whether the PFI was created in the normal course of business or whether the PFI was created for a specific event or transaction. PFI prepared in the normal course of business usually includes information that is prepared in conjunction with the company recurring budgeting and forecasting process.

  In contrast, PFI prepared for a specific event or transaction may be a "one off" set of projections or other prospective financial data that is influenced by the specific event or transaction for which the information was prepared.

  In many cases, PFI that was prepared in the normal course of business is viewed by the financial adviser as having the highest degree of objectivity.

- Was the PFI prepared by and approved by people who have the necessary knowledge and experience?

  This question tends to go hand-in-hand with whether the company routinely prepares PFI. In situations where the company routinely prepares PFI, there is usually a formal budgeting process in place where people with the requisite knowledge and experience prepare such information.

  The PFI is then reviewed and modified by senior management and eventually approved by the company board of directors. However, in situations where the budgeting process is less formal, or less frequent, the financial adviser will typically want to know who prepared the PFI and the level of oversight that was provided during the process.

  An evaluation of the preparer's qualifications usually provides the financial adviser with some insight as to how thorough the PFI may be.

  Also, whether the PFI was subject to review and approval by senior management or the board of directors often provides insight into the confidence company management has in the data.

- Was the PFI prepared on a bottom-up basis or a top-down basis?

  Most PFI is prepared one of two ways. With the bottom-up procedure, prospective data that is prepared by management of the company operating divisions is rolled up, or consolidated, to arrive at a top level projection.

With the top-down procedure, the PFI is prepared at the highest level of the organization and each operating division becomes responsible for their allocated portion of the total prospective financial performance.

Each procedure has its own strengths and weaknesses. In general, the bottom-up approach will lead to a more comprehensive set of PFI, which potentially may lead to data with a higher degree of reliability.

- What key assumptions are incorporated in the PFI?

In most cases, the PFI includes a projection of items such as revenue, expenses, income, working capital, and capital spending. The financial adviser typically reviews each line item and its underlying assumptions to evaluate the reasonableness of the PFI.

For example, due diligence regarding projected revenue may begin by comparing the company projected revenue growth rate with its historical revenue growth rate. However, little can be concluded about the PFI based on this comparison alone.

As a result, the financial adviser also evaluates the assumptions behind the projected revenue growth rate, such as the assumptions related to projected product sales volume and projected product pricing. In terms of expenses and income, the financial adviser typically reviews projected expense margins, income margins, and the breakdown of fixed expenses and variable expenses.

In terms of projected working capital and capital spending, the financial adviser typically researches whether the company is projecting an appropriate level of working capital and fixed assets that would allow the company to achieve the level of growth and profitability included in the PFI.

- Is the PFI a benchmark for actual performance or a motivational tool for company employees?

Some companies prepare PFI that is a realistic projection of expected financial performance. Other companies create overly optimistic PFI that is used as a tool for motivating employees to exceed certain benchmarks.

In the course of its work, the financial adviser inquires as to whether the PFI represents management's best estimate of expected performance or whether it represents a "stretch" goal that exceeds expected performance.

Furthermore, the financial adviser evaluates how expected performance is measured. In that regard, expected performance is often best measured by a probability-weighting of various possible outcomes.

For example, a company may prepare three projection scenarios—an upside case, a base case, and a downside case. In this regard, an "expected" case projection results from a probability weighting of the three possible outcomes.

If presented with multiple sets of PFI, all else being equal, a financial adviser would tend to use the data that represent company management's best estimate of expected future performance.

- Is the PFI stated on a GAAP basis or an income tax basis?

Many companies prepare their historical financial statements in accordance with GAAP. And, many companies may prepare their PFI on the same basis.

Preparing both historical and projected performance under the same basis of accounting allows for an apples-to-apples comparison of past financial performance to future financial performance.

However, there are instances where the financial adviser may be interested in an alternative presentation of the PFI.

For example, if using the discounted cash flow method in its fairness opinion analysis, the financial adviser may want to estimate after-tax cash flow to the company capital providers. In doing so, the financial adviser may be interested in a projection of depreciation, amortization, and income on an income tax basis rather than on a GAAP basis.

Quite often the financial adviser determines that the PFI needs to be adjusted to arrive at financial fundamentals that are suitable for the fairness opinion analysis.

- Does the PFI reflect the company on a stand-alone basis or on a merged basis?

Most PFI that is prepared in the normal course of business presents the company on a stand-alone basis. However, company management may also evaluate the company in the context of a potential transaction and its effect on the company revenue or cost structure.

> **"[T]he financial adviser should conduct proper due diligence on the company-provided financial information to ensure the analysis is based on a solid foundation of information."**

When conducting due diligence, the financial adviser should be aware of whether the projections reflect the target company on a standalone basis or whether the projections include expected post-acquisition expense reductions and synergies. The type of transaction may also have an influence on the PFI.

In a cash-based acquisition of the target company, it may be appropriate for the financial adviser to review the PFI of the target company on a standalone basis.

However, in a transaction where the merger consideration is the stock of the newly merged company, the financial adviser may also focus on the PFI of the newly merged company to evaluate the fairness of the merger consideration.

- How has the company performed in the past relative to its prior PFI?

  As part of the due diligence process, a financial adviser may request company management-prepared PFI from prior periods. This request is made in order to evaluate how the company performed in the past relative to its financial projections.

  If a company has a history of either consistently underperforming or overperforming its financial projections, the financial adviser usually considers that fact in reaching a conclusion about the quality of the PFI.

- Does the PFI make sense given overall economic activity, the condition of the industry in which the company participates, and the lifecycle stage of the company?

  Some of the most important due diligence that a financial adviser conducts on the PFI is to evaluate the overall reasonableness of the information. This procedure is performed by evaluating whether the company's projected performance makes sense relative to projected economic growth and projected growth in the company's industry.

  For example, a financial adviser would be skeptical of a general contractor's PFI if it showed uninterrupted growth during an economic recession and a downturn in construction activity.

  Likewise, the PFI may not make sense if the company is in the mature stage of its lifecycle, but the PFI includes growth rates that exceed the rate of growth of the industry as a whole. The PFI should make sense relative to external economic and industry factors.

Financial advisers who include a discounted cash flow analysis in their fairness opinion analysis typically spend a fair amount of time evaluating the quality of the PFI provided by target company management. As is the case with HFI, it is only after conducting sufficient due diligence on the subject company PFI that the adviser can use the PFI within a valuation method and arrive at a reliable range of value for the target company.

Summary and Conclusion

The methods and procedures applied in a fairness opinion analysis often mirror those that are applied in a valuation of the target company equity. However, the fairness opinion analysis—much like a valuation analysis—should not be a mechanical process where valuation methodologies are based on untested HFI and PFI.

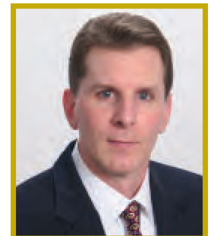
Instead, the financial adviser should conduct proper due diligence on the company-provided financial information to ensure the analysis is based on a solid foundation of information.

Small changes in the HFI or the PFI of the target company can determine whether or not a transaction is fair from a financial point of view. As a result, a component of a robust fairness opinion analysis typically includes a thorough review of both the target company HFI and PFI.

The naive acceptance of the company-provided financial information by not conducting sufficient due diligence may lead the financial adviser to issue a compromised fairness opinion.

Notes:

1. In the context of a fairness opinion analysis, the guideline publicly traded company method may be referred to as the comparable public company method and the guideline merged and acquired company method may be referred to as the precedent transaction method.



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Willamette Management Associates Thought Leadership in Valuation, Damages, and Transfer Price Analyses

Willamette Management Associates consulting experts and testifying experts have achieved an impressive track record in a wide range of litigation matters. As independent analysts, we work for both plaintiffs and defendants and for both taxpayers and the taxing authorities. Our analysts have provided thought leadership in breach of contract, tort, bankruptcy, taxation, family law, shareholder rights, antitrust, fraud and misrepresentation, and other disputes. Our valuation, damages, and transfer price analysts are recognized for their rigorous expert analyses, comprehensive expert reports, and convincing expert testimony. This brochure provides descriptions of recent judicial decisions in which our analysts provided expert testimony on behalf of the prevailing party.

Dissenting Shareholder Testifying Expert Services

In the matter of the *Wayne L. Ryan Revocable Trust, Steven Ryan and First Nebraska Trust v. Constance "Connie" Ryan and Streck, Inc.* (Case No. CI 14-1684), the District Court of Sarpy County, Nebraska, decided a matter described as one of the largest valuation disputes in Nebraska state court history. After the application of prejudgment interest, the fair value of the plaintiffs' ownership interest was estimated to be between $723 million and $804 million.

Willamette was retained to provide both consulting expert valuation services and testifying expert valuation services to the plaintiffs. Willamette managing director Kevin Zanni provided consulting expert services, and firm managing director Robert Reilly provided testifying expert services regarding the Streck fair value valuation.

In *Ryan*, Willamette and another well-known valuation advisory services firm applied the same valuation methodology, but reached significantly different opinions. In a 74-page published opinion, the court concluded that (1) the Willamette fair value conclusion of the subject equity interest was reasonable, and that value was accepted in full by the court, and (2) the defendants' testifying expert applied valuation variables designed to lower his fair value conclusion, and that value was rejected by the court.

In particular, the *Ryan* decision is representative of the Willamette thought leadership in fair value valuation matters related to statutory shareholder rights, dissenting shareholder appraisal rights, and shareholder oppression claims.

Willamette Management Associates

thought leadership

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Property Taxation Testifying Expert Services

In the matter of *Union Electric Company d/b/a Ameren Missouri v. Christopher Estes, Assessor, Cole County, Missouri*, No. 13-52002, 2019 WL 2369464 (Mo.St.Tax.Com. May 28, 2019), upon appeal and remand, the State Tax Commission of Missouri (the "STC"), found in favor of Ameren Missouri, the corporate taxpayer complainant. At issue in the matter was the need for STC to determine the appropriate amount of total depreciation to be applied to the Assessor's cost approach "market value" of the Ameren Missouri real property and tangible personal property.

The STC concluded that the taxpayer presented substantial and persuasive evidence to establish the correct amount of total property depreciation, including the identification and quantification of the taxpayer's economic obsolescence.

John Ramirez, Willamette director of property tax valuation services, provided consulting expert services—which included an economic obsolescence depreciation analysis and economic obsolescence depreciation report—on behalf of taxpayer Ameren Missouri. Robert Reilly, Willamette firm managing director, provided testifying expert services related to this public utility property tax valuation dispute.

The Missouri STC accepted the economic obsolescence analysis and conclusion—and the total depreciation calculation—prepared by Willamette Management Associates.

Estate Taxation Testifying Expert Services

In the matter of *Estate of Aaron U. Jones v. Commissioner,* T.C. Memo. 2019-101, the U.S. Tax Court adopted in full the value conclusions put forth by the Estate's valuation expert. In 2009, Aaron Jones gifted ownership interests in two companies: (1) Seneca Jones Timber Company ("SJTC"), a limited partnership that owned and harvested timberland, and (2) Seneca Sawmill Company ("SSC"), an S corporation that operated sawmills. In 2013, the Service issued a notice of deficiency for gift tax of approximately $45 million. The Estate brought this matter to the U.S. Tax Court.

Willamette was engaged by the Estate to provide valuation and testifying expert services. Scott Miller, Willamette vice president, provided valuation consulting services and Robert Reilly, a managing director of our firm, provided testifying expert services. Important issues in the dispute included (1) whether it was appropriate to tax affect the earnings of tax pass-through entities SSC and SJTC and (2) whether the income approach applied by the Estate's valuation expert was more appropriate for valuing the SJTC limited partnership units than the asset-based approach applied by the Service valuation expert.

In this important decision, the Tax Court adopted without adjustment the positions and value conclusions presented in the Willamette Management Associates valuation expert reports.

Willamette Management Associates

Transfer Pricing Testifying Expert Services

In the matter of *Amazon.com, Inc. & Subsidiaries v. Commissioner,* 934 F.3d 976 (9th Cir. 2019), the Ninth Circuit affirmed the U.S. Tax Court 2017 decision in favor of taxpayer Amazon. The Tax Court case involved a 2005 cost sharing arrangement that Amazon entered into with its Luxembourg subsidiary. Amazon granted its subsidiary the right to use certain pre-existing intangible property in Europe, including the intangible property required to operate Amazon's European website business.

The Tax Court concluded that (1) the Service's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable; (2) Amazon's CUT transfer price method (with some upward adjustments) was the best method to determine the requisite buy-in payment; and (3) the Service abused its discretion in determining that 100% of the technology and content costs constitute intangible development costs. The Tax Court noted the Service's buy-in payment discounted cash flow analysis improperly included all contributions of value, including workforce in place, going-concern value, and goodwill.

On appeal, the Service argued that "residual business assets" (e.g., workforce in place, going-concern value, goodwill, and future growth options) satisfied the then applicable regulation's definition of "intangible." The Ninth Circuit concluded otherwise, accepting taxpayer Amazon's position that the then applicable regulation's definition of "intangible" was understood to exclude goodwill and going-concern value.

Willamette Management Associates managing director Robert Reilly provided expert testimony in the Tax Court on behalf of taxpayer Amazon in this Section 482 intercompany transfer pricing case.

Willamette Management Associates

Shareholder Litigation Consulting Expert Services

In many instances, an attractive settlement is as good, if not better, than a judicial victory. This was true in the matter of *In Re Legacy Reserves LP Preferred Unitholder Litigation*. In this particular matter, the Delaware Chancery Court approved a settlement between Legacy Reserves LP ("Legacy") and its preferred unit holders that resulted in the preferred unit holders realizing a significant increase in the transaction value.

The plaintiff preferred unit holders brought an action against defendant Legacy to remedy the defendant's alleged breach of contract and breach of the duty of good faith and fair dealing in connection with a proposed transaction in which Legacy would be converted from a partnership to a C corporation. The proposed transaction would result in Legacy and its general partner becoming subsidiaries of Legacy Reserves Inc. ("New Legacy") and Legacy's common and preferred unit holders becoming common stockholders of New Legacy. Pursuant to the terms of the proposed transaction, each outstanding Legacy limited partnership unit would be converted into the right to receive 1 share of New Legacy common stock, each outstanding Series A preferred unit would be converted into the right to receive 1.9620 shares of New Legacy common stock, and each outstanding Series B preferred unit would be converted into the right to receive 1.72236 shares of New Legacy common stock. Based on the announced terms, the preferred investors would receive 17.7 percent of the business, while the common holders would receive 82.3 percent of the business.

Lead counsel for plaintiffs in the litigation retained Willamette to assist and advise them regarding the fair value of the Legacy Series A preferred units and Series B preferred units. After extensive analysis and negotiations, Legacy management signed a memorandum of understanding. Legacy admitted to none of the allegations, and the plaintiffs agreed not to further pursue Legacy on any grounds surrounding the C corporation conversion and the preferred unit conversion. In exchange, the Series A preferred unit holders received 2.9203318 shares of common stock for each preferred unit, while the Series B preferred unit holders received 2.90650421 shares of common stock for each preferred unit. This settlement resulted in the preferred investors receiving approximately 26 percent of the restructured entity and the common holders receiving approximately 74 percent of the entity.

Willamette managing director Timothy Meinhart provided valuation consulting expert services to the preferred unit holder plaintiffs in this matter.

Willamette Management Associates

A Survey of Recent Judicial Decisions Involving Fairness Opinions

Sean L. McGrane, Esq., and Brandon L. McFarland

Over the years, disclosures related to fairness opinions have become a focus of shareholder claims against the target company, and the target company board, in connection with a proposed merger or acquisition transaction. This discussion summarizes the regime governing disclosures related to fairness opinions. In addition, this discussion identifies and summarizes recent judicial decisions that address fairness opinion issues.

Introduction

Investment banks, financial advisers, and other valuation professionals are often called upon to provide fairness opinions to the boards of directors of companies involved in a merger or acquisition ("M&A") transaction.

Frequently, both the buying company and the selling company (the "target company") retain separate investment banks, advisers, or valuation analysts:

1. to review the terms of the potential transaction and
2. to evaluate whether the terms of the proposed transaction are fair, from a financial point of view, to the parties' shareholders.

While both the buyer company and the target company frequently obtain their own fairness opinions, litigation involving fairness opinions often centers on the fairness opinions offered to the target company's boards of directors.

In part, that is due to the fact that the provision of a fairness opinion to the directors of the target company is often disclosed by the target company to its shareholders as part of the proxy solicitation. This solicitation seeks shareholder approval of the proposed M&A transaction.

The buying company, by contrast, may not be required to seek shareholder approval of the M&A transaction.

The target company's board is not required to obtain a fairness opinion (to the best of our knowledge) under the laws of any jurisdiction. However, obtaining a fairness opinion from an independent third-party adviser frequently gives the board, and the company shareholders, comfort that the terms of the proposed M&A transaction are fair and, thus, the proposed M&A transaction is in the best interests of the shareholders.

Over the years, disclosures related to fairness opinions have become ripe for shareholder claims against the target company, and the target company board, in connection with a proposed M&A transaction.

Among other things, shareholders have brought claims alleging that the target company failed to adequately disclose:

1. the underlying financial data provided to, and reviewed by, the party performing the fairness review;
2. certain conflicts of interest that may have influenced the party performing the fairness review; or

3. certain assumptions or scenarios either considered or not considered by the party performing the fairness review.

Although there appears to have been a downtick in M&A litigation since the Delaware Chancery Court's landmark decision in 2016 in the *In re Trulia, Inc. Stockholder Litigation*[1] ("Trulia")—in which Chancellor Bouchard declined to approve a "disclosure only settlement" and pledged to apply greater scrutiny to such settlements going forward[2]—there has nevertheless been a steady stream of such litigations both in Delaware and in other forums.

This discussion (1) summarizes the regime governing disclosures related to fairness opinions and (2) also identifies and summarizes recent judicial decisions addressing fairness opinions.

This discussion not only summarizes the current legal landscape with respect to fairness opinions, but it is intended to make practitioners, valuation analysts, financial advisers, and other interested parties aware of the potential pitfalls that may arise in the next engagement.

The Applicable Disclosure Regime

Judicial opinions discussing fairness opinions typically arise in the context of claims brought by stockholders. Such claims allege that the target company issued a proxy statement that was materially false or misleading. The claims allege that the statement failed to disclose material facts, or omitted material facts.

The claims are usually lodged against certain directors and officers of the target company and the target company itself.

Usually, the shareholder will seek to enjoin the pending transaction through a preliminary injunction motion. However, disclosure claims can also be litigated even after an M&A transaction closes.

Historically, these types of disclosure claims were frequently brought as state law breach of fiduciary duty claims under the law of the state in which the target company is incorporated. The stockholder would typically allege that the directors of the target company breached their duties of care, loyalty, and/or candor (if such a duty exists) by issuing a materially false or misleading proxy statement.

Frequently, these claims were either brought in the Delaware Chancery Court and/or governed by Delaware law (as the state of incorporation).

More recently, and particularly in light of the Delaware Chancery Court's opinion in *Trulia*, shareholders appear to be more frequently bringing claims in federal courts around the country. These claims allege that the proxy statements violated provisions of the federal securities laws.

Specifically, Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") grants the Securities and Exchange Commission (the "SEC") the authority to promulgate rules and regulations for soliciting proxies on any registered security and makes it unlawful to solicit any proxy in violation of whatever rules the SEC promulgates.

The SEC promulgated Rule 14a-9 pursuant to this provision of the Exchange Act. Rule 14a-9 prohibits soliciting a proxy through materially false or misleading statements or omissions—including solicitations for shareholder approval of an M&A transaction.[3]

In order to state a claim under Section 14(a) of the Exchange Act and SEC Rule 14a-9, the plaintiff has to show that:

1. a proxy statement contained a material misrepresentation or omission, which
2. caused plaintiff's injury, and
3. the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.[4]

There is some conflicting authority about whether the defendants' state of mind in making the alleged misrepresentation or omission need only be negligent. A showing of recklessness or actual knowledge is not required.[5]

In any event, claims brought under Section 14(a) of the Exchange Act and SEC Rule 14a-9 are subject to the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which requires particularized factual allegations in order to survive a motion to dismiss.

The PSLRA does not apply in state court disclosure actions arising under state law. Therefore, stockholders in federal court disclosure actions face an additional hurdle in pleading their claims.

In addition to hearing claims under Section 14(a) and Rule 14a-9, federal courts may exercise their supplemental jurisdiction to hear disclosure-based breach of fiduciary duty claims arising under state law as well.

Recent Notable Decisions

In Re Almost Family Inc. Securities Litigation[6]

In *In re Almost Family Inc. Securities Litigation* ("Almost Family"), the plaintiff shareholder brought claims in the United States District Court for the Western District of Kentucky, Louisville Division (the "District Court of Kentucky") under Section 14(a) of the Exchange Act, and SEC Rule 14a-9. The plaintiff alleged that defendant Almost Family's proxy statement was materially false or misleading in certain respects. Almost Family provides home health care services.

The shareholder also brought state law fiduciary duty claims.

Notably, this case was adjudicated on a motion to dismiss, after a motion to enjoin the M&A transaction had previously been denied, and the merger had closed. This appears to be one emerging trend after *Trulia*—since disclosure-only settlements appear to be trending downward, more M&A litigations are being litigated after the proposed transaction has already been approved and consummated.

In *Almost Family*, the proxy referenced and included two fairness opinions—one prepared by an investment bank retained by the acquirer's board and one prepared by an investment bank retained by the target company's board.

The litigation focused on the fairness opinion issued for the target company's board, which the shareholder plaintiff alleged "omitted necessary financial information that would allow stockholders to understand the financial figures and fairness opinion included within the proxy."

In connection with the fairness opinion, the target company's investment bank was provided "unaudited prospective financial information" by the target company's management. The financial information was not "prepared with a view toward compliance with GAAP." These facts were disclosed by the target company in the proxy.

While the full 14-page fairness opinion prepared by the investment bank for the target company was included within the proxy, and some of the unaudited financial opinion was included in the proxy, not "all the financial data and figures which [the investment bank] relied on in preparing the fairness opinion" were included in or attached to the proxy.

The plaintiff shareholder attacked the fairness opinion and related disclosures on two grounds.

First, the plaintiff alleged that the financial projections in the proxy, and relied upon by the target company's investment bank, were misleading because "they were not prepared in accordance with GAAP." Specifically, the plaintiff alleged that SEC Regulation G required the target company to include GAAP-equivalent figures along with the non-GAAP figures prepared by management.

Regulation G states that "whenever a registrant . . . publicly discloses material information that includes a non-GAAP financial measure, the registrant must accompany the non-GAAP financial measure with" either comparable GAAP figures or a reconciliation.[7]

Regulation G, however, includes numerous exceptions, including one cited by the defendants in *Almost Family* which exempts from compliance "a non-GAAP financial measure included in a disclosure relating to a proposed business combination . . . if the disclosure is contained in a communication that is subject to" Item 1015. Item 1015, in turn, requires companies that receive fairness opinions to disclose summaries of those opinions, including "the bases for and methods of arriving at such findings and recommendations."[8]

The District Court of Kentucky agreed with the

defendant target company that:

1. the exception to Regulation G applied, and
2. the target company was not required to disclose GAAP-reconciled versions of the financials relied upon by the investment banker in preparing its fairness opinion.

The District Court of Kentucky agreed that the target company disclosed the unaudited financials relied upon by the investment bank in order to comply with Item 1015, and thus there was no requirement to disclose GAAP-reconciled figures.

The court noted approvingly that the target company had disclosed that the unaudited financials "were not prepared with a view toward public disclosure . . . nor were they prepared with a view towards compliance with GAAP," but were included in the proxy "solely to give stockholders access to information that was made available to Almost Family's board of directors and financial adviser."

Therefore, the portion of the plaintiff stockholder's disclosure claim aimed at the unaudited financial statements was dismissed.

Second, plaintiff alleged that the omission of certain financial data and figures relied upon by the target company's investment bank in preparing its fairness opinion deprived shareholders of the ability to fully understand the basis for the fairness opinion.

Specifically, plaintiff alleged that "the omission of [unlevered free cash flow] projections and the line items used to calculate the [unlevered free cash flow] projections" rendered the investment bank's "discounted cash flow analysis incomplete and misleading."

The plaintiff further alleged that omission of this material deprived the target company's stockholders of the ability to "assess the merit" and "determine the weight" of the conclusions reached in the fairness opinion.

The District Court of Kentucky disagreed, noting at the outset that "the law does not require disclosure of every financial input used by a financial adviser so that the shareholders can replicate the advisers' analysis." Rather, "all that is required regarding a fairness opinion is an adequate and fair summary of the work resulting in the opinion. . . . The proxy need not disclose financial inputs sufficient to allow the shareholders to reconstruct the analysis."

The District Court of Kentucky concluded that the omission of the unlevered free cash flow projections was not material because the proxy—which included a full copy of the fairness opinion itself—otherwise fairly summarized the work performed by the investment bank.

Often legal counsel and valuation analysts are provided with unaudited non-GAAP compliant financial projections and other financial data (i.e., internal historical financial statements) as data to rely on. Practitioners should be aware of the Regulation G and Item 1015 requirements when rendering a fairness opinion.

While the decision in the instant case points out that there are no legal requirements to disclose enough information to replicate the valuation analysts work, it is important that the analyst is cognizant to disclose enough information to provide shareholders a fair summary of the analyst's work.

Baum v. Harman International Industries, Inc.[9]

One area in which companies and their financial advisers should be cognizant when making disclosures is conflicts of interest that may exist for the adviser providing the fairness opinion. In shareholder litigation, plaintiffs frequently question the sufficiency of the disclosure of such conflicts-of-interest (real or potential).

Baum v. Harman International Industries, Inc. ("*Baum*") is a case in which such conflicts-of-interest claims survived a motion to dismiss and proceeded to discovery.

In *Baum*, a shareholder of the target company brought suit in the United States District Court for the District of Connecticut (the "District Court of Connecticut") alleging violations of Sections 14(a) and 20(a) (control person liability) of the Exchange Act and SEC Rule 14a-9.

The target company obtained fairness opinions from two separate financial advisers—each of which recommended that the target company accept the offer from the buyer (Samsung) to purchase its shares for $112 in cash. In its proxy statement, the target company disclosed that one of its advisers had provided certain services to Samsung in the "preceding two years," and identified certain of the services that had been provided.

The target company, however, only disclosed services provided to Samsung that had been concluded in the prior two years; it did not disclose ongoing services, including that one of its advisers' affiliates was still providing investment management services for one of the Samsung affiliates.

The plaintiff alleged that this potential conflict of interest should have been disclosed by the target company. Among other things, the plaintiff noted

that the target company's financial adviser had counseled the target company to reject a competing offer in favor of the Samsung offer.

The plaintiff alleged that the financial adviser, in counseling the target company to reject the competing offer, and in providing a fairness opinion in favor of the Samsung offer, could have been conflicted by virtue of its affiliate's relationship with Samsung's affiliate.

The District Court of Connecticut agreed, noting the following:

> The complaint explains that a potential conflict of interest by [the financial adviser] would be material because the [financial adviser] conducted the unsuccessful acquisition with Company A and prepared a fairness opinion recommending that the acquisition by Samsung be approved. The failure to disclose even potential conflicts of interest may be actionable under federal securities laws. The relevant inquiry is not whether an actual conflict of interest existed, but rather whether full disclosure of potential conflicts of interest has been made . . . [B]y only listing engagements that ended before [the financial adviser] issued its fairness opinion in November 2016, the proxy could have led shareholders to incorrectly believe that [the financial adviser] had no ongoing business relationship with Samsung apart from the acquisition. . . . Harman shareholders should have been given the opportunity to assess for themselves whether [the financial adviser's] ongoing relationship with Samsung was material.

The District Court of Connecticut then denied the motion to dismiss and reserved the question of whether the omission was material for summary judgment following discovery.

One important takeaway from *Baum* is that valuation analysts and advisers should review any and all relationships that may be considered a conflict-of interest and err on the side of disclosure. In Baum, there were competing bids from multiple potential buyers and the adviser failed to disclose an ongoing engagement with Samsung, one of the competing buyers.

Whether this affiliate relationship influenced the adviser's decision making or not, it was enough to cause the District Court of Connecticut to question the materiality of the omission.

Salladay v. Lev[10]

Salladay v. Lev ("*Salladay*") involves something of a "musical chairs" among financial advisers and investment banks advising a target company. Salladay addresses the sufficiency of the target company's disclosures related to the rotating cast of advisers.

This case was brought before the Court of Chancery of Delaware (the "Delaware Chancery Court").

For years, the target company had been exploring potential sources of financing and strategic transactions, and retained an investment bank ("Firm 1") to advise it throughout the process. Firm 1 did so, and eventually, a potential acquirer submitted a bid to acquire the target company.

The target company created a special committee to review the acquisition proposal. However, instead of using Firm 1, the special committee hired a different investment bank (Firm 2) to serve as its adviser in connection with an acquisition offer.

As alleged in the complaint, "just days" after Firm 2 was retained, it "abruptly terminated" its relationship with the special committee. Thereafter, the special committee hired a new firm (Firm 3) to serve as its adviser. Within eight days, Firm 3 reviewed the proposed transaction and issued a fairness opinion stating that the proposed consideration was fair, from a financial point of view, to the target company's shareholders.

The plaintiff was a shareholder in the target company and brought a number of state-law-based disclosure claims in connection with the proxy statement issued by the target company in connection with the proposed M&A transaction.

Among other things, the shareholder alleged that the proxy was materially misleading because it did not "disclose the reason why [Firm 2] terminated its engagement" several days after being retained.

The Delaware Chancery Court agreed with the plaintiff shareholder and denied the defendant's motion to dismiss on this issue, finding it "reasonably conceivable that missing information regarding the exit of [Firm 2] would have been material to a reasonable stockholder."

The Delaware Chancery Court explained as follows:

> The compressed timing of this transaction and the fairness opinion associated with it create a context in which information regarding a hired financial adviser that walks away becomes plausibly material . . . Presumably, [Firm 2] reviewed the transaction in preparation to provide an opinion. It

> then walked away. An innocent inference is that it declined to participate due to unforeseen conflicts or other logistics that made it impossible to turn a fairness opinion around in a compressed timeframe. The plaintiff's inference is that the financial adviser found it could not approve the transaction as it stood and so it walked away, and the company chose not to disclose its disapproval. Either way, in evaluating the transaction, the board and [Firm 3] would themselves want to know why a well-known financial adviser voluntarily terminated an engagement and walked away from a fully formed transaction. It follows that so would a reasonable stockholder. The fairness opinion is perhaps the most material factor in a 'sell/don't sell' binary decision, and the reasons for going to a second—arguably a third—financial adviser here, in the context of a near-completed deal and a tight schedule, are not trivial. . . . I find it reasonably conceivable that such disclosures, not made here, are material.

It is important for valuation analysts and advisers preparing a fairness opinion to understand the history of the transaction and to be aware of any other analyses or engagements with other advisers or consultants. A rigorous due diligence process typically yields the facts and circumstances of any previous engagements related to a particular transaction.

Valuation analysts and financial advisers can then independently determine whether these facts and circumstances are relevant to the current assignment.

Diekman v. Regency GP LP[11]

Like *Salladay*, *Diekman v. Regency GP LP* does not involve claims under the federal securities laws. This case was also tried in the Delaware Chancery Court and involves claims for breach of a Delaware partnership agreement arising, in part, out of the general partner's reliance on a fairness opinion obtained in connection with a merger.

The plaintiff was a unit holder of the defendant and target company Regency Energy Partners, LP ("Regency"), a Delaware limited partnership that traded publicly prior to the merger in question.

Regency entered into a merger agreement with another Delaware partnership, Energy Transfer Equity ("ETE"). Indirectly, both Regency and ETE were controlled by the same entity, meaning that the merger was a "conflicted transaction."

As such, prior to approving the merger, Regency established a "Conflicts Committee" to evaluate the merits of the merger and to make a recommendation as to whether it should be approved by Regency's unit holders.

In connection with its work, the Conflicts Committee retained a financial adviser to evaluate the terms of the transaction and render a fairness opinion. The case raises two interesting questions for practitioners and experts:

1. What constitutes "reliance" upon a fairness opinion?
2. Whether a new a fairness opinion should be provided after the terms of a merger change.

Reliance

On January 22, 2015—three days before it received the fairness opinion—the Conflicts Committee met and determined that the merger was fair to the unit holders. Three days later, after the proposed consideration to be received by the target's unit holders was increased, the financial adviser rendered an oral fairness opinion to the Conflicts Committee, opining that the proposed transaction (and the improved terms) was fair from a financial point of view.

The question before the Delaware Chancery Court was whether under these circumstances—where the Conflicts Committee determined that the less favorable terms were fair prior to even receiving the adviser's fairness opinion—the Conflicts Committee had actually relied upon the fairness opinion in deciding to recommend the proposed transaction to the target entity's unit holders.

The question of reliance was important because, under the target's partnership agreement, reliance on "investment bankers and other advisers" created a conclusive presumption that the general partner (or entities acting at its direction, like the Conflicts Committee) acted "in good faith."

On summary judgment, the Delaware Chancery Court determined that there was a material question of fact for trial about whether the Conflicts Committee had actually relied on the fairness opinion received on January 25, 2015—"given the evidence that the Conflicts Committee already had determined that the inferior January 22 terms were fair."

Changed Consideration

Additionally, after the financial adviser provided its fairness opinion on January 25, 2015, the compensation to be paid to the target company subsequently changed again. Specifically, in mid-February, the cash component of the consideration was replaced with additional units in the acquiring company. The

financial adviser did not update its fairness opinion to reflect or address this change.

The plaintiff argued that this, too, showed that the Conflicts Committee had not actually relied on the fairness opinion, since the fairness opinion did not actually evaluate the revised terms of the merger agreement.

The Delaware Chancery Court again agreed with the plaintiff and held that the question of whether the change in consideration was material—and thus the fairness opinion should have been updated—was "a fact question appropriate for trial, especially given that the value of the proposal could fluctuate since the exchange ratio did not have a collar."

M&A transactions can be a moving target for valuation analysts and financial advisers. When rendering a fairness opinion, valuation analysts and financial advisers need to be made aware of ongoing changes to the structure of the transaction and incorporate them into the analysis as appropriate.

In addition, during the course of their work, financial advisers and valuation analysts typically perform a thorough review of the target company's articles of incorporation or partnership agreement.

Summary and Conclusion

Often, litigation involving fairness opinions is related to the fairness opinions prepared for the target company's boards of directors. The judicial precedent summarized in this discussion provides practitioners with a survey of recent judicial decisions related to a target company's fairness opinion decided in both state and federal courts.

As summarized in this discussion, disclosures related to fairness opinions have become the focus of stockholders' claims against target companies, and those companies' boards of directors. The issues brought before either state court or federal court, or both, often relate to adequate disclosure.

An understanding of the judicial decisions in this discussion can assist practitioners to appropriately disclose:

1. the underlying financial data provided,
2. certain conflicts of interest, and
3. certain assumptions or scenarios either considered or not considered.

"M&A transactions can be a moving target for valuation analysts and financial advisers."

Notes:

1. 129 A.3d 884 (Del. Ch. 2015).
2. A "disclosure only settlement" is a settlement reached between the stockholder challenging the proposed transaction (purportedly acting on behalf of all stockholders) and the target company (or, in some cases, the buyer), in which the target company agrees to make certain additional disclosures relating to the proposed transaction in order to cure the purported deficiencies in the proxy statement issued by the target company seeking approval of the transaction. In addition to issuing supplemental disclosures, the target company usually also agrees to make a payment of attorneys' fees to counsel representing the plaintiff stockholder. The target company is usually incentivized to reach these settlements given the typical procedural posture of these cases, in which the stockholder brings (or threatens to bring) a preliminary injunction motion to enjoin the pending transaction. In Trulia, Chancellor Bouchard questioned the utility of "disclosure only settlements" and indicated such settlements (which require court approval) would be subject to greater scrutiny in Delaware.
3. 17 C.F.R. § 240.14a-9.
4. Baum v. Harman Int'l Indus., 408 F. Supp. 3d 70 (D. Conn. 2019).
5. See, e.g., In re Almost Family Secs. Litig., 2020 U.S. Dist. LEXIS 23456 (W.D. Ky. Feb. 11, 2020).
6. 2020 U.S. Dist. LEXIS 23456 (W.D. Ky. Feb. 10, 2020).
7. 17 C.F.R. § 244.100.
8. 17 C.F.R. § 229.1015.
9. 408 F. Supp. 3d 70 (D. Conn. 2019).
10. C.A. No. 2019-0048-SG, 2020 Del. Ch. LEXIS 78 (Del. Ch. Feb. 27, 2020).
11. 2019 Del. Ch. LEXIS 1334 (Del. Ch. July 19, 2019).

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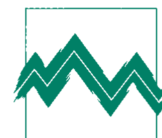

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Recent Trends in Delaware Chancery Court Appraisal Rights Cases

Nathan P. Novak

There are many U.S. federal and state laws that are designed to protect the rights of company shareholders—particularly noncontrolling shareholders (i.e., shareholders that otherwise lack significant influence over company decisions). Dissenting shareholder appraisal rights statutes provide protection to company shareholders in certain cases. These statutes can be developed and enforced both federally and state-by-state, and are typically designed to protect noncontrolling shareholders' financial interests in the case of a company change of control transaction. In recent years, the Delaware Court of Chancery (the "Delaware Chancery Court") has decided several shareholder appraisal rights cases. In these decisions, certain trends have developed in terms of how the Delaware Chancery Court has ruled on this often-controversial area of corporate law. This discussion provides an overview of some of the more recent trends in valuation-focused appraisal rights opinions that have been decided by the Delaware Chancery Court.

Introduction

For many years, Delaware has been a popular state of incorporation for American companies. Given the preponderance of corporations incorporated in Delaware, the state's corporate case matter legal decisions are often closely followed and studied by academics and professionals alike.

While there have been countless trials that have made their way through the Delaware Court of Chancery ("the Delaware Chancery Court"), recently some of the most widely followed cases have involved dissenting shareholder appraisal rights cases (also sometimes referred to as dissenters' rights cases).

In Delaware, Title 8, Section 262 provides shareholders certain protections. For example, Title 8, Section 262 of the Delaware Code ("Section 262") states that "any stockholder of a corporation of this State who holds shares of stock on the making of a demand . . . with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation . . . and who has neither voted in favor of the merger or consolidation nor consented thereto in writing . . . shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares. . . ."[1]

It is not uncommon for noncontrolling shareholders to effectively be forced to sell their shares of a company at a determined price upon the closing of a merger, sale, or other company change of control transaction. Section 262 is designed to protect those noncontrolling shareholders who, while forced to sell their shares, are not content with the financial consideration that is being paid to them in exchange for those shares.

In effect, Section 262 offers noncontrolling shareholders that are unhappy with the financial terms of a merger or a sale of a company to petition the Delaware Chancery Court in an effort to receive what they perceive to be the actual fair value of

their shares. These lawsuits are often referred to as appraisal rights cases.

Over the years, the Delaware Chancery Court has opined on numerous appraisal rights cases. In fact, the Delaware Chancery Court often sees several appraisal rights cases come to trial in any given year (which does not even consider that many more cases have likely settled or otherwise never reached trial).

In recent years, given that many appraisal rights cases have been tried in Delaware, certain trends have emerged regarding how the Delaware Chancery Court views certain recurring issues involved in those types of cases.

In particular, five noticeable trends have emerged in Delaware appraisal rights cases during the past several years:

1. The Delaware Chancery Court has recognized synergies that may be present—and need to be subtracted from fair value—in deal prices.
2. In determining fair value, the Delaware Chancery Court tends to give the most consideration to the deal price (assuming the selling process is fair and robust). Absent a fair and robust process, the Delaware Chancery Court has also considered the discounted cash flow valuation method.
3. The Delaware Chancery Court may be getting a little weary of appraisal arbitrage strategies involving investors effectively "buying into" litigation just before a transaction.
4. The Delaware Chancery Court has concluded on fair value compensation that is less than the deal price. Shareholders perfecting their appraisal rights should be aware that they may end up with less than other shareholders that accepted the deal price.
5. The Delaware Chancery Court is comfortable mixing and matching valuation analyses in order to come up with fair value. That is, typically the Delaware Chancery Court does not pick a single methodology, or a single expert, to agree with. And, the Delaware Chancery Court often reaches a decision based on multiple valuation-related analyses conclusions to arrive at fair value.

Fair Value and Deal Price Synergies

Section 262 states that if petitioners (i.e., noncontrolling shareholders subject to a merger or consolidation) are able to perfect their appraisal rights, then they are entitled to receive the fair value of their shares. Of course, the fair value (for statutory shareholder rights) standard of value is a standard that is often evolving and is generally influenced by past judicial decisions.

Recent Delaware Chancery Court decisions may provide relevant information regarding the determination of fair value, particularly in the context of an appraisal rights dispute.

The 2016 case styled *In re Appraisal of Dell Inc.* ("Dell") was a closely followed case involving appraisal rights. That case received attention throughout the valuation profession. The opinion, issued by Vice Chancellor Laster, drew upon case law precedent involving issues of fair value and contemplated what the fair value standard of value means to the Delaware Chancery Court.[2]

Vice Chancellor Laster decided that the final merger consideration is a relevant factor, but stated that "it is not the best evidence of the Company's fair value."[3]

Similarly, Vice Chancellor Laster concluded that, while it was a factor, "market price data is neither conclusively determinative of nor presumptively equivalent to fair value."[4]

A particular issue with using the deal price as evidence of fair value is the "recognized problem that an arms' length deal price often includes synergies."[5]

The 2017 reversal of the *DFC Global Corporation* ("DFC") case similarly discussed the importance of considering acquisition synergies that may be included in deal prices.[6]

While the opinion by Chief Justice Strine was favorable regarding the robust marketing process involved in the sale of DFC, it similarly discussed the difficulties in determining what portion of the deal price represents the fair value of the company as a stand-alone, going-concern entity, and what portion may represent post-merger synergies.

The value associated with post-merger synergies would not otherwise exist in the premerger company as a going concern on a stand-alone basis. Accordingly, it is understood that, because merger transactions may incorporate synergies into the deal price, that deal price may not represent the company's fair value as it is often interpreted by the Delaware Chancery Court.

More recently, the 2018 case styled *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.* ("Verition"), referenced that "The Dell and DFC decisions recognize that a deal price may include synergies, and they endorse deriving an indication of fair value by deducting synergies from the deal price."[7]

The *Verition* decision ultimately excluded discounted cash flow estimates of fair value and considered both "Aruba's unaffected market price of $17.13 per share and my deal-price-less-synergies figure of approximately $18.20 per share."[8]

However, the only indication of fair value relied on in the original *Verition* decision ended up being the unaffected market price of the company. Vice Chancellor Laster recognized that "my deal-price-less-synergies figure is likely tainted by human error. Estimating synergies requires exercises of human judgement. . . ."[9]

Accordingly, while the original *Verition* decision similarly recognizes the importance of excluding synergies in estimating fair value, it also recognizes the difficulty in doing so. Importantly, the original Verition decision was ultimately reversed and remanded on appeal. In its opinion, the Supreme Court of Delaware determined that the Delaware Chancery Court should have relied on deal-price-less-synergies, rather than the unaffected market price. The Supreme Court of Delaware ultimately determined that the fair value of the subject shares was $19.10 per share, which was determined based on a deal-price-less-synergies methodology.[10]

The takeaway from those recent cases regarding deal price considerations is that, even if the transaction involved a robust and fair marketing and bidding process, that final deal price still may not be a true representation of the target company's fair value.

That is largely due to the presence of synergistic value or synergistic premiums that may be included as a portion of the deal price consideration. Because synergies would not be available to a company on a premerger stand-alone basis, courts often understand that those synergies should not be included in determining the target company's fair value.

However, as discussed in the next section, despite the Delaware Chancery Court's relatively consistent acknowledgement that deal prices may contain synergies, that has not stopped many court opinions from relying on an unadjusted deal price as evidence of fair value.

Discounted Cash Flow Method, Deal Price, and Other Valuation Methods

As discussed in the section above, the Delaware Chancery Court often does not take a one-size-fits-all approach in determining the most appropriate methodology to apply in estimating a target company's fair value in appraisal rights cases.

For instance, despite ultimately determining that a discounted cash flow method was the best estimate of fair value, the original *Dell* opinion states that "in at least five decisions, the Court of Chancery has found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak."[11]

Exhibit 1 presents a list of several recent appraisal-rights-related Delaware Chancery Court opinions and the valuation methods applied by the court to determine fair value.

While Exhibit 1 is not an all-inclusive list of appraisal rights cases to go through the Delaware Chancery Court in recent years, it provides a good sample indicating certain trends regarding the valuation methods relied on by the court in those cases.

As evidenced in Exhibit 1, the two valuation methods that seem to get the most consideration in the Delaware Chancery Court are:

1. the discounted cash flow method and
2. the so-called "deal price" method (or otherwise, the deal price less post-merger synergies).

The discounted cash flow method is a generally accepted business valuation method that is applied in many valuation analyses. It is based on the fundamental financial principle that the value of a business is equal to the present value of its future cash flow.

While the discounted cash flow method relies on many inputs and assumptions, it has appeal to the Delaware Chancery Court. This may be because of its theoretical soundness and the ability for the court to determine what it believes to be the most reliable inputs to incorporate into a discounted cash flow analysis.

The so-called "deal price" method is generally considered to be the price the selling company shareholders received as a result of the merger or acquisition is representative of the target company's fair value.

As discussed above, the Delaware Chancery Court often relies on the deal price, but then subtract the value of certain perceived post-merger synergies that may be included in the unadjusted deal price.

Either way, the Delaware Chancery Court has demonstrated that, as long as the company's sale process was fair, thorough, and robust, it will often rely on the deal price as the indication of fair value.

However, in situations where the Delaware Chancery Court finds that the sale process was not

Exhibit 1
Delaware Court of Chancery Appraisal Rights Decisions
Methods Used by the Court to Determine Fair Value

Year	Case/Opinion	Methods Relied on by the Court
2015	*In Re Appraisal of Ancestry.com, Inc.*	Deal Price, DCF
2015	*Longpath Capital, LLC v. Ramtron International Corporation*	Deal Price (less synergies)
2015	*Merion Capital L.P. v. BMC Software, Inc.*	Deal Price
2016	*John Douglas Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.*	DCF
2016	*In Re Appraisal of Dell Inc.*	DCF
2016	*In Re Appraisal of DFC Global Corp.*	DCF, Comparable Companies, Deal Price
2016	*Merion Capital L.P. v. Lender Processing Services, Inc.*	Deal Price
2016	*In Re ISN Software Corp.*	DCF
2017	*ACP Master, Ltd. v. Sprint Corporation v. Clearwire Corporation*	DCF
2017	*In Re Appraisal of Petsmart, Inc.*	Deal Price
2018	*In Re Appraisal of AOL Inc.*	DCF
2018	*Veriton Partners Master Fund Ltd v. Aruba Networks Inc.*	Unaffected Market Price
2018	*In Re Appraisal of Solera Holdings, Inc.*	Deal Price (less synergies)
2019	*In Re Appraisal of Stillwater Mining Company*	Deal Price
2019	*In Re Appraisal of Columbia Pipeline Group, Inc.*	Deal Price
2019	*Kendall Hoyd v. Trussway Holdings, LLC*	DCF
2019	*In Re Appraisal of Jarden Corporation*	DCF, Deal Price (less synergies)
2020	*In Re Appraisal of Panera Bread Company*	Deal Price (less synergies)
2020	*Manichaean Capital, LLC v. SourceHOV Holdings*	DCF

DCF = Discounted cash flow
Sources: Opinions published in the above-referenced Delaware Court of Chancery cases.

robust, for one reason or another, the court tends to rely on a discounted cash flow method analysis conclusion.

Of particular note, as indicated in Exhibit 1, it appears that the Delaware Chancery Court's preference is generally for deal price fair value indications, however, the discounted cash flow method has been considered in many judicial decisions. For a time in 2016 and 2017, it was more typical for the Delaware Chancery Court to discard the deal price and rely solely on discounted cash flow method analysis.

However, that "trend" may simply be a coincidence as those particular cases likely involved certain issues that the Delaware Chancery Court found within the target company's sale process.

Trends in Appraisal Arbitrage

Section 262 of the Delaware Code offers appraisal rights to all shareholders who hold the stock (1) on the date of a making of demand through (2) the effective date of the merger or consolidation. That is, a shareholder need not be a long-term owner of company shares to be able to petition for appraisal rights.

A shareholder could theoretically purchase shares shortly before a merger and, as long as the shareholder owns those shares through the close of the transaction, it is possible to attempt to claim appraisal rights. That concept has given rise to an entire class of investor strategy, often referred to as "appraisal arbitrage."

Appraisal arbitrage is a strategy in which investors purchase shares of a company that are soon expected to be part of a merger transaction. Following the close of that transaction, those new investors will attempt to perfect their appraisal rights in order to make a profit on their investment. The idea being that, investors (typically as part of a hedge fund strategy) will be able to make a quick, court-ordered profit if they are able to prove that the fair value of the acquired company is more than what was actually paid as part of the final deal consideration.

In general, appraisal arbitrage is an intuitive strategy—there is seemingly little downside risk (an uninformed investor may think that, at worst, they will largely break even because they will be entitled to receive their share of the deal proceeds regardless of the appraisal action) and a seemingly plentiful upside gain opportunity (if the investor is able to show through, for example, a discounted cash flow method analysis that the fair value of the company far exceeds the deal price).

However, in practice, there are some issues to be aware of in the context of appraisal arbitrage. The primary issues include the following:

1. The Delaware Chancery Court may be growing somewhat weary of the practice of "gaming" the Delaware Code to the benefit of opportunistic investors, rather than for the protection of the general public.
2. There is significantly more downside risk than may be identified at first glance.

This section focuses on the first issue; the following section discusses the second issue.

In general, corporate law is often designed to protect those who are not in control. That is why there are shareholder oppression statutes, corporate fraud statutes, and many others that are designed to protect shareholders in the event that those in control of a company manipulate their power to the detriment of noncontrolling shareholders.

Similarly, it could be argued that is why Section 262 of the Delaware Code exists—to protect noncontrolling shareholders who are forced to participate in a change of control transaction and sell their shares, despite having little say in the process or the ultimately negotiated deal price.

However, as is often the case, the underlying purpose of a corporate law statute may be muddled over time, as investors seek ways to use the law to their advantage. Appraisal arbitrage is, effectively, a statute-driven investment strategy.

Despite relatively sound theory behind employing the strategy, there are some observable trends in recent Delaware Chancery Court decisions that indicate it may be getting more difficult to effectively employ the arbitrage strategy.

There have been some recent decisions in which the Delaware Chancery Court opinion has appeared to indicate a certain appraisal arbitrage weariness from the court.

For instance, Vice Chancellor Glasscock wrote in 2015 regarding the *Merion Capital LP v. BMC Software, Inc.*, opinion, "This case presents what has become a common scenario in this Court: a robust marketing effort for a corporate entity results in an arm's length sale where the stockholders are cashed out, which sale is recommended by an independent board of directors and adopted by a substantial majority of the stockholders themselves. On the heels of the sale, dissenters (here, actually, arbitrageurs who bought, not into an ongoing concern, but instead into this lawsuit) seek statutory appraisal of their shares."[12]

The fact that Vice Chancellor Glasscock identifies the plaintiffs as "arbitrageurs" who "bought into the lawsuit" in the first sentence of the opinion seems to imply a certain skepticism with regard to the circumstances of the investors in that case. Not surprisingly, the opinion then proceeds to largely disregard the petitioners' methodologies and to state that the deal price was the best indication of fair value in that case.

It appears that the Delaware Chancery Court has been careful to refrain from advocating for, or against, appraisal arbitrageurs and to instead interpret the relevant law as written. For instance, the case styled *In Re Ancestry.com, Inc.*, similarly involved a transaction in which arbitrageurs purchased shares of Ancestry.com, Inc., shortly prior to its acquisition by a private equity firm.

In the opinion, Vice Chancellor Glasscock wrote, "If the General Assembly wishes to address the 'problems' caused by appraisal arbitrage, either substantive or with respect to the operation of Section 262, presumably it will do so, but the fact that, in Ancestry's reading, the statutory language is an imperfect representation of legislative intent does not give a judge license to rewrite clear statutory language; nothing Ancestry has pointed out makes operation of the statute impossible or leads to a result that is absurd."[13]

So while in certain cases it may be possible to read between the lines in order to get a sense for a court's proclivity with regard to appraisal arbitrage strategy, it largely remains an issue that is dependent on the facts and circumstances of each case.

When Fair Value Is less than the Deal Price

Perhaps more concerning to appraisal arbitrageurs is the growing incidence of cases in which the court determines that the fair value of a target company's shares is actually less than the per-share price implied by the final transaction consideration.

That is, it is not unheard of and, in fact, somewhat typical, for petitioners in an appraisal rights case to end up with a court order that grants them less for their shares than they otherwise would have received had they foregone their appraisal rights and participated in the transaction with the other selling shareholders.

That phenomenon is able to occur because Section 262 clearly states that the standard of value in appraisal rights cases is fair value, and it gives the Delaware Chancery Court exclusive authority to determine that fair value.

Accordingly, if the court determines that the deal price does not provide a reliable indication of

fair value for one reason or another, that effectively opens the gates to allow for any other methodology that the court finds to be more reliable. In that case, the fair value concluded by the court could be either more than or less than the actual transaction value.

For example, as previously discussed, the Delaware Chancery Court has often indicated that a deal price may include synergistic value. At the same time, the Delaware Chancery Court has often indicated that fair value should represent a standalone value—and should exclude post-merger synergies.

Accordingly, based on that logic, it stands to reason that an argument could be made for many transactions that a deal price overstates the actual fair value of the target company.

Not surprisingly, in all of the cases listed in Exhibit 1 in which the method relied upon was the deal price less synergies, the Delaware Chancery Court ultimately concluded a fair value that was less than the deal price consideration received by the selling shareholders.

In more extreme cases, the Delaware Chancery Court may find that fair value is not simply deal price less synergies, but rather something substantially less than the deal price.

For instance, in the original *Verition* decision, the Delaware Chancery Court ignored the deal price entirely and found that the unaffected market price before the announcement of the transaction was the best estimate of the company's fair value.

In that case, the fair value of $17.13 initially provided to the petitioners was significantly less than the $24.67 per share implied by the deal terms (and received by the other selling shareholders).[14]

When neither the deal price nor unaffected market price are determined to be reliable, the Delaware Chancery Court has often used a discounted cash flow method analysis to determine the fair value of the subject shares. Similarly, the discounted cash flow method may result in a value that is more than or less than the agreed upon deal price.

In another matter styled *ACP Master Ltd. v. Sprint Corporation v. Clearwire Corporation*,[15] the Delaware Chancery Court found that a discounted cash flow methodology that resulted in $2.13 per share for Clearwire stock was the best indication of fair value. In contrast, the agreed upon deal price in the subject acquisition was $5.00 per Clearwire share.

The court-ordered fair value to be paid as consideration to the petitioners in that case was less than half of what would have been received had they foregone their appraisal rights and participated in the transaction with the other selling shareholders.

Although this section focuses on some of the more interesting cases in which fair value was determined to be less than the deal price, there have similarly been many cases in which the Delaware Chancery Court determined the opposite.

In other words, in certain cases the Delaware Chancery Court decided that the deal price was significantly less than the fair value of the target company. Those are typically cases in which the court determines there were certain insufficiencies in the deal process.

For example, there may have been conflicts of interest that affected board members' judgement, or there may not have been ample market time to get the best possible bid for the company. In those instances, it is not uncommon for the Delaware Chancery Court to conclude a fair value for the company's shares that is greater than the indicated deal price.

But, it is clear that appraisal arbitrageurs cannot simply assume that their investment strategy is low risk or that a deal price represents the floor of the consideration they are entitled to.

If the Delaware Chancery Court determines that the deal process was sufficient and robust, it is often an uphill battle to convince a court that the fair value of the company is something substantially greater than what was paid as transaction consideration.

Court Decisions and Certain Analyses

There appears to be a trend in terms of the general procedures or steps the Delaware Chancery Court takes with regard to valuation issues in appraisal rights cases. In many cases the court will scrutinize the deal process and determine whether it was sufficient to provide a good indication of the fair value of the company.

If that is the case, the Delaware Chancery Court may rely heavily on the deal price (either adjusted or unadjusted) in determining fair value. However, if the deal price is determined to be unreliable, the court has then typically turned to discounted cash flow methods in recent appraisal rights cases.

In those instances, it is typical for financial experts on both sides to present competing discounted cash flow analyses. It is often up to the court to reconcile significant differences between multiple discounted cash flow analyses in order to arrive at fair value.

In many instances, the court scrutinizes the various discounted cash flow method analyses and

places weights on the indicated values (e.g., 50 percent weight on petitioners expert's discounted cash flow method indication of value and 50 percent weight on respondents expert's discounted cash flow method indication of value).

This was the case, for example, in the original Dell decision, in which Vice Chancellor Laster selected the two most reliable discounted cash flow models and placed equal weight on their indicated values to arrive at fair value.[16]

In other instances, when the court appears to be most comfortable relying on a discounted cash flow method analysis, it may pick and choose certain assumptions or pieces of a discounted cash flow method analysis from various experts and make adjustments.

For example, in the case styled *Manichaean Capital, LLC v. SourceHOV Holdings, Inc.*, the Delaware Chancery Court almost entirely accepted the petitioners' discounted cash flow indication of value.[17]

The Delaware Chancery Court only made one adjustment to the size premium that was applied in the petitioners' discounted cash flow model.

Because Section 262 gives the Delaware Chancery Court broad authority to determine fair value in appraisal rights cases, it is sometimes difficult to predict how a court will apply various methods to reach a conclusion.

As discussed above, there are cases in which a court may adopt various experts' discounted cash flow models and simply weight the value conclusions. In other cases, the Delaware Chancery Court may adopt certain aspects of an expert's discounted cash flow model but change certain assumptions as it sees fit.

Summary and Conclusion

Given the prevalence of corporations incorporated in Delaware, the Delaware Chancery Court sees several high-profile corporate-law-related cases each year. Appraisal rights cases often lead to some of the most controversial decisions. These Delaware Chancery Court judicial decisions often involve complex valuation issues.

Due to the many appraisal rights cases tried in the Delaware Chancery Court each year, it is possible to identify certain trends regarding how the Delaware Chancery Court may view certain recurring issues.

However, the ever-evolving nature of case law means that, despite some of the previously discussed trends and issues regarding Delaware appraisal rights cases, it is often difficult to precisely predict how a trial will evolve or how a court will rule on certain issues.

Perhaps the only certainty with regard to appraisal rights cases that reach the Delaware Chancery Court is that there will no doubt be interesting legal and valuation issues involved.

Notes:

1. The Delaware Code, Title 8, Section 262.
2. In Re Appraisal of Dell Inc., C.A. No. 9322-VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016). For the purpose of this discussion we focus on the original decision in Dell, but we recognize in December of 2017, the Delaware Supreme Court remanded the Dell case back to Delaware Chancery Court on appeal. That appeal emphasized the deal price to be more relevant to fair value than the discounted cash flow method.
3. Id. at *22.
4. Id. at *23.
5. Id. at *25.
6. DFC Global Corporation v. Muirfield Value Partners, L.P., No., 518,2016, 2017 WL 3261190 (Del. Ch. Aug. 1, 2017).
7. Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., C.A. No. 11448-VCL, 2018 WL 922139 at *2 (Del. Ch. Feb. 15, 2018).
8. Id.
9. Id.
10. Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 210 A.3d 128 (Del. 2019).
11. In Re Appraisal of Dell Inc. at *23.
12. Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015).
13. In Re Ancestry.com, Inc., C.A. No. 8173-VCG2015 WL 66825 at *8 (Del. Ch. Jan. 5, 2015).
14. Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 2018 WL 922139.
15. ACP Master, Ltd. v. Sprint Corporation v. Clearwire Corporation, C.A. 8508-VCL, C.A. 9042-VCL, 2017 WL 3421142 (Del. Ch. July 21, 2017).
16. In Re Appraisal of Dell Inc.
17. Manichaean Capital, LLC v. SourceHOV Holdings, Inc., C.A. No. 2017-0673-JRS, 2020 WL 496606 (Del. Ch. Jan. 30, 2020).

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Litigation Insights from *Ryan*, a Shareholder Oppression Decision

Kevin M. Zanni

This discussion presents an insider perspective on the largest valuation-related judicial decision in Nebraska state court history.[1] This judicial decision is also considered to be the second-largest forced buyout in U.S. history.[2] This matter involved substantial value opinion differences that pitted two well-known valuation firms against each other. In Ryan*, the two valuation firms basically applied the same methodology but had differences of opinion related to (1) financial projections, (2) expected long-term growth rate assumptions, (3) selection of a modified capital asset pricing model equity size-premium, (4) selection of an unsystematic company risk premium, (5) the relevance of a failed merger and acquisition sales process, (6) application and selection of guideline public company pricing multiples, and (7) application of a tax pass-through entity valuation adjustment. In the end, the court accepted one value conclusion in full, and rejected the other value conclusion because it was found to be unreliable.*

Introduction

During the past 20 years, this author has prepared numerous valuation analyses for a wide variety of client matters. Many of the cases I work on, and have worked on over the years, involve business valuation disputes and damages measurement disputes.

These disputes have been tried in state court, the U.S. District Court, and U.S. Tax Court jurisdictions.

At Willamette Management Associates ("Willamette"), that is what we do. In many respects, that is what we are known for—valuation analyses that provide thought leadership for many purposes—including dispute resolution.

Recently, Willamette Management Associates worked on a minority shareholder oppression matter that resulted in the largest valuation-related judicial ruling in Nebraska state court history.

In *Ryan*, the District Court of Sarpy County, Nebraska (the "Court") found in favor of the Wayne L. Ryan Revocable Trust, Steven Ryan, and First Nebraska Trust, plaintiffs (collectively, the "WLRT").

The *Ryan* decision resulted in a total award of $722 million for the WLRT.

The *Ryan* matter was essentially a dispute between family members that involved the fair value valuation of Streck, Inc. ("Streck"), a multinational life sciences company.

Plaintiff, Dr. Wayne L. Ryan ("Dr. Ryan") founded Streck in 1971.

Unfortunately, Dr. Ryan passed away in November 2017, before the *Ryan* matter went to trial in 2018. After his death, his son Steven Ryan became the co-trustee for his revocable trust along with First Nebraska Trust.

Defendant Connie Ryan, Dr. Ryan's eldest daughter, is currently the Streck CEO and its president.

Connie has voting control of Streck by way of her ownership of Streck voting common stock.

Streck, Inc.

Defendant Streck is a private company. The company was founded in 1971, and it is based in Omaha, Nebraska.

Streck is a worldwide leader in developing and manufacturing quality control and diagnostic products in hematology, immunology, and molecular diagnostics for clinical and research laboratories. Streck research efforts have led to the development of several patented products for use in hematology, flow cytometry, and chemistry.

Streck has enjoyed significant financial and operational success since it began operations. Streck has increased sales every year since its inception in the 1970s.[3]

As of 2014, Streck controlled approximately 60 to 75 percent of the hematology controls market in the United States. Hematology controls accounted for approximately 34 percent (approximately $34 million) of the Streck sales in 2014.

By the time that Dr. Ryan left Streck in 2014, Streck's sales had reached $100 million, it employed 330 employees, and it operated out of a 200,000-square-foot facility in La Vista, Nebraska.[4]

Ryan Lawsuit

Prior to the filing of the complaint, there were two notable developments that led to the Ryan family discord.[5]

First, Connie Ryan gained voting control of Streck and was promoted to Streck CEO and its Chairman of the Board of Directors. Second, Connie and Dr. Ryan were not able to work together and Dr. Ryan's influence at Streck was increasingly diminished after Connie gained voting control.

As an example of the strained family relationship, as Streck engaged in a transaction process, Dr. Ryan, its largest shareholder and founder, was not allowed to participate in the process of selecting a potential buyer.

In March 2013, Eileen Ryan—Dr. Ryan's wife—passed away, and upon her death, Eileen's Streck voting stock transferred to her daughter Connie. This stock transfer gave Connie voting control of Streck, including the ability to appoint a majority of the Streck directors.[6]

Once Connie retained voting control of Streck, she assumed, based on her own recommendation to the Board, the position of CEO and Chairman of the Board of Directors, replacing her father in these roles.[7]

In 2014, just prior to the filing of the lawsuit complaint, Streck engaged in a failed sales transaction process as a way to buy out Dr. Ryan's interest. Duff & Phelps was hired in March 2014 to provide transaction advice for a proposed transaction process referred to as "Project Blizzard."

During Project Blizzard, Dr. Ryan and the trustee of Dr. Ryan's trust—daughter Carol Ryan—were excluded from the sales process. In August 2014, Project Blizzard ended without a completed transaction.

During the *Ryan* trial, the relative importance—and prescriptive pricing guidance—of Project Blizzard to the fair value determination of Streck were argued and decided.

The *Ryan* lawsuit was filed by Dr. Ryan, Dr. Ryan's Trust, and Carol Ryan, as the then-Trustee of Dr. Ryan's Trust in October 2014. The Complaint asserted two causes of action against Connie Ryan:

1. Her actions constituted acts of oppression.
2. As a shareholder, director, and president of Streck, she breached her fiduciary duties to Dr. Ryan and his Trust.[8]

Among the relief sought by plaintiffs was a request that Streck be sold to a third party.

Other Case-Related Facts

Between 2014 and the 2018 trial, there were several case-related actions. The following list summarizes many of these actions:[9]

- In December 2014, Streck appointed a special litigation committee, made up of members of its board of directors, allegedly to make a recommendation of whether to purchase Dr. Ryan's shares.
- The special litigation committee hired a valuation firm, Empire Valuation Consultants ("Empire"), to estimate the value of Streck.[10]
- On January 9, 2015, plaintiffs served the First Set of Requests for Production of Documents to Streck.
- Empire issued a report on or about January 16, 2015. The Empire report provided its opinion on the value of Streck as of October 29, 2014. To value Streck, Empire was instructed to follow certain procedures used by defendant's valuation adviser.
- On January 19, 2015, Streck filed an election to purchase Dr. Ryan's shares. Since that date, Streck has withheld paying

dividends to Dr. Ryan in order to finance the purchase of Dr. Ryan's shares.

- Pursuant to Nebraska Revenue St.§ 21-20, 166(3), the filing of this election to purchase commenced a 60-day period for negotiation of the fair value of Dr. Ryan's shares.
- On January 29, 2015, plaintiffs' counsel at Holland & Knight wrote to Streck's counsel at Kutak Rock and requested certain information for the purposes of determining the fair value of Streck.[11]
- On February 20, 2015, Streck, through its counsel, made an offer to purchase Dr. Ryan's shares for $219 million, which included $34 million in cash.
- The February 2015 offer included approximately $80 million in discounts for lack of marketability and lack of control, discounts that the Court later ruled were inapplicable to the determination of fair value in this case.
- In July 2016, just prior to the original trial date in 2016, Stacey Ryan—another daughter of Dr. Ryan—filed a lawsuit that resulted in a two-year delay in the Ryan matter.
- The trial took place in District Court of Sarpy County, Nebraska, on September 24, 2018, through October 4, 2018. Sarpy County is located just outside of Omaha, Nebraska.

Financial Adviser Experts

There were four primary financial advisers/experts that provided trial testimony. On the plaintiffs' side, Willamette and Brown Gibbons Lang & Company ("BGLC") provided testimony—each providing its own opinion of value.

However, Willamette was the plaintiff's primary financial valuation expert and BGLC assisted by providing expert testimony specifically related to the failed Project Blizzard transaction process.

On the defendants' side, there was one primary financial adviser from a self-described "global advisory firm" ("GAF").[12]

The defendants countered BGLC with an investment banker from Capstone Headwaters ("Capstone").

Just prior to the date of the Complaint on October 29, 2014, Connie Ryan engaged in estate planning, relying on a valuation prepared by GAF with a valuation date as of July 31, 2014. This GAF fair market value valuation, therefore, preceded the GAF fair value valuation used in the *Ryan* matter.

For purposes of this discussion, we refer to the fair market value valuation report as GAF Report #1 and the fair value valuation report as GAF Report #2.

The defense also engaged Loop Capital ("Loop") to provide expert valuation testimony, however, at trial, Loop did not testify.

The Valuation Dispute

In *Ryan*, the valuation firms—Willamette and GAF—basically applied the same valuation methodology but had differences of opinion related to the following:

1. The financial projections
2. The expected long-term growth rate
3. The selection of a modified capital asset pricing model ("MCAPM") equity size premium
4. The unsystematic company equity risk premium
5. The relevance of a failed merger and acquisition sales process
6. The application and selection of guideline company pricing multiples
7. The application of a pass-through entity valuation adjustment

Relativity and Document Production

The Willamette work on this matter required the review of thousands of documents, financial statements, spreadsheets, memorandums, and other due diligence materials. For Project Blizzard, Streck provided a document room for potential buyers that hosted thousands of documents and due diligence materials. We were supplied with many of the same Project Blizzard documents.

To assist us, Holland & Knight allowed us access to Relativity, an e-discovery document review platform used in *Ryan*. At the date of our report, there were approximately 6,024 documents on Relativity.

The Willamette initial document review objectives were to determine:

1. evidence of company-prepared financial projections from prior years and
2. the most current financial projection as of the valuation date.

Based on our document search using Relativity, we identified company-prepared Microsoft-Excel-

based projections that were dated at various dates in 2011, 2012, 2013, and 2014.

We applied company financial projections prepared in 2011, 2012, and 2013 in order to analyze:

1. if Streck overperformed or underperformed its long-term company-prepared projected financial performance as compared to its actual financial performance and
2. how (if at all) the company changed its long-term financial projections over time.

In other words, we analyzed whether the company met or exceeded expectations and how financial performance manifested itself in subsequent iterations of financial projections.

Based on our analysis, we found that Streck regularly exceeded one-year management projections by more than 10 percent based on revenue and by approximately 15 percent based on pretax income. The amount by which Streck exceeded management projections increased the further out the projection period.

For example, the financial projections prepared for fiscal year 2012—a projection that was prepared in 2011—were exceeded by more than 2 percent based on revenue and more than 15 percent based on pretax income in the one year ended July 2012.

Using the same financial projection, fiscal year 2014 revenue for the period ended in July 2014 exceeded its projection by 21 percent and projected pretax income was exceeded by 65 percent.

From our observations of single-year financial performance projections and multiyear financial performance projections, we concluded that Streck consistently exceeded its financial projections. In our opinion, Streck exhibited a very low risk of not meeting its financial projections.

For the valuation date financial projection, we identified numerous versions of financial projections prepared in 2014. We reviewed all the 2014 financial projections, and we selected a version dated August 2, 2014. This financial projection was the closest financial projection prior to the October 29, 2014, valuation date.

The financial projection we used agreed with the financial projection used by Loop. However, this financial projection was not used by GAF. GAF used a few company source documents to create its own projection. The GAF projection provided a noticeably lower financial projection than the company-prepared financial projection.

Financial Projections

As noted, we observed that Streck consistently outperformed its projected performance. At trial, Mike Morgan, the Streck CFO in 2014, acknowledged that Streck "planned too conservatively and that is why actual [results] beats plan every year."[13]

Streck had a stated goal of achieving $200 million in sales by 2020.[14] However, according to Morgan, his management-prepared projections were much more conservative than that.

CEO Connie Ryan expressed confidence that the Streck 2014-2019 management-prepared financial projections would be achieved and indicated they were "deliberately conservative."[15]

These deliberately conservative projections were provided to potential buyers in Project Blizzard. The projections were also used for the dispute analysis. Two factors that intentionally made the financial projections knowingly conservative included:

1. the exclusion of a potential new Streck business opportunity and
2. an understated product profit margin that was expected to improve.[16]

With respect to how the Streck growth prospects compared to the overall market, BGLC investment

banking executive John Riddle explained that Streck had a very attractive profile for revenue growth and earnings growth and a dominant position in certain product markets.[17]

Riddle specializes in providing investment banking services to companies in the health care industry. His experience includes companies in the diagnostic health care space, like Streck.[18]

According to Riddle, "there is no other company like Streck in America certainly, and perhaps in the world" and Streck has "niche market dominance."[19]

That dominance, as Riddle explained, led to market power that was independent of patent protection or some process knowledge or other specific intellectual property.

Assessing the Streck projections as compared to typical business practices, Riddle identified that Streck had huge growth opportunities, high actual growth, dominant product franchises, and additional areas of technological advancement.

Based on that, in addition to statements made by the Streck management team, Riddle explained that management projections were too conservative, and the company's growth was described too conservatively to prospective buyers.[20]

In contrast to Riddle, Capstone investment banker James Calandra, despite seeing communication from Streck management in which management described their own projections as conservative, refused to accept that Streck's projections were conservative.[21]

GAF essentially agreed with Calandra and did not provide an explanation for ignoring the conservative nature of the management-prepared financial projections. By creating and using a lower set of financial projections, the impact to value was a $10 million decrease—holding all other valuation variables constant.

In addition to creating a lower five-year discrete projection (fiscal year 2015 through fiscal year 2019), GAF ignored the relative high rate of projected growth for fiscal year 2019 and immediately dropped projections to a 3 percent long-term growth rate.

Streck had a long history of significant growth, and that growth was expected to continue for the foreseeable future. Based on our analysis, and the opinions of others including Loop and Empire, there was no reason to think that Streck growth would immediately fall off a cliff.

To support its 2020-2024 projected revenue growth rates, Willamette used equity securities analyst reports for publicly traded companies that were included in its guideline publicly traded company ("GPTC") method.

Exhibit 1 presents a comparison of 2020 to 2024 projected revenue growth rates between (1) Willamette and Empire and (2) Willamette and GAF.[22]

In *Ryan*, the Court decided that the Streck financial trends were more in line with Willamette projections than GAF projections. For example, at trial, the Court noted that "it's been established through the evidence that the projections that this company has made historically up to the valuation date were extremely conservative."[23]

Regarding its growth prospects, the Court found that Streck's historical growth rates would likely continue during 2014 through 2019, and Streck was well positioned to maintain its market share in hematology and its growth in molecular diagnostics.[24]

Expected Long-Term Growth Rate Projection

In addition to differences in the discrete period growth rates over the period of 2015 through 2024, there were difference of opinion with regard to the expected long-term growth rate assumptions. For the years 2025 forward, otherwise known as the "terminal growth period," Willamette selected a long-term growth rate based on the following factors:

Exhibit 1
Comparison of Projected Revenue Growth Rates

	Projections (Based on Streck 000411)				
Empire Valuation Consultants, LLC - Streck Revenue Performance Comparison	2020	2021	2022	2023	2024
Empire Report Revenue Growth Rate Projection - Streck 000411	8.0%	8.0%	7.0%	5.0%	3.5%
Willamette-Streck Revenue Annual Growth Rate Projection	8.0%	8.0%	7.0%	6.5%	4.5%
Difference between Empire Growth Rate Projection and Willamette Growth Rate Projection	0.0%	0.0%	0.0%	-1.5%	-1.0%

	Projections (Based on Streck 000527)				
Global Advisory Firm - Projection of Streck Revenue Performance	2020	2021	2022	2023	2024
GAF Report #2 Revenue Growth Rate Projection - Streck 000527	3.0%	3.0%	3.0%	3.0%	3.0%
Willamette-Streck Revenue Annual Growth Rate Projection	8.0%	8.0%	7.0%	6.5%	4.5%
Difference between GAF Report #2 Growth Rate Projection and Willamette Growth Rate Projection	-5.0%	-5.0%	-4.0%	-3.5%	-1.5%

1. Streck's historical financial fundamental growth rates
2. The anticipated life sciences industry growth rate
3. Equity analysts' long-term growth rates for guideline companies
4. Long-term gross domestic product growth rates plus inflation rate expectations as estimated by economists surveyed in the *Livingston Report*, an economic report published by the Federal Reserve Bank of Philadelphia.[25]

Based on those factors, Willamette estimated that Streck's terminal growth rate was 4.5 percent. At trial, Willamette analyst Robert Reilly explained that the 4.5 percent terminal growth rate assumes that Streck is going to revert back from growing at a super normal growth rate to growing no faster than inflation plus real growth in the economy.[26]

As Reilly stated:

> Streck then goes from sprinting to jogging on a treadmill. They just stay in place. They're not getting any bigger than their competitors. They're not getting any bigger than the industry. They're not getting any bigger than the economy. They just start jogging in place on a treadmill, they're going to grow at about 4½ to 5 percent per year.

The 4.5 percent terminal growth rate was a "downward biased assumption" because Streck had been reporting consistently increasing profit margins and the projected long-term growth rate was half of the industry's historical growth rates.[27]

The Court found that the Willamette long-term growth rate assumption was similar to conclusions reached in *Ferolito v. Arizona Beverages USA LLC* ("*Ferolito*"), No. 004058-12, 2014 WL 5834862 (N.Y. Sup.) (N.Y. Oct. 14, 2014).[28]

In *Ferolito*, the court found that the plaintiff expert's use of a 4.5 percent terminal growth rate was appropriate and even overly conservative because it assumes the company will grow based on the expected inflation rate plus real growth in gross domestic product.

In contrast, the GAF analyst predicted growth from 2020 forward would immediately fall off to 3 percent and remain at 3 percent in perpetuity. Had GAF used a 4.5 percent growth rate rather than a 3 percent growth rate, its valuation under the discounted cash flow ("DCF") method would have increased by $65 million.[29]

At trial, the GAF analyst attributed this decrease in the Streck growth rate to 3 percent based on the following factors:[30]

> So, I started with, you know, I did consider the macroeconomic factors, and I won't rehash that. But in addition to that, also looked at the company specific factors. So those would normally include things like, okay, well, how can the company actually grow in the future. One way might be to increase market share. Well, that's not very likely because the company already has, you know, it's the market giant . . . Another way to potentially-you know, another aspect of company growth I looked at was, okay—and we're talking about growth from starting in 2020 and going forward. Well, at the end of 2019, 30% of their business is tied to patents in the hematology control business that expire. . . .
>
> And then, last, we have the issue, and it's come up before, with respect to BCT, you know, that line of business. It has 95% margins and it's not protected by patents.

At trial, it was noted that the GAF analyst listed nearly the same factors he considered in selecting his company-specific risk factor applied in the MCAPM. In effect, the GAF analyst admitted to double-counting risk in the selection of the long-term growth rate and the company-specific risk factor.

The GAF analyst had previously testified in *Charron v. Sallyport Global Holdings, Inc.*,[31] that using the same risk factors to lower projections and justify company-specific risk is "double-counting."[32]

Selection of Equity Size Premium

It is generally accepted that, based on empirical observation, small companies are a greater investment risk than larger companies and, therefore, smaller companies have a greater cost of capital than larger companies.[33] In other words, there is a significant (negative) relationship between size and historical equity returns. The *Duff & Phelps Valuation Handbook*—now the Cost of Capital Navigator database website—is a common reference source for the size premium risk adjustment.

The *Valuation Handbook* provides empirical evidence of the size premium phenomena. The *Valuation Handbook* defines the size premium as the difference between actual historical excess returns and the excess return predicted by beta (referred to as the "CRSP size premium").

Both GAF and Willamette used the Duff & Phelps CRSP size premium study to select an equity size premium to apply in its respective MCAPM equity cost of capital model. The difference in the equity size premium selection between GAF and Willamette was approximately 150 basis points.

On one side, the selection of the micro-cap premium of approximately 3.9 percent was used. On the other side, the selection of the eighth decile size premium of approximately 2.4 percent was used.

Willamette applied the CRSP size premium data associated with companies valued between $636 million and $1.055 billion.[34]

In order to avoid the circular issue of selecting a size premium based on the resulting income approach method conclusion, Willamette based its CRSP size premium selection on its market approach, GPTC method, conclusion of value.

GAF applied a CRSP size premium associated with companies valued between $2.4 million and $632.8 million. The "micro-cap" category encompasses the 9th and 10th deciles of the Size Premia Study.[35]

To rebut this selection, at trial, Reilly testified that the 10th decile includes "noise" in the form of small, nonprofitable companies.

CRSP 10th decile companies exhibiting the most noise comprise the Duff & Phelps 10th decile subclassification 10z—the lower quarter of the 10th decile.

According to James Hitchner in *Financial Valuation and Litigation Expert*, "It's important to note that 80 percent of the companies in decile category 10b are from 10z. As such, let's focus on 10z. At the 50th percentile of 10z the operating margin is –1.11 percent. Yes, on average, these companies are losing money. At the 25th percentile the operating margin is –21.27 percent. Furthermore, 62 percent of the companies in 10z are from only three industry sectors: financial services, technology, and healthcare."[36]

The distressed company issue can be seen through analysis of the 10th decile subcategories of 10y and 10z.[37]

In *Ryan*, the Court found that all offers received for Streck through the Project Blizzard process would have placed the company in the 9th decile, not the 10th. In fact, if the GAF analyst had used his guideline merged and acquired company method valuation based on Project Blizzard pricing indications, he would have concluded Streck fell into the 9th decile.

According to the Court, the inclusion of the 10th decile by the GAF analyst was intended to lower his valuation for Streck.[38]

At trial, the GAF analyst claimed that he also used another methodology to determine Streck's size premium. However, this other methodology did not appear in any GAF expert report prepared in *Ryan*.[39]

This other methodology was based on the application of the *Duff & Phelps Risk Premium Report*. The *Duff & Phelps Risk Premium Report* can be used to develop a size-related risk premium based on a regression model.

Upon redirect examination at trial, Willamette demonstrated how the additional methodology, in the instant case, was not reliable. For example, using the selected "guideline companies" for comparison purposes, Willamette demonstrated how GPTC companies with market value of equity greater than $1 billion could yield an equity size premium estimate in the CRSP 10th decile range using the GAF methodology.

The difference, using publicly traded company Abaxis, Inc. ("Abaxis"), as an example, is observable by treating a CRSP 7th decile company as a 10th decile company based on the *Duff & Phelps Risk Premium Report* methodology.[40]

According to CRSP 7th decile statistics, Abaxis had an equity size risk premium of 1.94 percent based on the 2014 *Valuation Handbook*.

In contrast, the *Duff & Phelps Risk Premium Report* methodology regression model provided a size premium estimate for Abaxis of approximately 5.80 percent.

Exhibit 2 provides the analysis of Abaxis as of October 29, 2014.

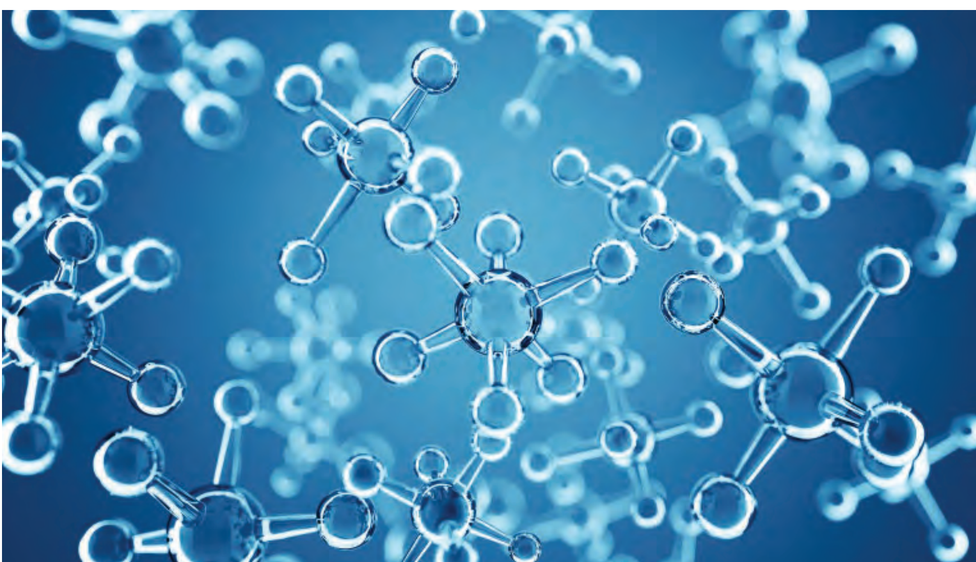


Exhibit 2
Size Risk Premium Attributed to Abaxis, Inc.

Financial Fundamental	Abaxis, Inc., Financial Fundamental $MM	Regression Equation Variables		Equity Risk Premium over CAPM
		Constant	Coefficient	
Latest 12 Months Book Value of Equity	197	9.22%	-1.79%	5.11%
Latest 12 Months Total Asset Value	227	10.57%	-1.94%	6.01%
5-Year Average EBITDA	27	8.95%	-1.92%	6.20%
Latest 12 Months Revenue	176	9.41%	-1.57%	5.89%
			Mean Indication	5.80%
Abaxis, Inc., Market Value of Equity as of October 29, 2014	1,119			
Duff & Phlelps, 2014 *Valuation Handbook* , CRSP 7th Decile Indication				1.94%

CAPM = Capital asset pricing model

Sources: As indicated and S&P Capital IQ database.

The Court concluded that the GAF analyst's "explanation" of how he utilized this other methodology was convoluted and not credible.[41]

Had GAF applied the size premium for the 9th decile, and held all other factors equal, its valuation under the DCF method would have increased by $59 million.[42]

Because of the rounding convention used for the MCAPM cost of equity model presented in the Willamette report, the use of the ninth decile or the eight decile did not change its MCAPM cost of equity model conclusion.

Unsystematic Risk Premium

The unsystematic equity risk premium component is sometimes applied by analysts. The decision to apply the unsystematic equity risk premium should be well supported by the facts and circumstances of the subject analysis.[43]

This component is used to incorporate risk that is specific to the subject investment—for example, lack of management talent, potential labor issues specific to the subject company, potential of losing a key client or key personnel, and/or potential cost/risk not identified in financial projections, and so forth.

One argument against applying the unsystematic equity risk premium is that capital market theory suggests that unsystematic equity risk can be diversified away if an investor holds a well-diversified and large portfolio of common stocks.

In general terms, the higher the identified company-specific risks, the higher the percentage premium applied. At trial, Willamette explained that determining the risk premium involves the judgment of the valuation expert. Willamette applied a 0.5 percent company-specific risk premium based on its analysis of Streck, including its level of customer concentration.[44]

What might be considered a weakness of Streck could, in turn, be considered a strength of Streck's business due to its long-term contractual relationships.

As of October 2014, Streck had long-term contracts in place with its most important customers.[45] For example, Sysmex, Streck's largest customer, had a six-year contract that ran through July 2020 and could only be terminated after July 27, 2020.[46]

Sysmex, which purchased Streck's hematology controls and accounted for approximately 30 percent of Streck's revenue, was totally "dependent" on Streck.[47]

Another mitigating factor to consider is that, as previously discussed, Streck management admitted—and the Court found—that it prepares deliberately conservative financial projections. The history of, and managements admission of, preparing deliberately conservative financial projections suggested that Streck, as of the valuation date, presented a relatively low risk of achieving its own financial projections.

In contrast, the GAF analyst applied a 1 percent company-specific—unsystematic—risk factor to his discount rate estimate. The GAF analyst testified that a 1 percent company-specific risk factor was appropriate for the following reasons:[48]

> And now we get down to the point where there is some level of judgment involved,

for sure, and that's the company-specific risk premium. And this is—this is a risk factor that you consider with respect to understanding, well, is-are there risks that are unique to Streck that I haven't accounted for yet. In the case at hand, based on some of the factors I've already talked about today, but customer concentration, the patents expiring, the fact that there's no patents on the BCT line of business, et cetera, I've already talked about a lot of those, I concluded a company-specific risk premium of 1 percent.

Although certain Streck patents were due to expire, Streck had a relatively full pipeline of patent applications in process. As of May 2014, Streck had 28 issued patents and 35 pending patent applications.[49]

Furthermore, at trial, Willamette argued that just because a patent is due to expire does not mean product revenue disappears overnight, or perhaps at all.

As previously discussed, the Court found that the risk factors the GAF analyst considered in selecting a company-specific risk premium were essentially the same risk factors the GAF analyst used to justify his lower projections.[50]

Failed Merger and Acquisition Sale Process

In March 2014, Streck engaged Duff & Phelps Securities, LLC, to help Streck find a company buyer through the Project Blizzard sales process. Just prior to the start of Project Blizzard, Streck had several indications of interest from potential buyers including Warren Buffet.[51]

As an anecdotal point of reference, in January 2014, Dr. Ryan reached out to Carson Wealth Advisers and requested that it provide a business enterprise value estimate. According to Carson Wealth Advisers, using a 17 times earnings before interest, taxes, depreciation, and amortization ("EBITDA") pricing multiple, Streck was valued at $850 million.[52]

Once Duff & Phelps was hired, it worked to identify potential buyers, it provided the buyers with certain financial information, and it set up meetings between Streck and the buyers. At some point, Connie Ryan eventually concluded, however, that Duff & Phelps did not have adequate experience in Streck's product markets and lost confidence in working with Duff & Phelps.

Project Blizzard ran over the course of three rounds. In the first round, 10 potential buyers submitted bids that ranged from $387 million on the low end to $625 million on the high end.[53]

None of the bids included the Streck cash and securities. As of October 2014, Streck had $76.5 million in cash and securities. The highest bidder in round one was the private equity firm GTCR. However, GTCR was not selected to move to Project Blizzard round two.

At trial, Riddle testified that it was highly unusual that GTCR was not permitted to advance to the second round.

In Project Blizzard round two, four firms advanced including Waterstreet, Carlyle, Capricorn, and Warburg Pincus. However, it appeared that Streck did not intend for Capricorn to be a serious buyer.[54]

Instead of including the round one highest bidder, Streck decided to exclude GTCR in favor of Capricorn.

In July 2014, at a Streck board of directors meeting, Dr. Ryan made his frustrations of Project Blizzard known by way of the following statement:[55]

> And in addition to that, all the money and everything that was put into it, I put right back into it. So, that's why we're here. And I own now 92% of the stock. Connie owns eight. And the Board has zero. You have nothing to lose. I have everything to lose in this decision you're making. And I want you to know that, and I think it's right that you should know it. . . . I have requested that my Trustee, Carol, and the Trustee of the Eileen Ryan Revocable Trust, which is the First National Bank of Omaha, be made part of this process. I think it's unfair when they have that much money at stake, and everything else, for them to not be included. If you don't want them included, ok, then I will have to change whatever plans I've got for going forward. . . . The decisions about the bidding process and the bidders are being made without input from approximately 92% of the total votes. . . . So you go, but I tell you, I think this is. And I talked to Jim yesterday, and I told him some of the same thing. I think there's some things wrong, and I think, I don't know how to correct them without going way beyond what this meeting is really intended for. So I thought, well, I'll just tell you very briefly where I am and what I think.

For Project Blizzard round three, three of the private equity firms submitted letters of intent—Carlyle, Waterstreet, and Warburg Pincus. Carlyle offered $590 million and proposed using leverage

of 5 times EBITDA with a reverse break-up fee of 5 percent of the purchase price.[56]

It also agreed to exclude Sysmex, Beckman Coulter, Abbott, Siemens, and any other specific hematology instrument manufacturers, to the extent Streck had any concerns, as potential buyers at such time as Streck was resold.

Waterstreet provided similar terms to Carlyle but offered $530 million.[57]

In addition, Waterstreet agreed to exclude any hematology instrument manufacturer that held a 10 percent or greater share of the worldwide market for hematology instruments. Warburg Pincus offered only $500 million in the form of $450 million in cash and $50 million in an earnout.[58]

BGLC investment banker Riddle testified that, based on his knowledge of Streck, he expected to see offers for Streck during the Project Blizzard process that were "several hundred million" dollars higher than the actual letters of intent received.[59] Riddle testified that there were three aspects to Project Blizzard process that limited the price offered, including:

1. the insistence on a reverse breakup fee,
2. the limitation on leverage implied by Streck during the process, and
3. the elimination of bidders, notably the highest and most qualified, GTCR.

The breakup fee was rather unorthodox, the leverage restriction had chilling effect on bidders, and the elimination of GTCR was highly unusual.

With regard to Project Blizzard and its pricing indications, only GAF found the Project Blizzard pricing to be prescriptive to value. In its Streck valuation, GAF based its entire merger and acquisition approach value conclusion on the Waterstreet pricing multiple from the failed sales process.

GAF was the only valuation analyst to give any weight to the failed sales process. In other words, Loop, Empire, and Willamette did not rely on the failed sales process as a direct valuation indication.

The use of a failed sales process as value indication is rather unusual. One reason the process failed was because the proceeds offered by the prospective buyers were not enough to compel the collective 92 percent owners to sell the business. While you had a willing buyer, you did not have a consensus willing seller at the Project Blizzard pricing indications.

Because the Streck fiscal year 2015 financial performance was better than its fiscal year 2015 projected performance, as of October 2014, an adjustment to the implied Project Blizzard EBITDA multiples was considered—a so-called "October Effect."

Based on this October Effect, the Carlyle offer could be adjusted to $606 million from $590 million and the Waterstreet offer could be adjusted to $544 million from $530 million.[60]

Subsequent to Project Blizzard, GTCR made a September 2014 offer to purchase Streck for approximately $675 million on a cash-free basis.[61]

At trial, the Court ruled that the GTCR offer was a legitimate offer and was an indication of a "floor" value as of October 2014.[62]

To that end, the Court ruled that the flawed and failed Project Blizzard yielded a minimum fair value estimate of Streck stock as of the valuation date.

Market Approach and Selected Pricing Multiples

GAF and Willamette both selected guideline public companies and applied guideline company pricing multiple to arrive at GPTC value indications.

As presented in Exhibit 3, Willamette analyzed Streck as compared to selected guideline companies.[63]

Streck was smaller than the GPTCs, but generally Streck was much more profitable than the GPTCs.

To select pricing multiples, Willamette considered the following factors:

1. Streck is a private company and, in general, private companies may sell at lower multiples than comparable publicly traded companies.
2. Streck is more profitable than the GPTCs.
3. Streck has consistently exceeded its projected performance and, therefore, the Streck Projected Year 1 and Projected Year 2 financial fundamentals may be understated.
4. In terms of size, based on earnings before interest and taxes ("EBIT") and EBITDA financial fundamentals, Streck is comparable to the median of the GPTC indications.
5. Noted company-specific risk factors.

One of the noted company-specific risk factors involved the Streck portfolio of intellectual property and patents that were due to expire in the next several years. However, Willamette testified that the risk associated with the Streck patent portfolio was akin to that of the guideline public companies it selected.[64]

Exhibit 3
Streck Financial Fundamentals and Selected Ratio Compared to Guideline Publicly Traded Companies

Size (LTM revenue, $000)	
Bio-Rad Laboratories, Inc.	2,153,877
Sysmex Corporation	1,773,484
Bio-Techne Corporation	357,263
Affymetrix Inc.	341,393
Luminex Corporation	224,033
Abaxis, Inc.	176,178
Streck Inc.	*104,490*

Size (LTM total assets, $000)	
Bio-Rad Laboratories, Inc.	3,467,751
Sysmex Corporation	1,886,427
Bio-Techne Corporation	862,491
Affymetrix Inc.	478,227
Luminex Corporation	330,512
Abaxis, Inc.	226,611
Streck Inc.	*118,560*

Growth Rate (projected yr. 2 revenue growth rate)	
Abaxis, Inc.	12.6%
Sysmex Corporation	10.3%
Luminex Corporation	8.3%
Streck Inc.	*9.0%*
Bio-Techne Corporation	7.5%
Bio-Rad Laboratories, Inc.	4.1%
Affymetrix Inc.	4.9%

LTM Profitability (EBIT to revenue)	
Streck Inc.	*48.6%*
Bio-Techne Corporation	47.4%
Sysmex Corporation	19.1%
Abaxis, Inc.	13.2%
Luminex Corporation	11.9%
Bio-Rad Laboratories, Inc.	6.0%
Affymetrix Inc.	-1.5%

LTM Profitability (EBITDA to revenue)	
Bio-Techne Corporation	51.6%
Streck Inc.	*51.2%*
Sysmex Corporation	25.3%
Luminex Corporation	18.7%
Abaxis, Inc.	17.6%
Bio-Rad Laboratories, Inc.	13.0%
Affymetrix Inc.	8.7%

Liquidity (current ratio)	
Bio-Techne Corporation	17.8
Abaxis, Inc.	9.8
Streck Inc.	*5.1*
Luminex Corporation	5.1
Bio-Rad Laboratories, Inc.	3.6
Sysmex Corporation	2.3
Affymetrix Inc.	2.3

Size (LTM EBITDA, $000)	
Sysmex Corporation	448,200
Bio-Rad Laboratories, Inc.	281,067
Bio-Techne Corporation	184,324
Streck Inc.	*53,542*
Luminex Corporation	41,855
Abaxis, Inc.	30,969
Affymetrix Inc.	29,827

Activity (working capital turnover)	
Streck Inc.	*5.2*
Affymetrix Inc.	3.4
Sysmex Corporation	2.6
Luminex Corporation	2.0
Bio-Rad Laboratories, Inc.	1.6
Abaxis, Inc.	1.2
Bio-Techne Corporation	0.9

Leverage (equity to total capital)	
Luminex Corporation	100%
Sysmex Corporation	100%
Abaxis, Inc.	101%
Bio-Techne Corporation	100%
Streck Inc.	*95%*
Bio-Rad Laboratories, Inc.	86%
Affymetrix Inc.	81%

In other words, all of the guideline companies have some intellectual property risk as patent owners and life science product manufacturers. Guideline companies enjoy patent protection, but, obviously, that protection does not last forever. Typically, life sciences companies patent new products and often use patent protection to defend products from intellectual property infringement. In Streck's management-prepared strategic plan, Streck described both "defensive" and "offensive" strategies to protect its intellectual property portfolio.[65]

At trial, GAF argued that Streck was in relative peril due to expiring intellectual property rights that served as the underpinning for the following:

1. Decreased financial projection expectations
2. Higher costs of capital
3. Selection of low GPTC pricing multiples

As presented in Exhibit 4, Willamette selected multiples slightly above the low end of the range of multiples for the guideline public companies.[66]

In selecting the relevant multiples, Willamette generally applied downward-biased pricing multiples in order not to overvalue Streck.

GAF claimed to apply the GPTC method to value Streck. However, at trial, the GAF expert ultimately concluded that none of the companies he selected compared to Streck.

With some exceptions, the guideline public companies selected by GAF were the same as (1) Willamette, (2) Empire, and (3) Loop.

Because all other valuation advisers used essentially the same GPTCs, it was somewhat unusual that GAF sought to discredit the use of the GPTC method to value Streck.

In addition to trying to discredit the GPTC method, GAF changed its application of its GPTC method between GAF Report #1 and GAF Report #2.

The change in application provided a significantly lower GAF Report #2 value conclusion than if GAF had consistently applied the GPTC method.

In GAF Report #1, GAF applied guideline EBITDA pricing multiples at the lower quartile

Exhibit 4
Willamette-Prepared Guideline Publicly Traded Company Method Summary and Conclusion

Value Measure	Streck Inc. $000	Guideline Publicly Traded Company Pricing Multiples Low	High	Median	Selected Pricing Multiple [b]	Market Value of Invested Capital $000	Equal Value Measure Weight [a]	Weighted Value $000
MVIC/ EBIT:								
Projected Year 2	60,640	13.0	26.5	18.7	14.0	848,960	0.14286	121,280
Projected Year 1	54,860	14.1	31.5	21.2	15.0	822,898	0.14286	117,557
Latest 12 Months	50,808	18.0	27.1	23.9	19.0	965,352		
MVIC/EBITDA:								
Projected Year 2	62,782	7.8	14.8	13.8	11.0	690,598	0.14286	98,657
Projected Year 1	56,940	8.8	17.2	14.7	12.0	683,284	0.14286	97,612
Latest 12 Months	53,542	10.8	22.6	17.3	13.0	696,050	0.14286	99,436
MVIC/Revenue:								
Projected Year 2	120,712	1.3	5.9	2.8	5.5	663,918		
Projected Year 1	110,729	1.3	6.4	3.0	6.0	664,374	0.14286	94,911
Latest 12 Months	104,490	1.4	8.5	3.2	7.0	731,429	0.14286	104,490
							1.00000	
Indicated Fair Value of Invested Capital (noncontrolling level of value basis)								733,942
Indicated Fair Value of Invested Capital (rounded) [b]								771,000

MVIC = Market value of invested capital

[a] We excluded the high and low indication of value.

[b] Guideline company multiples are calculated on a noncontrolling level of value basis. Because we are estimating a fair value, and fair value is on a controlling level of value basis, we added a 5 percent owership control price premium to the noncontrolling level of value indication.

indication. In GAF Report #2, a valuation that was as of three months later than GAF Report #1, GAF applied GPTC pricing multiples that were at the lowest GPTC pricing indication. In the three months from July to October, GPTC pricing multiples had increased and Streck financial performance also increased.

The change in application methodology resulted in a value decrease of approximately $172 million, holding all else equal.[67]

With respect to the guideline merged and acquired company ("GMAC") method, Willamette prepared an analysis by selecting guideline transactions. GAF prepared an analysis that relied on the Project Blizzard pricing only. The GAF analysis did not include the GTCR offer in September, just after Project Blizzard ended.

The Court found that the GAF GMAC method appeared to reflect the report's downward bias.

Tax Pass-Through Premium Consideration

There are several benefits of tax pass-through entity ownership. According to *Business Valuation and Federal Taxes: Procedure, Law and Perspective*, a few of the major benefits of owning a tax pass-through ownership interest include the following:

> Income is subject to only one level of taxation at the individual shareholder level, with no double taxation. C corporations can accumulate earnings, paying income tax only at the corporate level, and undistributed earnings are not subject to shareholder-level taxation.
>
> Owners of the pass-through entity receive an increase in the basis of the shares to the extent that taxable income exceeds distributions to shareholders. In other words, income retained by the S corporation adds to the tax basis of the

shareholder stock, reducing the shareholder's capital gain upon sale. This requires some analysis of the investment horizon of buyers.

A buyer may pay more for the increased tax savings available to S corporations, if he can receive a step-up in basis. For example, the sale of the entire business may be treated as an asset sale under [Internal Revenue Code] section 338, which increases the buyer's basis.

The buyer of C corporation stock generally realizes future depreciation and amortization based on the tax basis of the underlying assets. However, all else being equal, the buyer will be willing to pay more for an S corporation business in which assets receive a step-up in basis, because the buyer's effective future income taxes will be reduced.

Further, pass-through entity owners receive proceeds upon sale that are taxed only once. Gains on sale of assets by a C corporation are taxed at the corporate level, and then distributions are taxed again at the shareholder level. Likely exit strategies therefore become an important consideration for valuation.[68]

Because the subject interest represented an interest in a tax pass-through corporation, and one of the primary economic benefits is the elimination of double taxation, the Streck distribution history was relevant. To that end, Streck had a history of paying distributions in excess of its tax pass-through shareholder tax obligations.

All Willamette-prepared Streck value conclusions—based on the DCF method, GPTC method, and the GMAC method—provided a C corporation equivalent value. Because Streck is not a C corporation, but has elected to be taxed as an S corporation, it was necessary to adjust the values determined by these three valuation methods by what is referred to as an "S corporation premium."[69]

Both Willamette and GAF applied an S corporation premium to determine the Streck value.[70]

To support its S corporation premium selection, Willamette calculated the S corporation premium using four different methodologies:

1. The S corporation economic adjustment multiple ("SEAM") analysis
2. Empirical research as provided by the Erickson and Wang Study
3. The S corporation methodology as used in *Delaware Open MRI Radiology Associates v. Howard B. Kessler* ("*Kessler*")[71]
4. The methodology presented in the Fannon and Sellers book, *Taxes and Value, The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*[72]

These four methodologies provided a range of S corporation premiums of 12 percent to 17 percent. Based on these methodologies, Willamette concluded that a 14 percent premium reflects the economic benefits attributable to Streck's elected income taxation status as an S corporation.

The 14 percent price premium was supported by the S corporation premium conclusions based on the application of the *Kessler* decision methodology and the SEAM analysis methodology.

Applying the S corporation premium to the indicated value of Streck resulted in an $817 million valuation conclusion.[73] This value conclusion was prior to adding cash and marketable securities of $76.5 million.[74]

GAF applied an S corporation premium to only the values derived from the DCF method and the GPTC method. Because GAF selected an average price indication from the failed Project Blizzard as a value indication for Streck, it did not apply an S corporation premium to its GMAC method value estimate.[75]

To estimate an S corporation premium to apply to the DCF method value estimate and GPTC method value estimate, GAF relied exclusively on its SEAM method calculation—the only method presented by GAF.

GAF calculated the same S corporation premium as Willamette.[76] However, instead of applying the 14 percent premium, GAF cut the premium in half and applied a 7 percent S corporation premium. According to its report, GAF cut the premium in half based on the following factors:

1. The S corporation election was at risk.
2. There were limited potential buyers of an S corporation.
3. Tax laws might change.
4. Streck might not be profitable.

At trial, the GAF analyst discussed these factors.[77] The GAF analyst testified that there was a risk during 2014 that the Obama Administration would change the tax code.

At trial, the GAF analyst testified to the following:[78]

> Q. All right. Do you recall any discussions occurring at that time that went into your analysis at least that would suggest if the Republican house was interested in tax increase in October of 2014?

> A. I believe they—I believe-and who knows; right? If this is a risk, it's not a for sure. I believe there was a lot of articles that I have read where there might have been a tradeoff that said, hey, if we can get these corporate tax rates down to where they think they need to be, we'll maybe give a little bit on the high end for individuals, which is a double whammy as it relates to—you know, both of those are going the opposite directions, which it actually lowers or eliminates the SEAM adjustment altogether.
>
> Q. So it's your opinion, who knows; right?
>
> A. It's a risk. It's a risk that a C Corporation doesn't have.

The GAF analyst then testified that there had been "discussions" at Streck about converting to a C corporation.[79] But there was no evidence of such discussions presented at trial.

Willamette also rebutted the methodology, or the lack thereof, employed by GAF for reducing the S corporation premium in half.[80]

Reilly testified that "[t]here's simply no quantitative variable for making a probability adjustment. It's just not in any of these models."

An article mentioned by GAF at trial indicated that the SEAM model assumed certain factors, and could be adjusted if those factors were not present. However, the article did not describe a quantitative means for making the adjustment, and it certainly did not describe a means of arbitrarily chopping the premium in half based on an unsupported potential change in the U.S. Tax Code.

The GAF reduction in the S corporation premium, all other things being equal, reduced its valuation by $32 million.[81] The arbitrarily halving of the S corporation premium reflects GAFs downward bias.

Pricing Evidence and Valuation Conclusion

At trial, GAF accused Willamette of concluding on a value that was "off the charts." However, pricing for Streck, based on Project Blizzard, and value indications based on generally accepted valuation methodology provided a rather wide range chart.

Project Blizzard and the subsequent GTCR offer provided EBITDA pricing multiples of just above 8 on the low end and nearly 13 on the high end. The GPTC business enterprise to EBITDA pricing multiples, provided by pricing multiples presented in the GAF Report #2 analysis, provided a range from 9.3 times EBITDA to 28.4 times EBITDA.

Figure 1 provides an illustration of how the GPTC business enterprise to EBITDA pricing multiples aligned with the (1) implied GAF business enterprise to EBITDA pricing multiple and (2) implied Willamette business enterprise to EBITDA pricing multiple.

As can be observed in Figure 1, the only analysis that did not fit within the GPTC pricing multiple range was the implied GAF Report #2 analysis. The lowest GPTC business enterprise to EBITDA pricing multiple was 9.3, and the GAF implied business enterprise to EBITDA pricing multiple was 9.06.

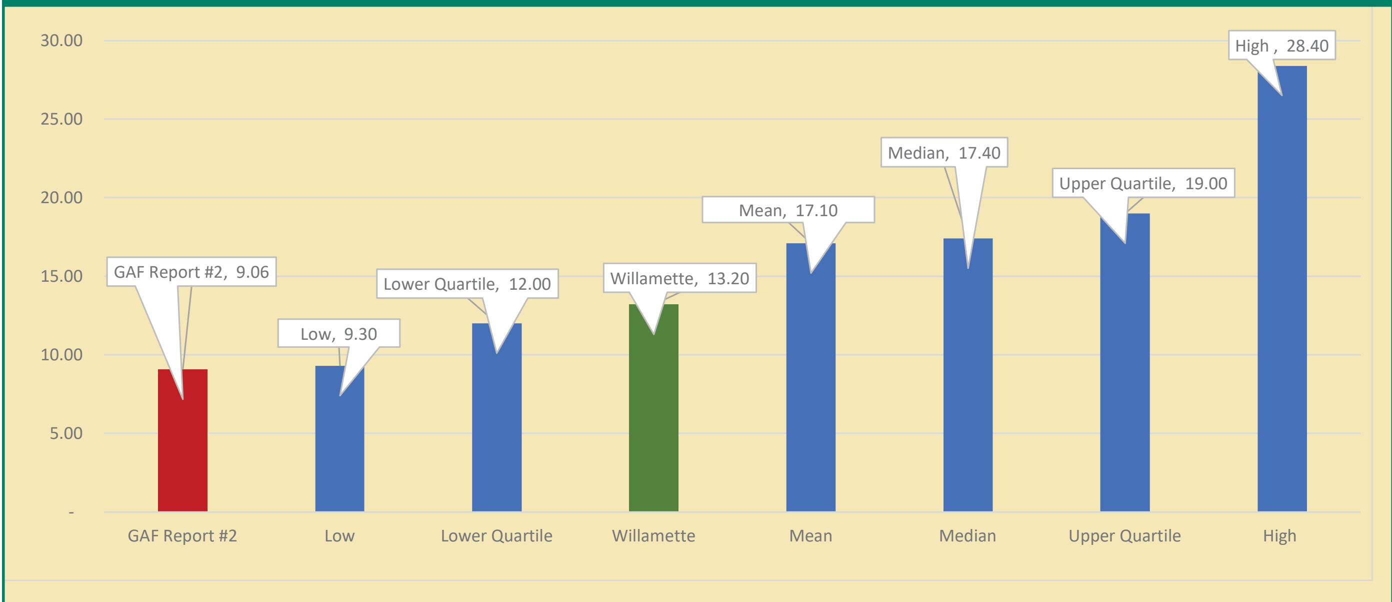
Court Findings in the Ryan Order

GAF valued Streck at $505 million, on a cash-free basis.[82]

That value was less than the Project Blizzard value indications after accounting for the improved Streck financial performance as of October 2014. The GAF value conclusion was approximately $145 million lower than the midpoint of the September 2014 GTCR price range offer to buy Streck.

In *Ryan*, the Court ruled that the defendant had failed to meet its burden of establishing a fair value

Figure 1
Business Enterprise to EBITDA Pricing Multiples Comparison
Using GAF Report #2 Pricing Multiples



of its stock. According to the Court, the GAF analyst valuation work reflected a downward bias in the following ways.[83]

- He disregarded already conservative management financial projections without explanation.
- He applied a size premium that was out of line with the Project Blizzard bids and inappropriately included companies in the 10th decile.
- He "double counted" by applying the same risk factors to lower projections and to justify a company-specific risk premium. This practice has been specifically identified by the *Kessler* litigation ("To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients' objectives, when other valuation inputs fail to do the trick.").
- He assigned pricing multiples to Streck that were well below those of the companies he selected as being comparable for purposes of his publicly traded company analysis.
- He assigned pricing multiples to Streck that where well below those assigned by his own colleague who prepared the GAF Report #1, in spite of the fact that the valuation date for GAF Report #2 was only three months after the valuation date of GAF Report #1.
- He arbitrarily reduced the S corporation premium by half and cited "evidence" (e.g., the risk of an Obama Administration tax increase) which did not exist to support this reduction.

Because of the noted issues, the Court concluded that GAF applied variables designed to lower its valuation of the fair value of Streck and Dr. Ryan's shares.[84]

Therefore, the Court rejected the GAF conclusion. By rejecting the GAF conclusion, the Court accepted the Willamette conclusion in full—a conclusion that was $312 million higher than the GAF conclusion prior to prejudgment interest.

Summary and Conclusion

This discussion presented an insider perspective on the largest valuation-related judicial decision in Nebraska state court history. This judicial decision is also considered to be second largest forced buyout in U.S. history.

The *Ryan* matter was essentially a dispute between family members that involved the fair value valuation of Streck, a multinational life sciences business. The *Ryan* decision is a valuation heavy—that is, many dispute-related valuation disagreements between experts—shareholder oppression matter. Because the experts were more than $300

million apart in the business enterprise value conclusion of Streck, something had to give.

In *Ryan*, two well-known valuation firms provided expert testimony. The firms generally applied the same methodology, but had differences of opinion related to the following:

1. Financial projections
2. Expected long-term growth rate
3. Selection of an MCAPM equity size-premium
4. Selection of an unsystematic company risk premium
5. Relevance of a failed merger and acquisition sales process
6. Application and selection of guideline company pricing multiples
7. Application of a tax pass-through entity valuation adjustment

In the end, the Court accepted one valuation conclusion, in full, and rejected the other valuation conclusion because it was found to be unreliable.

The Court concluded the defendants' valuation expert provided a biased work product. The following discussion presents a summary of the dollar-impact of the bias, as summarized by the Court:[85]

- Had the defendants' analyst used management projections instead of creating his own projection, the DCF valuation would have increased by $10 million. The downward biased projection also affected the GPTC method. However, that impact was not quantified for the Court.
- Had the defendants' analyst used the 9th size decile instead of the micro-cap size category, the DCF valuation would have increased by $59 million.
- Had the defendants' analyst used a 4.5 percent terminal growth rate rather than a 3.0 percent terminal growth rate, the DCF value would have increased by $65 million.
- Had the defendants' analyst not arbitrarily cut the S corporation premium in half, his valuation would have increased by $32 million.
- Had the defendants' analyst used consistent methodology between the first Streck valuation report and the second Streck valuation report, the GPTC method would have increased by $172 million.

All of the Court findings related to the dollar impact of analyst bias were calculated in isolation. In other words, certain of the Court findings, when taken together, have a more significant impact on value than in isolation.

Having worked on *Ryan*, and having worked on dispute-related matters like *Ryan*, it is typically an advantage to the valuation analyst when the legal team provides:

1. unfettered access to case documents in a document management software platform,
2. enough time so that court deadlines do not impair the quality of the analysts' work, and
3. an engaging process whereby in-person meetings and phone calls are held on a regular basis.

If all three advantages are present, the valuation analyst and the legal team should be able to find common ground and present their best case to the trier of fact.

Notes:

1. In the matter of the Wayne L. Ryan Revocable Trust, Steven Ryan and First Nebraska Trust., as co-trustees for the Wayne L. Ryan Revocable Trust, and Steven Ryan, as personal representative of Dr. Wayne L Ryan, deceased v. Constance "Connie" Ryan and Streck, Inc., Case No. CI 14-1684 ("Ryan"), opinion and order filed on July 23, 2019 ("Order").
2. Andrew Maloney, "Chicago Attorney Led Legal Effort in $725M Forced-Buyout Dispute," Lawbulletinmedia.com (September 10, 2019).
3. Order, 10.
4. Ibid., 5.
5. The Wayne L. Ryan Revocable Trust, Carol Ryan as trustee for the Wayne L. Ryan Revocable Trust, and Dr. Wayne L. Ryan, an individual, Plaintiffs v. Constance "Connie" Ryan and Streck, Inc., Defendants Complaint, filed October 30, 2014 ("the Complaint").
6. Order, 2.
7. Ibid., 3.
8. Ibid.
9. Ibid., 1, .60–61, and 73–74.
10. We note, we have included the name Empire Valuation Consultants, LLC, as it appears in the Order. Empire did not provide court testimony in the Ryan matter.
11. Plaintiff's counsel at Holland & Knight included Richard Winter, Michael Zdeb, and Maureen Schoaf. In addition to Holland & Knight, Marnie A. Jensen of Husch Blackwell, LLP., along with her colleagues at Husch Blackwell, were

important members of the plaintiff legal team in Ryan.

12. The name of the global advisory firm, and the defendants' expert, is provided in the Order on page 47.
13. Ibid., 9.
14. Ibid.
15. Ibid.
16. Ibid.
17. Ibid., 4.
18. Ibid., 13.
19. Ibid.
20. Ibid., 14.
21. Ibid., 29.
22. Ibid., 32.
23. Ibid., 10.
24. Ibid., 14.
25. Ibid., 32.
26. Ibid.
27. Ibid., 33.
28. Ibid.
29. Ibid., 48.
30. Ibid., 49.
31. Charron v. Sallyport Global Holdings, Inc., No. 12cv6837, 2014 WL 7336463 at *10 (S.D.N.Y. Dec. 24, 2014).
32. Ibid., 52.
33. Kevin M. Zanni, "Equity Size Premium Observations and Delaware Fair Value, Part I of II." NACVA quickreadbuzz.com online publication (November 7, 2019): 4.
34. Order, 36.
35. Ibid., 49.
36. Jim Hitchner, "How to 'Rig' a Valuation: The Discount Rate," *Financial Valuation and Litigation Expert* (February/March 2013).
37. Kevin M. Zanni, "Cost of Capital Theory and Application for Fair Value Controversy Matters." *Willamette Management Associates Insights* (Autumn 2017): 84.
38. Order, 50.
39. Ibid.
40. Abaxis, Inc., is no longer publicly traded. It now operates as a subsidiary of Zoetis, Inc. At the time it was acquired in 2018, Abaxis had a market capitalization of $1.9 billion.
41. Order, 50.
42. Ibid.
43. Zanni, "Equity Size Premium Observations and Delaware Fair Value, Part I of II," 3.
44. Order, 37.
45. Ibid., 12.
46. Ibid., 12.
47. Ibid.
48. Ibid., 51.
49. Ibid., 7.
50. Ibid., 52.
51. Ibid., 15.
52. Ibid.
53. Ibid., 18.
54. Ibid., 19.
55. Ibid., 19–20.
56. Ibid., 20.
57. Ibid., 21.
58. Ibid.
59. Ibid., 25.
60. Ibid.
61. Ibid., 24.
62. Ibid., 25.
63. Ibid., 39.
64. Ibid.
65. Ibid., 7.
66. Ibid., 40.
67. Ibid., 54.
68. David Laro and Shannon Pratt, *Business Valuation and Federal Taxes, Procedure, Law and Perspective*, 2d ed. (John Wiley & Sons, 2011), 104, 105.
69. Order, 45.
70. Ibid.
71. Delaware Open MRI Radiiology Associates v. Howard B. Kessler, et al., 898 A.2d 290, 339 (Del. Ch. 2006).
72. Nancy J. Fannon and Keith Sellers, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle* (Portland, OR: Business Valuation Resources, April 2015).
73. Order, 46.
74. Ibid.
75. Guideline merged and acquired company method is sometimes referred to as the guideline transaction method.
76. Order, 57.
77. Ibid.
78. Ibid.
79 Ibid.
80. Ibid., 58.
81. Ibid.
82. Ibid., 59.
83. Ibid., 66.
84. Ibid.
85. Ibid., 58–59.

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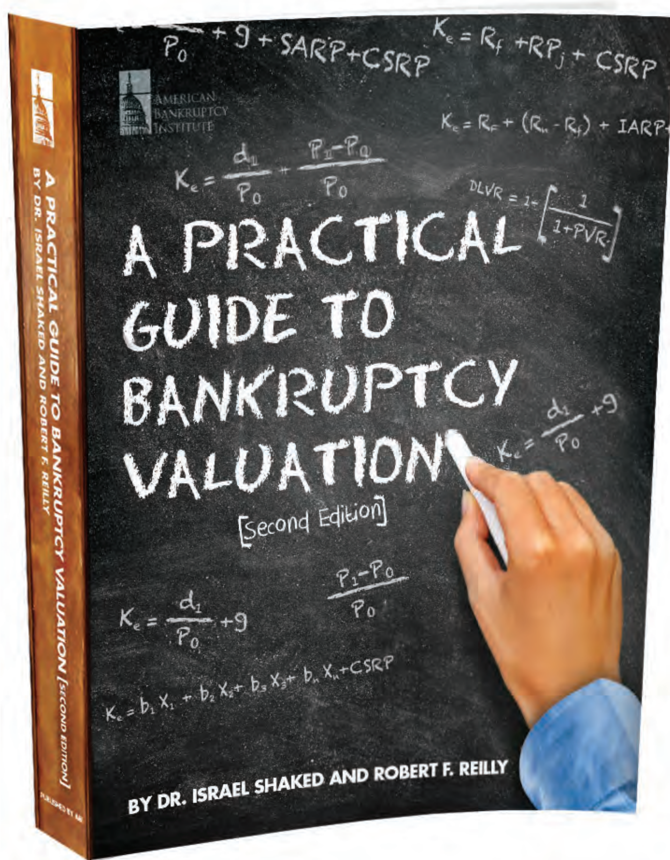
A PRACTICAL GUIDE TO BANKRUPTCY VALUATION, 2ND ED.

A Practical Guide to Bankruptcy Valuation provides practical guidance on the valuation of a business, business ownership interest, security, or intangible asset within a bankruptcy context.



Published by the American Bankruptcy Institute, the revised and expanded second edition of *A Practical Guide to Bankruptcy Valuation* contains a wealth of information on how solvency and capital adequacy analyses, creditor-protection issues, debtor-in-possession financing, fraudulent conveyance and preference claims, restructuring of debtor securities, sale of bankruptcy estate assets, plans of reorganization, bankruptcy taxation issues and fresh-start accounting issues, among others, are factored into properly valuing a bankrupt company.

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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Glossary

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The Use of the Credit Shelter Trust in the Time of Portability

Andrew Brajcich, CPA

The credit shelter trust has been a widely used tax savings tool for estates that exceed the exclusion amount. However, the use of credit shelter trusts has grown out of favor ever since the U.S. Congress amended the Internal Revenue Code to allow for the portability of a spouse's unused exclusion amount. This discussion analyzes the continued use of a credit shelter trust in conjunction with the unlimited marital deduction in order to achieve estate tax savings for estates that hold appreciating assets.

Introduction

Historically, any unified transfer tax credits not used on the estate tax return were lost and could not be used by another taxpayer. In 2010, the U.S. Congress amended Internal Revenue Code Section 2010 to provide to the surviving spouse a unified credit equal to the tax on his or her basic exclusion amount as well as any unused exclusion amount of a deceased spouse.

Referred to as "portability," this provision seemingly nullified the utility of the credit shelter trust, a tool of tax planners to make use of any remaining wealth transfer tax credits on the decedent's estate tax return.

This discussion explores the continued utility of the credit shelter trust and illustrates circumstances where large estates can pay less in estate tax by using the credit shelter trust than they would pay by making the portability election.

Background of the Marital Deduction

Section 2056 provides a deduction from the gross estate for property that passes to the surviving spouse of the decedent. Known as the unlimited marital deduction, this provision provides for a deferral of wealth transfer tax on the property left to the surviving spouse until his or her death, at which time any remaining property is presumably included in the surviving spouse's gross estate.

Depending on how long the surviving spouse lives after the decedent's passing, the benefits of the deferral can be quite significant for larger estates.

The following example illustrates the economic benefit associated with the marital deduction.

Joan dies with a gross estate of $25 million, leaving it all to her spouse Tracy. Joan's estate pays no estate tax by taking a marital deduction, which reduces her taxable estate to zero.

If Tracy were to live another 20 years, she would enjoy the use of the entire $25 million left to her by Joan for that period. If there were no marital deduction, Tracy would receive less than the full $25 million at Joan's death because tax would be due from Joan's estate.

Assuming a 40 percent flat unified rate, no remaining unified credit, and no marital deduction, our simple example would yield Tracy only $15 million in a net bequest from Joan after the $10 million ($25 million estate × 40 percent tax rate) in estate tax is paid.

Therefore, the marital deduction provides the surviving spouse Tracy with the use of the $10

million in tax that would otherwise be payable to Treasury upon Joan's passing.

In this example, Tracy will ultimately pay tax on the property Joan left her; however, it will be at a later date. Therefore, the marital deduction is not an exclusion—but rather a deferral of tax on the property passed to a surviving spouse.

Through this deferral, the surviving spouse gets use of the wealth transfer taxes over her lifetime in what has often been described as an interest-free loan from the government.

Perhaps the term "unlimited" marital deduction is a misnomer. While a decedent may leave as much property outright to his or her spouse free of wealth transfer tax, limitations generally do apply when the property is of a terminable interest.

Terminable Interest Property

An exception to the marital deduction is the terminable interest rule found at Internal Revenue Code Section 2056(b). Under this rule, a marital deduction is denied for property in the form of a terminable interest left to a surviving spouse.

A terminable interest is defined as an interest in property that will cease upon the passage of time or on the occurrence or an event.[1]

Terminable interests include a life estate or a term of years.[2] Under the general rules defining the gross estate,[3] a terminable interest originating with the decedent would generally not be included in the surviving spouse's gross estate, unless the surviving spouse had a general power of appointment over the property.[4]

An exception for the terminable interest rule is found at Section 2056(b)(7) for "qualified terminable interest property" ("QTIP").

By election, the decedent's estate may take a marital deduction for certain terminable interests that pass to the surviving spouse in exchange for the inclusion of the entire value of the property in the surviving spouse's gross estate.[5]

Additionally, should the surviving spouse give away the qualifying interest during life, Section 2519 will treat the disposition as a constructive transfer by the surviving spouse of all the interest in the property other than the income interest, and gift tax implications will follow accordingly.

The QTIP must be a qualifying income interest for life. Specifically, the surviving spouse must be entitled to all of the income from the transferred property for life and such income must be payable at least annually.

In addition, no person may hold the power to appoint any portion of the property to anyone but the surviving spouse.

Placing property in trust and making a QTIP election:

1. permits the decedent some measure of control over the property after death and
2. provides a deferral of estate tax through a marital deduction.

That is, it provides the decedent the ability to take care of his or her surviving spouse while dictating the ultimate disposition of the property.

For example, let's now assume that Tracy is Joan's second spouse and that Joan had children from her first marriage. By giving property outright to Tracy in her will, Joan cannot ensure that her children will be taken care of after Tracy's passing.

This is because Tracy can do whatever she wants with the property bequeathed to her outright. Realizing this may not be the best result, Joan can place her property in a QTIP trust to Tracy for life and the remainder to her children upon Tracy's death.

By virtue of the election, Joan's estate takes a marital deduction and defers tax on the transfer of wealth. In addition, Joan gets to take care of her spouse and children.

The Credit Shelter Trust

As its name implies, the credit shelter trust is designed to utilize the remaining unified credit of a decedent through the use of a trust. A decedent establishes a trust and designates an amount of property equal to the remaining applicable exemption be passed to the trust.

If the decedent wishes for his or her surviving spouse to have access to the property in trust, the trust can be established with terms that do not qualify for a QTIP election.

By doing so, the decedent's estate cannot take a marital deduction for the property passing to the credit shelter trust and thus, the property is subject to estate tax. That estate tax will be reduced by the decedent's remaining unified credit.

Let's now assume Joan in our example has an estate of $25 million and has enough unified credit to cover the estate tax on $5 million of property transferred. In her will, Joan sets up a credit shelter trust and directs her administrator to transfer $5 million to it.

The credit shelter trust provides the trustee with the power to use the property for the benefit

of Tracy in certain circumstances. The residuary of Joan's estate then passes to Tracy under the will through a QTIP trust.

As a result of the credit shelter trust, Joan's taxable estate of $5 million after her $20 million marital deduction pays no estate tax due to her remaining unified credit.

Tracy gets access to all of Joan's property if needed, Joan's estate pays no estate tax, and Joan uses all of her available unified credit.

Portability

Every estate is entitled to a unified credit against estate tax.[6] For 2020, this credit equals the estate tax due on a taxable estate of $11.58 million.

This figure, technically termed the basic exclusion amount, is varyingly referred to as the applicable exemption or the applicable exclusion. It is indexed for inflation from 2010 on an initial amount of $10 million.[7]

For deaths in 2010 and after, a surviving spouse may use any unused exclusion of his or her deceased spouse, technically termed the deceased spousal unused exclusion amount ("DSUE"), provided the surviving spouse has not remarried.[8]

Returning to the original facts in our example, had Joan left her entire estate outright to Tracy and used none of her unified credit, Tracy would be able to use a credit equal to the tax on her basic exclusion amount—as well as Joan's unused basic exclusion amount.

It is worth noting that while Tracy's basic exclusion continues to increase annually with the inflation adjustments provided under Section 2010, the value of Joan's unused exclusion is locked at the amount applicable in her year of death.

The portability of the unused exemption of a decedent to his or her surviving spouse would appear to eliminate the utility of the credit shelter trust. However, as the following example illustrates, for estates above the exclusion amount with appreciating property, that may not be the case.

Joan has a gross estate of $25 million. Neither she nor Tracy make any lifetime gifts. To simplify the calculations, let's assume the following:

1. The basic exclusion amount is $10 million in Joan's year of death and increases $500,000 per year.
2. The estate tax is a flat 40 percent.

Let's also assume that Tracy owns no other property and the value of QTIP property remains at $25 million during her life.

In the current year, Joan passes away and leaves her entire estate in a QTIP trust to her spouse Tracy with the remainder to be paid to Joan's children from her first marriage upon Tracy's death. As a result, Joan's estate will pay no estate tax.

Upon Tracy's death 20 years later, she will include in her gross estate the property in the QTIP trust. However, Tracy will have Joan's unused exemption of $10 million in addition to her own exemption of $20 million at the time of her death. Joan and Tracy collectively pay no estate tax.

Without a Credit Shelter Trust
A Constant Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(25,000,000)
Taxable Estate	0
Tax (40%)	0
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

Without a Credit Shelter Trust
A Constant Estate Value Example
Tracy's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	0
Taxable Estate	25,000,000
Tax (40%)	10,000,000
Section 2010 Credit	(12,000,000)
Tax Due	$ 0

Now let's assume that Joan's property appreciates to $40 million over the 20 years in which Tracy survives her.

If Joan simply leaves all of her property to Tracy in a QTIP without the use of a credit shelter trust, the two collectively will pay $4 million in tax under our simple example.

Without a Credit Shelter Trust
An Increasing Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(25,000,000)
Taxable Estate	0
Tax (40%)	0
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

Without a Credit Shelter Trust
An Increasing Estate Value Example
Tracy's Form 706

Gross Estate	$ 40,000,000
Marital Deduction	0
Taxable Estate	40,000,000
Tax (40%)	16,000,000
Section 2010 Credit	(12,000,000)
Tax Due	$ 4,000,0000

Now let's assume that Joan uses a credit shelter trust and transfers to it $10 million, the amount of her available exclusion. Tracy will not include this property in her gross estate upon death. Also, let's assume that all of Joan's property increases to $40 million while Tracy survives her.

Therefore, the $10 million in the credit shelter trust increases to $16 million and the $15 million in the QTIP trust increases to $24 million.

Under these circumstances, the $1.6 million total estate tax paid between the two is significantly less than the $4 million total tax in the above example.

With a Credit Shelter Trust
An Increasing Estate Value Example
Joan's Form 706

Gross Estate	$ 25,000,000
Marital Deduction	(15,000,000)
Taxable Estate	10,000,000
Tax (40%)	4,000,000
Section 2010 Credit	(4,000,000)
Tax Due	$ 0

With a Credit Shelter Trust
An Increasing Estate Value Example
Tracy's Form 706

Gross Estate	$ 24,000,000
Marital Deduction	0
Taxable Estate	24,000,000
Tax (40%)	9,600,000
Section 2010 Credit	(8,000,000)
Tax Due	$ 1,600,000

The DSUE amount is not indexed for inflation. Therefore, there exists a planning opportunity to place the decedent spouse's assets that are expected to appreciate during the life of the surviving spouse into a credit shelter trust. This allows the decedent to pay his or her incident of wealth transfer tax when the property is lower in value—as compared to the property value when the surviving spouse passes years later.

The examples provided above are simplified and illustrate the savings for large estates. Nonetheless, this estate freeze opportunity should be considered by financial and estate planners, particularly when their clients have children from a prior marriage.

Summary and Conclusion

Often overlooked as an estate planning opportunity since the introduction of portability, the credit shelter trust remains a viable tax savings tool for estates above the exclusion amount.

By placing property that is expected to appreciate into a credit shelter trust, a decedent can transfer the property before its value increases by utilizing any remaining exclusion amount. This exclusion amount is not indexed for inflation once portability to the surviving spouse occurs.

For estates that are large enough to be subject to the federal estate tax, the overall tax savings associated with the use of the credit shelter trust can be substantial.

Notes:

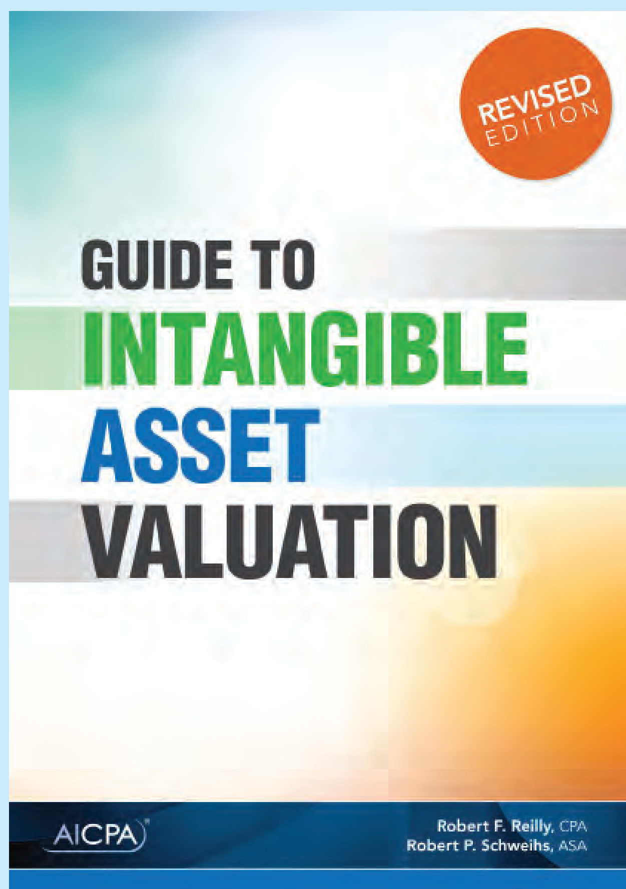
1. 26 CFR § 20.2056(b)-1(b).
2. Id.
3. See §§2031 through 2046,
4. §2041. A surviving spouse has a general power of appointment if 1) the surviving spouse is entitled to all of the income from the transferred property for life, 2) such income is payable at least annually, or 3) the surviving spouse holds a power of appointment over the property that is exercisable in favor of the surviving spouse or the surviving spouse's estate.
5. §2044.
6. §2010.
7. The $10 million is effective for deaths after December 31, 2017, and before January 1, 2026. Prior to the 2017 Tax Cuts and Jobs Act, the basic exclusion was indexed from 2010 on $5 million. Without further action from Congress, in 2026 the basic exclusion amount will return to a number indexed from $5 million from the year 2010.
8. §2010(c).

Andrew Brajcich is an Associate Professor of Accounting and the Director of Graduate Accounting at Gonzaga University. He also serves as Secretary of the Board of Directors for the Washington Society of CPAs. He may be reached at (509) 313-7053 or at brajcich@gonzaga.edu.

We are pleased to announce the Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

Who Would Benefit from This Book

- Litigation counsel involved in tort or breach of contract matters
- Intellectual property counsel
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- Property tax practitioners
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- Valuation analysts
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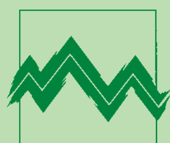

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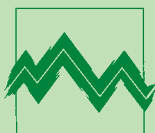

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On Our Website

Recent Articles and Presentations

Robert Reilly, a managing director of our firm, authored an article that was published in the August/September 2020 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article is "Valuation Analyst Considerations Regarding Closely Held Company Buy/Sell Agreements."

Ownership succession and estate planning are two common concerns of private company owners. Such private company owners sometimes utilize buy/sell agreements to help address both of these concerns. Robert's article focuses primarily on buy/sell agreements related to closely held tax pass-through entities. He summarizes the two primary types of company buy/sell agreements: (1) cross-purchase agreements, and (2) redemption agreements. Robert describes several ways in which these two types of buy/sell agreements fund the redemption of the company owner's equity interests. He explains many of the reasons why the company owner or the company itself would implement a buy/sell agreement. In particular, he focuses on the taxation planning, compliance, and controversy considerations with regard to closely held company buy/sell agreements. Robert explores the business valuation provisions of the buy/sell agreement. In particular, he considers the rules and the limitations related to the company owner's reliance on a buy/sell agreement valuation formula for estate tax planning and estate tax compliance purposes.

Kevin Zanni, a managing director in our Chicago office, along with Mark Rodriguez of MR Valuation Consulting, presented a webinar. The webinar was sponsored by California Water Association, the Public Utilities Commission of the State of California and the California State Water Resources Control Board. The webinar was conducted on August 19, 2020. The title of Kevin and Mark's webinar was "Water System Valuation: RCNLD Analysis."

Kevin and Mark review the valuation engagement process and discuss general valuation principles and practices. They present an overview of relevant California statutes and guidance for water system valuation. Kevin and Mark explore both reproduction cost new and replacement cost new and discuss the differences. Finally, they discuss various forms of obsolescence that may apply in water system valuations, including economic obsolescence and functional obsolescence.

Robert Reilly authored an article that was published in the June 10, 2020, issue of QuickRead. QuickRead is published by the National Association of Certified Valuators and Analysts® (NACVA®). The title of Robert's article is "Valuation Treatment of the ESOP Repurchase Obligation Liability."

There are certain valuation aspects that are unique to ESOP sponsor company valuations. The ESOP repurchase obligation is one of those aspects. Robert's article provides a hypothetical ESOP sponsor company valuation to illustrate the alternative valuation treatments for the repurchase obligation on the sponsor company share price conclusion. This article is intended to clarify and enhance the ongoing discussion among valuation analysts regarding the treatment and presentation of the repurchase obligation in valuations performed for ESOP administration and regulatory compliance purposes.

Fady Bebawy, a vice president in our Chicago office, authored an article that was published in the April 8, 2020, issue of *Wealth Management*, www.wealthmanagement.com. The title of Fady's article is "Fifth Circuit Disallows Discount for Lack of Control."

Fady discusses the recent Fifth Circuit Court of Appeals decision in *Estate of Strightoff v. Commissioner*. In that decision, the court ruled that the estate wasn't entitled to a discount for lack of control for a substituted limited partnership interest with control rights.

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Communiqué

In Print

Robert Reilly, firm managing director, and Connor Thurman, Portland office associate, authored an article that appeared in the July 2020 issue of *Journal of Multistate Taxation and Incentives*. The title of Robert's and Connor's article is "Best Practices in the Measurement of Functional or Economic Obsolescence in the Valuation of Industrial or Commercial Property."

Robert Reilly also authored an article that appeared in the July/August 2020 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Performing the Construction Company Functional Analysis."

Robert Reilly also authored an article that appeared in the August/September 2020 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article was "Valuation Analyst Considerations Regarding Closely Held Company Buy/Sell Agreements."

Robert Reilly served as the co-editor of the American Bankruptcy Institute book published in 2020 and titled *Developing the Evidence Using Prospective Financial Information in Bankruptcy and Other Litigation for Business Valuation, Damages, and Other Applications*.

Fady Bebawy, Chicago office vice president, authored an article that appeared in the online publication of the *Trusts & Estates* journal at www.wealthmanagement.com. The article appeared on April 8, 2020, and was titled "Fifth Circuit Disallows Discount for Lack of Control."

Kyle Wishing, Atlanta office manager, authored an article that was published in the National Association of Certified Valuators and Analysts ("NACVA") online publication at quickreadbuzz.com on June 10, 2020. The title of Kyle's article was "Valuation Treatment of the ESOP: Repurchase Obligation Liability."

Kyle Wishing also authored an article that was published in the Summer 2020 issue of *Journal of Employee Ownership*. The title of that article was "Valuation Treatment of the Repurchase Obligation Liability."

Ben Duffy, Atlanta office manager, also authored an article that was published in the NACVA online publication at quickreadbuzz.com on June 3, 2020. The title of Ben's article was "ESOP Implementation Considerations: A Leverage ESOP versus a Non-Leverage ESOP."

In Person

Curtis Kimball, Atlanta office managing director, participated in a webinar panel discussion sponsored by the National Trust Closely Held Business Association. The webinar was presented on July 23, 2020, and the topic was "Valuing Closely Held Assets in Today's World."

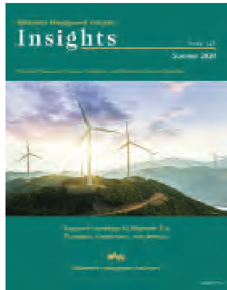
Kyle Wishing, Atlanta office manager, delivered a webinar sponsored by the ESOP Association on August 11, 2020, The title of Kyle's presentation was "ESOP Valuation Reports: What's a Fiduciary to Do?"

Kyle Wishing will also deliver a presentation at the Tennessee Society of CPA's 2020 Forensic and Valuation Service Conference on October 20, 2020. The topic of Kyle's presentation will be "Estimating Long-Term Growth Rates in Times of Economic Uncertainty."

Encomium

We are pleased to recognize the contribution of Chicago office vice president Nathan Novak to the American Institute of Certified Public Accountants ("AICPA"). Nate was the principal author of the 2020 revisions to the AICPA professional guidance entitled "Best Practices in Intangible Asset Valuation—Cost Approach Methods and Procedures." This valuation-related professional guidance is available through the forensic and valuation services section of the AICPA website.

Insights Thought Leadership Archives



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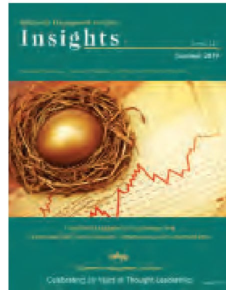

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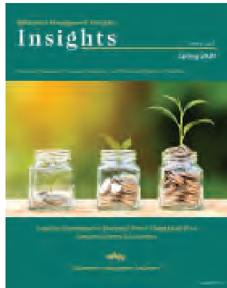

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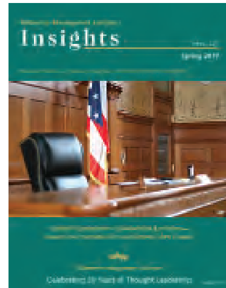

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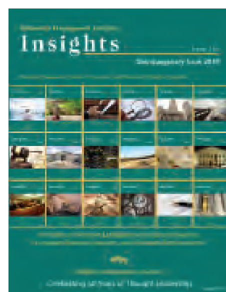

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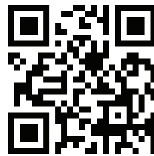

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