# Value Management Inc.

*The Business Valuation Specialist*

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# Issues & Updates

## In This Issue



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## *Scrutiny Heats Up on Valuations and Fairness Opinions in M&A Deals*

It’s almost a certainty that in the next publicly-traded M&A deal in which you’re involved, the shareholders will sue. The latest research says that shareholders sue in 94% of M&A deals[1], which puts valuations and fairness opinions squarely in the hot seat.

**Two trouble spots:** Recent litigation has triggered criticisms by the courts in two areas relevant to valuation experts: (1) conflicts of interest between the client and its financial advisors; and (2) problematic valuations and financial analyses.

The situation has become so serious that it prompted Leo Strine, chief justice of the Delaware Supreme Court, to write a paper that gives advice to legal and financial advisors involved in M&A transactions. Strine, former chancellor of the Delaware Court of Chancery, devotes a lot of his discussion to how advisors can conduct an M&A process in a way that “reduces conflicts of interests and addresses those that exist more effectively.”[2] *Bottom line:* If you don’t “do right” by your clients, you’ll get into trouble (and so will they).

The most significant recent legal development is the Chancery’s finding in the Rural Metro[3] case that the Royal Bank of Canada (RBC), which served as the company’s financial advisor, was liable for aiding and abetting the directors’ breach of fiduciary duty by causing an ill-timed, below-fair-value sale of the company based on manipulated valuation analyses. Steven M. Davidoff, a professor of law at the University of California, Berkeley, pointed out that RBC was playing both sides of the fence: It was an advisor to the seller while at the same time seeking a fee to provide financing to the buyer. The fee for the sale of Rural Metro was only $5.1 million, but the financing fees the buyer paid would be as much as $20 million. Vice Chancellor Laster found that this double-dealing induced RBC to sell Rural Metro on the cheap in order to get the financing engagement. To calculate the $91 million in damages to Rural Metro shareholders, the court used the valuation methodology common in statutory appraisal actions—cases in which shareholders sue to receive the fair value of their interests.

**What to do:** To “do right” by their clients, valuation experts should:

- Set a well-defined scope of the engagement, with any limitations clearly stated;
- Ensure that the inputs to the valuation are carefully thought out and defensible;
- Do a complete in-depth analysis when selecting comparable companies (e.g., geographic concentration, product lines, and customers);
- Know how to use transactional databases;
- Conduct an internal review of valuations and fairness opinions;
- Advise clients of all existing conflicts of interest;
- Keep an eye out for any new conflicts of interest that may come along during the course of the engagement;
- Avoid contingency fees or any related business involving the client or other transaction participants; and
- Maintain careful and complete documentation for every aspect of the work performed.

In light of all of the trouble surrounding M&A deals, boards of directors will place a much greater importance on a top-

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notch fairness opinion and independent valuation to help defend themselves against shareholder lawsuits, which are now inevitable.

[1]Shareholder Litigation Involving Mergers and Acquisitions—Review of 2013 M&A Litigation, Cornerstone Research, 2014.
[2]Leo E. Strine, "Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone (October 2014). Available at SSRN: ssrn.com/abstract=2514520.
[3]In re Rural Metro Corp. Shareholders Litigation, 2014 Del. Ch. LEXIS 36 (March 7, 2014).

## Industry Rule-of-Thumb Metric Used for Valuation

In the infamous *Adelphia* case (*Adelphia Recovery Trust v. FPL Group, Inc. (In re Adelphia Corp.)* 2014 Bankr. LEXIS 2011 (May 6, 2014)), a complicated bankruptcy case that involved allegations of fraud, the issue was a possible "fraudulent conveyance," which was a buyback of stock. Two experts were brought in to determine whether the company was solvent at the time of the transaction.

Both experts agreed that there were no reliable cash flow projections because the financial history was tainted by fraud. The plaintiff's expert developed his own cash flow projections and used a DCF analysis as his only method to conclude that the company was insolvent at the time of the transaction. The defendant's expert based his market-based analyses—comparable company analysis and precedent transaction analysis—on a revenue-per-subscriber metric and concluded that the company was solvent.

**DCF inappropriate:** This is another instance where the court found little value in using a DCF analysis to produce a reliable indicator of value. It noted that the DCF works best when you have accurate projections of future cash flows and when there is no taint of fraud. The data underlying the plaintiff expert's projections were filled with "uncertainties," the court said.

The court said that the defendant's expert produced a valuation "more closely tied to the market." That is, a value the company actually could get for its assets in a sale. The value-per-subscriber method was widely used in the industry and the subscriber numbers were some of the few accurate data points the company had. That, coupled with the lack of comparables, made the court comfortable with the rule of thumb approach.

## Noteworthy Business Valuation Cases of 2014

The year 2014 produced a number of significant decisions from various federal and state courts that added new layers of understanding of valuation- and expert-related issues. Below is our list of the 5 "must know" cases.

**Estate of Richmond, 2014 Tax Ct. Memo LEXIS 26 (Feb. 11, 2014)**
In this major ruling in an estate tax dispute, the Tax Court prescribes the use of the net asset value method to determine the value of a holding company whose assets are mostly marketable securities and says discounting for the built-in capital gains ("BICG") tax requires determining the present value of the future BICG tax liability.

**Sloan Valve Company v. Zurn Industries, Inc., 2014 U.S. Dist. LEXIS 39678 (March 26, 2014)**
In a patent infringement case, the court excludes a royalty analysis that strayed from the "classic way" in that the expert used the number of infringing products, not revenue, as the royalty base and a dollar amount, not the percentage of the revenue, as the royalty rate.

**Laidler v. Hesco Bastion Environmental, Inc., 2014 Del. Ch. LEXIS 75 (May 12, 2014)**
In a statutory appraisal action arising out of a short-form merger, the Delaware Court of Chancery (J. Glasscock) adopts the direct capitalization of cash flow (DCCF) analysis the parties' experts advocated because of the unique nature of the target's business and factors affecting the transaction.

**Estate of Adell v. Commissioner, 2014 Tax Ct. Memo LEXIS 155 (Aug. 4, 2014)**
Here is another Tax Court opinion that has caused a spirited debate among valuation professionals. Even though the court disapproves of the estate's "conflicting expert reports" as to the value of the decedent's 100% interest in a C corporation, it ultimately adopts the estate's DCF valuation, finding its treatment of personal goodwill is more credible than the IRS's approach.

**In re LightSquared Inc., 2014 Bankr. LEXIS 2984 (July 11, 2014)**
In the notorious fight over a Chapter 11 satellite and broadband services provider, the Bankruptcy Court rules on the debtors' reorganization plan. Perhaps no aspect of the case raises as many eyebrows as the $1.25 million fee one litigant's valuation expert commanded for three weeks of what the court calls "an unimpressive piece of work."

## Taking the Mystery Out of Embedded Brand Values

How do you value a brand that's intertwined with all of the other assets of the company? This is a phenomenon that's not well understood. Fortunately, there is research that reveals how brands are valued in an actual acquisition.

**New data:** In 2013, a consortium of Berkshire Hathaway and 3G Capital acquired H.J. Heinz. The brand value was reported as worth $12.1 billion, which represented 40.5% of enterprise value, according to a new report, "Global Top 20 Brands in 2013," from Markables. The rankings in the report represent brand values that follow international accounting and financial reporting standards. Plus, they were calculated by independent certified appraisers, audited by CPAs, and now appear on the balance sheets of the acquirers. Some of the other famous brands in the Top 20 list include:

| | Brand Value ($ millions) | % of Enterprise Value |
|---|---|---|
| Sprint | $6,455 | 11.8% |
| Crown (Corona beer) | 2,306 | 32.6 |
| Sealy | 524 | 40.9 |
| Kayak | 496 | 26.5 |
| Saks Fifth Avenue | 374 | 11.5 |
| Wish -Bone | 348 | 60.4 |
| Skippy | 265 | 39.8 |

**Key ratios:** The 2013 Top 20 brands accounted for 34.3% of all assets of these enterprises (including other intangibles, goodwill, plant and equipment, inventory, and receivables). The figure is in line with previous years. The average brand premium of the Top 20 was 8.0% of net revenue in 2013. That is, 8% of revenue represents profit directly attributable to the brand. This figure is lower than in 2012 but higher than it was in 2010 and 2011.

Markables (requires login) has a database of over 5,000 trademark valuations published in financial reporting documents of listed companies from all over the world. The database reports value solely for the use of trademarks (not bundled with other rights). It also contains trademark assets that have longer lives than is typical.

## *New Research Suggests Private Equity Firms Manipulate Valuations*

Soon-to be-released research suggests that private equity funds are not doing valuations properly, reveals a report in the *International Business Times ("IBT")*. PE firms may have "effectively embellished their returns to make them look more attractive to pension managers," says the report.

**Against theory:** A key element of PE firms' marketing pitch is that their investments overall are less volatile, or

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## ~ VMI Highlights ~

In case you missed it, **VMI** is now blogging! Here are a few of our recently published posts:

- Little Known Ways to Increase Your Company's Stock Value
- The Secret to Successfully Selling Your Business
- Simple Checklist to Understanding the ESOP Valuation Process for Internal ESOP Trustees

To read more, visit us on the web at www.ValueManagementInc.com or email smw@valuemanagementinc.com to have them sent directly to your inbox!

On March 12th, Andrew Wilusz gave a presentation at the Pennsylvania Bar Institute's "Estate Planning: Beyond the Basics" seminar that was held in Philadelphia. His topic was "The Five C's of Ethics for Estate Planning Professionals."

**Value Management Inc.** was a sponsor at the First Business League Expo at the Union League in Philadelphia, PA on April 16th.

Ed Wilusz spoke at the ESOP Association's Spring Conference in April. His topic was "Repurchase Obligation Basics."

Ed Wilusz, Susan Wilusz Marano and Greg Kniesel attended the 38th Annual ESOP Conference held in Washington DC on May 7th and 8th. Greg Kniesel participated on a panel that discussed ESOP Transaction Financing Issues.

On June 4th, Andrew Wilusz will be speaking at a CPA "Lunch & Learn" to be held in Marlton, NJ. His topic is "ESOPs in Action: Case Studies of Companies with or Considering ESOPs."

If you are interested in having one of our analysts give a business valuation related presentation to your firm or at a conference, please contact Susan Wilusz Marano at smw@valuemanagementinc.com or at 215.343.0500.

less risky, than the S&P 500 index. The new research challenges that position. “The industry’s assertion contradicts classic financial theory, which stipulates that highly levered investments are inherently more volatile than less-leveraged investments,” says investment banker **Jeffrey Hooke** (FOCUS), a co-author of the new study. “Our study casts doubt on that marketing ploy.” Hooke worked on the new study with researchers from George Washington University

“The investments in private companies may only appear safer because the private equity managers are in control of how the investments look on paper, not because the actual value of the assets [is] more stable or better performing,” he told IBT.

In our Fall 2014 Issues & Updates (see “Best Practices for Fund Valuations as SEC Crack Down”), we pointed out that scrutiny would increase on PE fund valuations due to concerns by the Securities and Exchange Commission over alleged overvaluations. The SEC implemented an audit program and stepped up its enforcement actions.

## *DOL Scuttles ‘Appraiser-as-Fiduciary’ Rule for ESOPs*

The Department of Labor (DOL) will abandon the “appraiser-as-fiduciary” rule from its planned reproposal of a broader fiduciary rule, according to a report in *Capital Action*, a publication of the American Society of Appraisers (“ASA”). The proposed rule, in limbo for three years, would have classified appraisers as ERISA fiduciaries in connection with valuations of employee stock ownership plans (ESOPs).

Opponents of the proposed rule claimed that it would create a conflict between a fiduciary’s strict duty of loyalty to plan participants and professional appraisal standards, which require an appraiser to perform assignments with impartiality, objectivity, and independence. Appraisers also feared that the rule would force them to buy expensive fiduciary insurance, hire specialized counsel, and expose them to unwarranted litigation.

**ABOUT VALUE MANAGEMENT INC. VMI** is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 6,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI’s** clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.



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