VALUE MANAGEMENT INC.

Investment Banking + Valuation Services

ISSUES + UPDATES 3RD QUARTER 2023

Ten Steps to Selling Your Business – Part 1

Selling your business is a giant leap away from daily operations and is often a once-in-a-lifetime event. Rather than jumping into the unknown, owners would do well to consider proceeding in a measured way, with the help of experienced professionals. Presented below are the first five of the ten steps to selling your business.

1. Explore Options

- Even if you're not thinking about selling now, it's never too early to consider business succession/continuation planning. Some options include:
  - i. Transfer or sell the business to family or management
  - ii. Transfer or sell the business to an Employee Stock Ownership Plan (an "ESOP")
  - iii. Find and train a successor, and establish a buy-out plan
  - iv. Find a professional partner, such as a private equity group, that could provide some liquidity, a cash infusion, and an eventual way out
  - v. Sell to buyers able and ready to take the company to the next level
  - vi. Some combination or variation of the above

2. Assess Potential Sale

- It's important to define what you are selling, what might be expected of the seller, and what you should reasonably expect to net from the sale. The investment banker should help you understand the process, including:

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VMI Highlights:

Please help us congratulate Max Lesoine who was promoted this month from junior analyst to analyst. Great job, Max!

Susan Wilusz and Greg Kniesel will be presenting at the ESOP Association's Multi State conference being held in Albany, NY in mid-September. Susan is helping lead the Women's Session as well as joining a "Dirty Dozen" panel. Greg will be speaking on "ESOP Valuations in an Uncertain Time."

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i. Determining what buyers will get in the sale, such as:

   Company name, right to service clients, equipment, vehicles, working capital, royalty rights, own or lease facility, owner's post-transaction role, management and employees

ii. The current market and prospects for your company

iii. A price range and potential and/or likely related terms

iv. Deal timeline

3. Hire Investment Banker and Identify Deal Team

- The investment banker can run the deal, and allow you to focus on your business. The deal team includes:

  i. Experienced M&A attorneys who review all documents to be signed, offer advice & counsel, and draft the purchase agreement that secures and protects the deal obtained by the investment banker

  ii. The company's external accountant is asked to explain as needed any aspect of the company's accounting

  iii. The business owner and/or their trusted employee(s) at the company who will help the investment banker and attorneys to gather all required company information and documentation

4. The Sale Process

- An integral part of the process is data gathering. Potential buyers will expect to see certain information that should allow them to determine their level of interest and eventually the price they are willing to pay.

  i. Access to key company data in a timely and efficient manner is crucial to a successful sale

  ii. A process must be established to obtain data securely in a timely and efficient manner

  iii. The investment banker can facilitate the process so as to allow the company to function normally

5. Run Business as Usual

- You explored your options, understand what you have to offer, know what to expect in a sale, have made the decision to sell by hiring an investment banker and identifying the deal team, you understand and approved the plan to sell, and established a process to enable the deal team to do their jobs, now:

  i. Resist the urge to tell people until the time is right

  ii. Operate the business as you did prior to making the decision to sell

  iii. If there is a grey area because a big money decision is involved, discuss it with the deal team

  iv. Get back to work and run the business as usual!

While steps one through five discuss considerations or actions of the business owner, steps six through ten, which are presented below, relate directly to the sale of the business and considerations and actions of the investment banker and the deal team. Steps 6 through 10 will be discussed in more detail in Part 2 of this article which will appear in the 4th quarter edition of this newsletter.

6. Contact Buyers

7. Negotiate with Buyer(s)

8. Facilitate Buyer Due Diligence

9. Draft Purchase Agreement

10. Close Deal!

If you can't wait, call Andrew Wilusz to discuss any or all of the above!

Tax Court (Grudgingly) Allows Tax Affecting

Estate of Cecil v. Comm'r, T.C. Memo 2023-24; 2023 Tax Ct. Memo LEXIS 24 (Feb. 28, 2023)

In 2010, the Cecils, William and Mary, made gifts of minority shares of stock of The Biltmore Corp. (TBC) to their five grandchildren (in the case of William) and to two children (in the case of Mary). The Biltmore Corp. is an S corporation. As a result of an audit of the gifts by the IRS, a deficiency of $13,022,552 was assessed the two petitioners. The Cecils petitioned the Tax Court to redetermine the deficiency separately.

Mr. and Mrs. Cecil argued at trial that (1) the reported values were too high and (2) they were owed a tax refund. The Court ultimately decided that Mr. and Mrs. Cecil's valuation experts had provided the most appropriate fair market values for the TBC. Further, because TBC is an S corporation, the Court's decision in Cecil accepted tax-affecting the earnings of an S corporation (which has been rejected by the IRS and the court in pror cases) and the use of the S Corporation Economic Adjustment Multiple ("SEAM") to capture the tax benefit of S corporations. As a result, this decsion opens the door for valuation analysts to consider using both methods to value an S corporation under certain circumstances.

DOL—Finally—Agrees to Provide Regs on ESOP Valuations

At long last, the door has been opened for the Department of Labor (DOL) and the valuation profession to work together to develop guidance on ESOP valuations.

The DOL has just committed to move forward with long-awaited rule making with stakeholder input on the valuation of company shares to be bought by an ESOP, according to a release from The ESOP Association (TEA). The regulation will clearly define "adequate consideration" under Section 408(e) of the Employee Retirement Income Security Act of 1974 (ERISA). It's been four decades since such regulations were proposed but never finalized.

Valuation experts have long maintained that the DOL has been playing by its own valuation rules in its aggressive enforcement of ESOPs—rules that are not consistent with accepted valuation standards. After a long winning streak, the courts rejected the DOL's valuations in several recent and important cases alleging that the ESOPs overvalued (and thus overpaid for) the stock of the sponsoring companies.

Déjà vu? In the past, the DOL has indicated that it would finish up the rules, but the agency never followed through. Hopefully, this time will be different. "There is not much trust between ESOPs and the DOL, so we hope this isn't a case of 'fool me twice,'" said James Bonham, TEA president, in the release.

Valuation and ESG

Do higher environmental, social, and governance (ESG) scores result in higher valuations? At a recent conference, Professor Aswath Damodaran (New York University Stern School of Business) discussed ESG and its impact on valuations. He believes it is the most emptiest concept in business and is only benefiting consultants, investment managers, scoring/ratings providers, and those pushing for more disclosures[1]. He points out that currently there is little evidence that being "good" (although he points out there can never be a consensus on what is "good") makes companies more profitable and valuable, though there is some evidence that "not being bad" can be a risk-reducing strategy. In his blog, he has been very vocal in his strong criticisms of ESG as a "weapon of mass distraction."

Damodaran hopes that ESG will fade away, but he understands that some other "next big thing" would replace it. He guesses that it will be something that many ESG experts and advocates are already using as an alternative: "sustainability." He's not even sure what that means, but, at its worst, it "becomes a way to try to keep corporations alive forever, a dreadful idea, where zombie and walking dead companies suck up capital and resources—and drag the rest of us down into the abyss with them."

[1]Damodaran has several posts on ESG on his blog, Musings on Markets, at aswathdamodaran.blogspot.com.

Firms Most Impacted by the Labor Shortage

The health services, professional and business services, trade, and accommodation and food services industries have the highest numbers of job openings, according to recent data from the U.S. Chamber of Commerce[2]. But the accommodation and food service sector is especially feeling the pain—these firms have had the highest "quit rate" since July 2021. The quit rate is the number of employees who leave companies on their own (not those who are laid off or fired) expressed as a percentage of total employment.

These workforce troubles can wreak havoc on firms and have ripple effects that affect a valuation. Recent updates on some sectors are provided below.

Hotels are offering a raft of incentives to lure staff as the industry continues to experience staffing shortages, Hotel Management reported in February. A new survey of hoteliers conducted by the American Hotel & Lodging Association shows that nearly 80% of hotels are experiencing staffing shortages, with 22% saying the shortage is severe. The most critical staffing need is housekeeping, with 43% of respondents ranking it as their top hiring need. While 71% of respondents say they are increasing wages, 64% are offering greater flexibility with hours, a third report expanding benefits, and 81% say they are still unable to fill open positions. Post-COVID-19, there's a lot less service included in the full-service hotel experience, Cayuga Hospitality Services reported in March. Amenities including bell service, turndown service, and trash pickup have largely vanished, with housekeeping now typically provided only on demand.

Restaurants operators hoping for relief this year from the inflationary pressures and labor shortages that plagued the industry in 2022 are likely to be disappointed, according to a December article in QSR. Food and energy costs, which only recently have begun to show signs of easing, will continue to pressure restaurant profits in 2023. To preserve profits, 90% of restaurants have raised menu prices and changed offerings due to rising costs and ingredient shortages, according to QSR. Ongoing inflationary pressure, growing economic uncertainty, and continued labor and ingredient shortages will combine to challenge restaurant managers.

[2]"Understanding America's Labor Shortage: The Most Impacted Industries," March 23, 2023, U.S. Chamber of Commerce, uschamber.com/workforce/understanding-americas-labor-shortage-the-most-impacted-industries.

New York Court Awards Lost Corporate Opportunity and Punitive Damages in Restaurant-Related Case

O'Mahony v. Whiston, 2023 N.Y. Misc. LEXIS 651; 2023 NY Slip Op 30482(U) (Feb. 15, 2023)

This case concerned disputes among the owners of an Irish soccer bar. The case was primarily a derivative action regarding the rights of the old bar rather than those of the minority shareholders. After a dispute with the landlord, the lease at the original location was lucratively bought out. The proceeds were used to establish a new bar, identical to the old bar with the same name (Smithfield), a few blocks away. The majority owners of the old corporation (Dubcork) used the assets of Dubcork to open the new bar in a new corporation (Moxy), "thereby misappropriating a corporate opportunity of the corporation that owned the old bar (Dubcork), effectively cutting out plaintiffs, its minority shareholders."

It would be a breach of fiduciary duty if an agent of a corporation secretly established a competing entity. (*American Baptist Churches of Metro NY v. Galloway*) "The court finds that Dubcork had a tangible expectancy of owning the relocated version of its bar that was presented to the public as a continuation of the same bar." The settlement proceeds were sufficient to open the new bar. The testimony of the plaintiffs that they were unaware what was really going on was credible. "[P]laintiffs never had the opportunity to make a fully informed decision based on all of the material facts about the plans for the new bar." The plaintiffs did not waive or ratify the defendants' conduct. The court found that Dubcork was entitled to the lost value of the opportunity to own Moxy and also to punitive damages.

The court findings resulted in a total corporate opportunity damages of $2,820,417. Among other damages, the court also found three defendants liable for $100,000 each in punitive damages, and a total of $648,551 for unreported cash.

Minority Shareholder Receives Award of $12 Million for Breach of Contract and a $58 Million Buyout Award for His Minority Interest

Koch v. Koch, 2022 WL 1467980 (May 6, 2022)

This shareholder dispute case involved two businesses (SKT, a trucking/transportation company and KI, a distributor of chain, cable, rope, and other related products) in Minnesota owned by three brothers. One of the brothers, Jim Koch (the plaintiff), had a falling out with the other two, Randy and Dave Koch (the defendants). A temporary agreement was made among them in 2006, which included among other things, that there would be regular bonus distributions as long as all three continued to own the companies. On a continuing basis, they were to receive one-third each of 25% of annual pretax profits of KI. Bonus payments were also designated for SKT.

Subsequently the relationship and actions of the parties deteriorated. In particular, an IRS audit of the two businesses triggered a disagreement as to whether required payments under the agreement had to be tax deductible. “The 2006 Settlement Agreement did not expressly condition payment of bonuses on tax deductibility, but Defendants deducted the payments as employee compensation every year until 2013.” The defendants believed that deductibility was essential for the payments to be made, but Jim said he would not have signed the agreement if deductibility had been a requirement. Randy and Dave said the opposite. Jim’s attorney testified that deductibility was never made a precondition to payment.

The jury found that the 2006 settlement agreement did not require the payments to be tax deductible and went on to find that the defendants breached the 2006 settlement agreement. Damages of $12 million were awarded to Jim.

The purchase price under Minnesota law for a buyout was the fair value of the seller’s interest in the company. Both sides offered expert testimony of appraisers as to the fair value. Both experts considered the three approaches to value. They did not agree on a valuation date. Neither side applied a marketability discount to the value determined. Using the valuation date of May 31, 2017, the Court concluded that the fair value of SKT was $160,000,000, and the fair value of KI was $30,000,000. Jim’s interest in these companies was valued at $58,000,000.

Delaware Supreme Court Upholds ‘Entire Fairness’ of a Tesla Acquisition

In re Tesla Motors Stockholder Litig., 2023 Del. LE XIS 178 (June 6, 2023)

This was an appeal of an April 2022 Chancery Court opinion. At issue was the 2016 stock acquisition of SolarCity Corp. by Tesla Inc. Tesla’s shareholders claimed that Elon Musk caused Tesla to overpay for SolarCity through his alleged domination and control of the Tesla board. Their primary theory of liability at the trial was that SolarCity was insolvent at the time of the acquisition. The Court of Chancery assumed Musk had control of Tesla and, therefore, applied Delaware’s most stringent standard of review: entire fairness.

The trial court’s finding that the stockholder vote was informed was supported by the record. The appellants contend the Court of Chancery erred in relying on the stockholder vote for five reasons:

1. Musk’s involvement was not properly disclosed to stockholders;
2. Tesla’s disclosures about SolarCity were misleading;
3. Evercore’s warning about SolarCity’s liquidity covenant was not disclosed;
4. SolarCity’s credit downgrades were material to the stockholders; and
5. “[S]everal institutional stockholders held shares of both Tesla and SolarCity, raising questions of their disinterest and a reliance on their votes.”

A fact was material if it would likely be important in a shareholder’s decision on how to vote.

As to Musk's involvement, the Court of Chancery found that the definitive proxy "did disclose that [Musk] and Lyndon" Rive—Musk's cousin—had conversations, including in February 2016, about Tesla acquiring SolarCity. As to Musk and Evercore, the appellate court noted that a single disclosure problem might not affect the total mix provided to the shareholders. The Court of Chancery noted that the Evercore discussions were not to impede the process, and the appellate court found no reason to disturb that finding.

The Court of Chancery found no disclosure violations in connection with SolarCity. Also, according to the Court of Chancery, "[t]he market generally understood SolarCity's liquidity challenges" and expert witnesses conceded that market participants were aware of the risk that SolarCity might breach its Liquidity Covenant. These facts were unchallenged in the Court of Chancery record.

As to the credit downgrades to SolarCity, the Court of Chancery observed that, if SolarCity's largest lender was not deterred by the credit downgrades, then the market was likely not to be deterred also. The appellate found no reason to disturb the Court of Chancery's finding.

As to the cross-holdings of many of the institutional investors, the Court of Chancery concluded that "[e]ven with these issues in mind, however, I cannot, as factfinder, conclude that such a large majority of Tesla's stockholders would have voted to approve a transaction whereby Tesla would acquire an insolvent energy company, as [the appellants] would have me believe."

The appellate court affirmed the rulings of the Court of Chancery which found the acquisition to be "entirely fair."

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