VALUE MANAGEMENT INC.

Investment Banking + Valuation Services

ISSUES + UPDATES 1ST QUARTER 2024

The FTC Has Proposed Banning Most Noncompete Agreements

For the supposed purpose of fostering competition in the labor market, the Biden Administration's Federal Trade Commission is proposing to ban most noncompete agreements. Restrictions on noncompetes have usually been governed by state laws, and the courts have often looked at them under the lens of reasonableness. But the agreements have helped to protect trade secrets, confidential information, and goodwill from unfair competition by former employees.

Some states already limit or prohibit some or all noncompetes, but the FTC proposal would go beyond the state laws in some cases. There are some exceptions such as for selling 25% or more of a business. California has banned or severely restricted most noncompete agreements, so it serves potentially as a good test market for the FTC proposal.

Consider Meta's new Twitter clone, Threads. It has already been sued by Twitter and Elon Musk, which claims that it uses Twitter trade secrets, provided presumably by former Twitter employees, for its operating platform. Trade secrets might be protected under other statutes, but the point is made that banning noncompetes creates more hurdles for protecting its business.

The FTC proposal is likely to receive wide-spread legal challenges.

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VMI Highlights:

Congratulations to Kaitlin Wilusz, ASA, CFA, on her new position as a Director at VMI. While performing valuations for a variety of purposes, Kate has a concentration in ESOP-related appraisals and has been involved in over 40 ESOP transactions over the last several years.

Be sure to check out Ed Wilusz's article, "What Every Estate Attorney Should Know About Business Valuations" in the Philadelphia Bar Association's Probate & Trust December 2023 newsletter (found at https://philadelphiabar.org/?pg=ProbateAndTrustLawSectionNewsletters).

Private Cost of Equity Up, Per 2023 Pepperdine Report

Private-company cost of equity is higher this year across nearly all categories. The 2023 Pepperdine survey provides an analysis based on expected rates of senior lenders, asset-based lenders, mezzanine funds, private equity groups, venture capital firms, angel investors, privately held businesses, investment bankers, business brokers, limited partners, and business appraisers. Bank loans have the lowest average expected returns (a median return of 6.5% to 7.8%, depending on loan size), while capital obtained from angel investors has the highest expected returns (ranging from a median of 23% for later-stage financing to 38% for seed money).

Below is a chart showing the ranges of returns the various respondents expect at various levels.

2023 Pepperdine Private Capital Markets Rates of Return	
Type of Private Capital Funding	**Pepperdine Median Rate of Return (Range)**
Banks	6.5%-7.8%
Asset-based lenders	8.0%-15.5%
Mezzanine financers	13.0%-17.0%
Private equity groups	25.0%-35.0%
Venture capital groups	28.0%-33.0%
Angel investors	23.0%-38.0%

Seller Breached Terms of Merger Agreement Including That Statements Were GAAP-Compliant

***For NetApp, Inc. v. Cinelli,* 2023 Del. Ch. LEXIS 220; 2023 WL 4925910 (Aug. 2, 2023)**

This Delaware Chancery case concerned a claim for breach of contract and fraud in connection with the sale of a private company. The Delaware Chancery held that the plaintiff, NetApp Inc., prevailed because the defendant and seller, Cinelli, breached multiple representations in the merger agreement, including that the statements were GAAP-compliant and represented bona fide transactions. The cumulative misstatements amounted to fraud. Because the plaintiff proved the misrepresentations of the value of the business damaged it, it was awarded damages. The Delaware Chancery also accepted the plaintiff's Guideline Public Company Method as the most responsible estimate in the record of the company's value as it was a blended approach.

Cloud Jumper, a struggling private company, recorded internal software usage as revenue in its unaudited financial statements. When Cloud Jumper was sold to the plaintiff, it kept quiet about this practice. The defendant claimed that the misrepresentations were inadvertent and averred that the silence did not damage the plaintiff. Judgment was entered in favor of the plaintiff.

"That leaves the quantification of NetApp's damages—by far the murkiest issue before me. The parties agree in theory that expectation damages are the proper approach, but they lack a shared understanding of what that means in application." The Delaware Chancery calculated the damages at $4.6 million.

New York Court Allows Enforcement of Under-Market-Value Buy-Sell and Approves At-Will Termination of Shareholder-Employees

***Laurilliard v. McNamee Lochner, P.C.,* 2023 N.Y. Misc. LEXIS 3296; 2023 NY Slip Op 50671(U) (June 29, 2023)**

Plaintiffs Kevin Laurilliard and Paul Pastore brought this commercial action against the law firm McNamee Lochner PC as well as nine individuals alleged to be "majority shareholders" of the firm.

The plaintiffs, minority shareholder employees in a law firm, brought suit against their firm for breaching their employment contracts. The court determined that the plaintiffs were at-will employees and that there was no breach of their agreements when they were terminated. The court also determined that the under-market-value payment ($100) under their repurchase agreements was allowable since they were at-will employees.

Ten Steps to Selling Your Business

By Andrew Wilusz

in our last newsletter, we presented steps one through five of "Ten Steps to Selling Your Business," discussing the owner's decision to sell, establishing related goals, and assembling the deal team. For convenience, presented below are all ten steps, with steps six through ten relating directly to the sale of the business and the considerations and actions of the investment banker and the deal team.

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 Offering

- It's important to define what you are selling and to understand early in the process what you should reasonably expect in return. An investment banker can help you understand what you have to offer and what you are likely to receive in return for it, including:
  i. Determining what buyers will get in the sale, such as:
    1. 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. Timing and a deal timeline.

3. Hire Investment Banker and Identify Deal Team

- The investment banker will run the deal, which involves creating and executing a plan to sell the business, while coordinating activities with the deal team. 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 any aspect of the company's accounting as needed.
  iii. The business owner and/or their trusted employee(s) who will help the investment banker and attorneys to gather all required company information and documentation.

4. Enable Investment Banker and Deal Team

- After hiring an investment banker, it is important to let them do their job by facilitating the data gathering process.
  i. Access to key company data in a timely and efficient manner is crucial to a successful sale.
  ii. For the company, data gathering can be a time-consuming distraction.
  iii. A process must be established to obtain data securely in a timely and efficient manner.
  iv. The investment banker should accommodate the process so as to allow the company to function normally.

5. Business as Usual

- You completed steps one through four, now what:
  i. Resist the urge to tell people until the time is right.
  ii. If there is a grey area involving a big money decision, discuss it with the deal team.
  iii. Operate the business as usual.

6. Contact Buyers

- After the company's data is gathered and

prepared for presentation to buyers, the investment banker contacts buyers to identify interest and to solicit bids.

i. The investment banker will develop a list of potential buyers.

ii. Buyers may be contacted simultaneously or in groups (an “auction”).

iii. A more strategic approach may be used, where buyers are sorted based on owner goals and then contacted individually, or in a certain order.

iv. The contact is typically initiated via email or phone call.

v. Qualified interested buyers will sign a non-disclosure agreement (“NDA”).

vi. Buyers under NDA will receive enough company information to enable them to formulate and submit an initial offer (sometimes called an “indication of interest” or an “IOI”).

> *“...negotiations begin with the first contact between buyer and seller, and they can continue until the deal closes (and sometimes beyond!).”*

7. Negotiate with Buyer(s)

- M&A insiders know that negotiations involve much more than agreeing on a price: negotiations begin with the first contact between buyer and seller, and they can continue until the deal closes (and sometimes beyond!).

i. Depending on the specifics of the plan to sell the business, pricing negotiations may begin with the investment banker stating the seller’s pricing range or requesting the buyer to make an offer (an IOI).

ii. While pricing seems to be the most important part of negotiations, the terms of payment are equally crucial because they determine when, how, if, and how much the seller gets paid.

iii. The post-transaction role of the current owner(s) is often part of early discussions, as are plans for management and employees, buying or leasing the facilities, or relocating the business.

iv. After the buyer and seller verbally agree on price and terms, the buyer will submit a letter of intent (or an “LOI”), which is a largely non-binding written agreement stipulating the terms of the deal as agreed to thus far (typically, the only binding provisions of an LOI are confidentiality and the “period of exclusivity,” a set timeframe during which the seller agrees not to talk with other buyers).

v. While it is mostly non-binding, the LOI is a legal document and its contents can foreshadow key legal issues which will be negotiated in the mid-to-latter parts of due diligence, when the purchase agreements which bind the transaction are drafted.

vi. After an LOI is executed and the buyer’s due diligence begins, unexpected changes can cause the parties to re-think and possibly renegotiate, or to walk away from the deal (such as changes in the seller’s company, its outlook, its customers, its industry, its market, the economy, global events, or the buyer’s circumstances, especially financing!).

vii. Drafting the purchase agreement(s) involves a series of negotiations on a variety of important issues, having legal and financial consequences – this is why it is critical for the seller to have experienced M&A lawyers on their team.

viii. The terms of the agreement or claims made by the buyer or seller can lead to post-transaction negotiations.

8. Facilitate Buyer Due Diligence

- Buyers typically seek a period of exclusivity lasting 60 to 90 days during which time they request and scrutinize detailed information on virtually

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all aspects of the seller's business, including: financial performance & accounting, taxes, customers, products, services, management & employees, facilities & environmental, machinery & equipment, information technology, human resources, insurance, and legal matters.

i. Buyers seek to validate the accuracy of what they have been told and what they believe about the business, ensuring that it is a "fit."

ii. Buyers attempt to understand how THAT business works (even companies doing the same work can operate very differently).

iii. Buyers need to plan and prepare for the transition of the business and be ready to assume control and direct operations on Day 1 after the closing.

iv. On behalf of the seller, the investment banker will oversee, coordinate, assist, & facilitate the buyer's due diligence activities with the seller and the seller's team.

9. Draft Purchase Agreement(s)

- Purchase agreements set forth the final terms of the transaction(s) and bind the parties to those terms.

i. The buyer's legal team will begin working on drafting the purchase agreement(s) about mid-way through due diligence.

ii. The purchase agreement which transfers ownership of the business and/or its assets is typically called a stock purchase agreement or an asset purchase agreement.

iii. If the company's buildings and/or other real estate is also part of the transaction, a separate real estate purchase agreement may be necessary.

iv. It is important that the seller's legal team is well-versed in deal language because the terms of the purchase agreement not only define what the seller will receive in return for the business, it is critical in ensuring that they get to keep it!

10. The Closing!

- The "Closing," which typically comes on the last day of due diligence, refers to finalizing the deal by the parties executing or signing the purchase agreement(s).

i. The "Soft Closing"!

1. The Closing is typically scheduled on the last day of due diligence unless the size of the transaction requires pre-merger reporting to the Federal Trade Commission (the "FTC") under the Hart-Scott-Rodino ("HSR") Act.

   a. The HSR Act and its implementing rules require the parties to certain mergers and acquisitions to submit premerger notification to the FTC and the Antitrust Division of the U.S. Department of Justice (the "DOJ"), which involves completing HSR forms, and to wait a specified period before consummating their transaction.

   b. The 2023 reporting threshold is $111.4 million, meaning that transactions below that value at the time of closing are not required to submit premerger notification.

2. If pre-merger notification is required, there can be a "Soft Closing," where the purchase agreements are signed but do not become fulling binding (hence, the Soft Closing name) until they receive approval from the FTC/DOJ.

ii. While there is much activity and anticipation for the Closing, the task of finalizing the deal is somewhat anti-climactic.

1. The signature pages of the purchase agreement(s) are signed in advance and held by the parties' attorneys.

2. Payment to the seller is pre-arranged.

3. The Closing occurs when the signature pages are exchanged.

iii. For sellers, one of the most exciting parts of the Closing is that when the deal is done, the funds are released!

Contact Andrew to discuss the steps to selling your business (amw@valuemanagementinc.com).

U.S. District Court Overturns Jury Award for Consequential Damages

Endless River Techs. LLC v. Trans Union LLC, 2023 U.S. Dist. LEXIS 725; 2023 WL 24101 (Jan. 3, 2023)

The parties had entered into a development agreement and contract for services for "the joint development and commercialization of a method for providing insurers on-line, real-time comparison price quotes to consumers ('Quote Exchange')." Trans Union LLC (the defendant) admitted having breached the contract by not recognizing the ownership rights of Endless River LLC (the plaintiff) to Quote Exchange. A jury trial on damages followed.

Trans Union LLC had a motion for judgment as a matter of law. This motion was subsequent to the court's determination that Trans Union did breach its contract with Endless River. "[A] jury was instructed to determine whether damages had been proven on the breach of contract claim, and if so, in what amount."

The jury determined that Endless River proved by a preponderance of the evidence that it had suffered damages in the amount of $18.3 million proximately caused by Trans Union's breach of contract (i.e., not returning source code for the Quote Exchange). Trans Union argued that the damages were barred by Section 8.2 of the contract. "Section 8.2 of the Contract between the parties contains this type of limiting clause in the form of a waiver of liability barring recovery of any consequential or indirect damages, including lost profits or revenue." Illinois courts have read similar language to mean that precluded recovery was allowed only when they constituted "consequential damages" and not direct damages.

The parties did not agree on whether the $18.3 million in damages were consequential, which the contract barred, or direct, which the contract allowed.

After reviewing motions by the parties, the judge sided with the defendant in determining that the damages awarded were "consequential damages" and not "direct damages" and were not allowed under the contract between the parties.

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