



March 2011 Valuation Cases

In this update, we have the following cases:

1. Golden Telecom, Inc. v. Global GT LP 2010 WL 5387589 (Del. Supr.) (Dec. 29, 2010) 2010 – An important case concerning the standards and requirements of transactional data in fairness opinions.
2. Link v. L.S.I., Inc., 2010 WL 5402970 (S.D.) (Dec. 29, 2010) – A South Dakota shareholder buy-out case concerning Fair Value versus Fair Market Value doctrines and discounting.
3. Slater v. Slater, 2010 WL 5356556 (Or. App.) (Dec.29, 2010) – An Oregon family law case addressing personal versus enterprise goodwill in relation to non-competition agreements.

Del. Supreme Court: Should Market Price Conclusively Establish Fair Value?

Golden Telecom, Inc. v. Global GT LP 2010 WL 5387589 (Del. Supr.) (Dec. 29, 2010)

In the first phase of this important decision, the Delaware Chancery Court decided several key aspects of calculating a discounted cash flow analysis in the statutory fair value appraisal process.

Most notably, the court declined to adopt Ibbotson's historic equity risk premium (ERP) in the favor of one closer to supply-side ERP. The court also rejected the tax rate used by the company (Golden Telecom) and its financial advisors in the merger prospectus in favor of an adjusted rate that reflected the company's three-year historic average.

Ultimately, based on all the financial facts and expert evidence in the case, the Court of Chancery found that Golden Telecom's \$105 merger price fell short of its statutory fair value by more than \$25 million, and the parties appealed three issues to the Delaware Supreme Court (The complete digest of *Global GT LP v. Golden Telecom, Inc.* appears in the July 2010 BVU.)



Bright line rules would shift burden of proof.

First, the company claimed that in an efficient market Delaware courts should defer exclusively to the merger price in statutory fair value appraisals-or at the very least the merger price should provide a rebuttable “presumption” of fair value.

The Delaware business statutes, however, require the Court of Chancery to make an independent determination of fair value after accounting for "all relevant factors," the state Supreme Court explained. The statute "neither dictates nor even contemplates" considering the transactional market price of the underlying company, In fact Delaware precedent specifically defines “fair value” as the value to a shareholder in the firm as a going concern rather than its value in a merger or other transactional context. The current appraisal scheme may be imperfect, the court “said, but it is also controlling, and leaves “little room for this court to graft common law gloss on the statute.”

Accordingly, “there is no basis for a court, in a statutory appraisal proceeding, to the statutory fair value,” the court held. Setting the merger price as conclusive or even presumptive evidence of fair value-even in the face of a “pristine” merger process and “wildly divergent” expert opinions-would contravene the statute and the “reasoned holdings” of precedent, the court said. It would also inappropriately shift the responsibility of determining fair value from the courts to the parties.

The court used much the same rationale to assess the cross-appeal by Global GT, the dissenting shareholder. Specifically, Global argued that instead of using the adjusted tax rate of 31.6% the Court of Chancery should have deferred to the 30% tax rate that the company's financial advisors used in their fairness opinion at the time of the merger. Permitting public companies to “walk away” from their own company-specific data previously provided to stockholders during the merger process conflicts with the important “duty of candor” in Delaware's corporation laws Global claimed. It also detracts from the goal of accurately determining fair value in a statutory appraisal proceeding.

The court rejected a "bright line" rule that would bind public companies to transactional data in a subsequent appraisal proceeding, however It reemphasized the flexibility of the appraisal process, noting the "significant discretion" given to the Court of Chancery to make the fair value determination, based on all the facts of the case. Nowhere does the statute hold the parties to previously prepared data, the court said. In addition the



adoption of strict rules to govern the process would likely increase the cost of "an already expensive proceeding."

Finally, public companies distribute data to their stockholders to convince them that a transaction is financially fair. In the context of a merger 'fair price' accounts for various transactional factors such as synergies between the companies "Requiring public companies to stick to transactional data in an appraisal proceeding would pay short shrift to the difference between valuation at the tender offer stage-seeking 'fair price' under the circumstances ... and valuation at the appraisal stage, seeking 'fair value' as a going concern," the court said. Finally, any concerns that companies might manipulate data from the transaction to the appraisal proceeding can be addressed by shareholders in a breach of fiduciary duties suit.

"We expect many companies will advocate the same company-specific data in appraisal proceeding that they have previously advocated in proxy materials," the court said. "Delaware law does not require them to do so, however." In this case, the Vice Chancellor had a rational basis for accepting the company's adjusted tax rate even though it differed from the rate the company used in its proxy statement, and the court confirmed the same.

An established expertise. As a last matter Golden claimed that the Vice Chancellor abused his discretion in determining the company's fair value at \$125 per share. The standard for reviewing his valuation is "formidable," the court observed. It could overturn the Vice Chancellor's factual findings only if they have no support in the record or his valuation is "clearly wrong."

More importantly, the members of the Court of Chancery have developed substantial expertise in statutory appraisal cases, including an ability to critically assess one expert's model methodology, and calculations against another's. So long as their conclusions are based on sufficient evidence, the Delaware Supreme Court will ratify them, "even if we might independently reach a different conclusion." Against this backdrop of substantial deference it found that in this case, the Vice Chancellor addressed each factual finding and expert methodology, and followed "an orderly and logical deductive process in arriving at his conclusions" Without discussing its specific aspects, the court confirmed the final \$125 per-share valuation.



CVS Comment: In our view the Delaware Chancery Court continues to deal with some of the most in-depth issues and discussions concerning valuations and fairness opinions. We believe the Court got it right in not requiring transaction data to be the seminal valuation factor in fairness opinions.

Statutory Fair Value Must Account for Company-Specific Risk

Link v. L.S.I., Inc., 2010 WL 5402970 (S.D.) (Dec. 29, 2010)

Two brothers owned a Wisconsin company that produced meat and cheese snacks for only one customer—a corporation owned by their father. After years of family conflict, one son agreed to leave the production company, but the parties were unable to negotiate a satisfactory buyout price for his 50% interest. At trial for judicial dissolution and statutory fair value appraisal, the parties agreed that the son would select one appraiser, the company another, and then they would select a third neutral appraiser.

The three appraisers independently determined both the fair market value and the fair value of the departing son's shares. The appraisers then exchanged their preliminary reports and met to discuss their conclusions. Although the neutral appraiser originally determined the son's 50% interest had a fair value worth \$21 million, the company's appraiser convinced him to reduce this amount to \$16.5 million, based on the company's reliance on a sole customer (owned by the father). After a vote, the three appraisers concluded that \$16.5 million was the "undiscounted" fair value of the son's interest. The fair market value of the shares was \$11.2 million, they said. The trial court adopted the \$16.5 million fair value for the son's shares, and he appealed.

Son says the appraisers incorrectly applied a discount. The appellate court first reviewed the dissenting shareholders statute, which expressly requires a "fair value" appraisal "without any discounting for lack of marketability or minority status." In addition, the court reviewed a 2001 case, *First Western Bank Wall v. Olsen*, 621N.W.2d 611 (S.D. 2001), which applied the statute to the valuation of a dissenting minority shareholder's stock. However, neither the statute nor *Olsen* controlled the current case, the court said, because it concerned the buyout of a 50% owner's shares. Such owners are more akin to "willing sellers" (rather than dissenting shareholders) when they petition the court for dissolution of the company, the court said. Nevertheless, some of the same still apply. In particular, a judicially ordered buyout does not involve a third-party buyer. Instead, by transferring the minority shareholders' interests to the company (and the remaining shareholders), it increases



their ownership and control. "This makes application of a 'fair market value' determination inappropriate," the court found, "because the economic reality is that the shares are not being bought on the market." Further, in *Olsen*, the court specifically declined to equate "fair value" under the dissenting shareholders' statute with "fair market value." A statutory fair value appraisal must, the court added, "focus on the stock only as it represents a proportionate part of the enterprise as a whole."

In this context, the court considered the son's argument that a "non-marketability discount inappropriately tainted the valuation process." Specifically, he claimed that the neutral appraiser agreed to reduce his initial value from \$21 million to \$16.5 million because "a hypothetical willing buyer would pay less for [the company] because of the significant risk associated with such a high customer concentration."

However, both the neutral appraiser and the company's appraiser testified that the \$16.5 million represented the value of the son's 50% interest without discounts. Moreover, the trial court expressly rejected the application of discounts in this case as "unjust and inequitable." At the same time, it rejected the higher valuation by the son's expert, finding some of his assumptions, including pricing projections, were flawed. The son's expert also incorrectly valued the company in relation to the father's other holdings rather than as a standalone enterprise. Finally, the trial court declined to adopt the \$11.2 million fair market value by all the appraisers because it included discounts. As a result, the neutral appraiser's reduction from \$21 million to \$16.5 million "was not a discount," the court found, but an appropriate consideration of one among "many factors of the business that had to be considered." Accordingly, it confirmed the statutory buyout of the son's shares at the \$16.5 million statutory fair value.

CVS Comment: Most state shareholder statutes are governed by the *Fair Value* doctrine as opposed to *Fair Market Value* doctrine.

May a Divorce Court Presume Noncompete in Valuing a Prof. Practice?

Slater v. Slater, 2010 WL 5356556 (Or. App.) (Dec.29, 2010)

(A similar case *McReath v. McReath*, the recent decision by the Wisconsin Court of Appeals, which held that all salable professional goodwill, as evidenced by a non-compete agreement, is a divisible marital asset. This new decision by the Oregon Court of Appeals gives some indication whether family courts in other jurisdictions will



follow *McReath* when determining whether to premise the value of a professional practice on the assumption that the owner-spouse would be bound by a non-compete.

Successful chiropractic practice. In this case, the husband purchased a solo chiropractic practice in 1996 for \$157,500, which included \$37,000 for goodwill and the prior owner's patients list, plus \$75,000 for his promise not to compete. Over the next ten years, the husband boosted annual practice revenues from approximately \$450,000 to \$635,000, an amount substantially above the national average. By this time, the practice employed a staff of four, including an associate chiropractor who executed a non-compete when he joined. As sole owner, the husband did not work under an employment contract with his firm and had no plans to sell or retire. Moreover, if he had to sell, he insisted that he would never sign a non-competition agreement.

At trial the wife's expert valued the practice under both the capitalization of earnings and the capitalization of excess earnings approach. He averaged the resulting values to conclude the practice was worth \$610,000, without any specific apportionment to goodwill. He did testify, however, that subtracting the value of net tangible assets (approximately \$160,000) from the total value yielded nearly \$450,000 in goodwill value—all of which was attributable to the business, he said, and none to the husband. In other words the wife's expert claimed that all of the goodwill value of the practice was enterprise goodwill, subject to division.

By contrast, the husband's expert valued the tangible assets of the practice under the adjusted book value approach at just over \$200,000. He then applied the market approach (comparable transactions) and the income approach (capitalization of excess earnings and capitalization of earnings) to reach a fair market value for the practice of \$504,000. In his opinion, the portion of goodwill value was approximately \$304,000 (\$504,000 - \$200,000), of which 10% was attributable to revenues generated by the husband's associate chiropractor (roughly \$30,000). The balance of goodwill, \$273,000, was directly attributable to the husband's ongoing efforts and personal skills, the expert said—in particular his status as a preferred provider for an insurance company that covered local government employees. Accordingly, he calculated the total divisible asset value of the practice at just over \$230,000 (\$504,000 - \$273,000).

Both experts agreed that were the husband to sell his business, any buyer would insist on a non-competition agreement. At the same time the wife's expert believed that, because a sale would require a non-compete, its value should be included in the practice's overall fair market value. He did not assign a specific value to a non-



compete, but he testified that if the practice sold without one, the business would be worth less than his reported \$610,000, because the new owner would risk losing the revenue stream protected by a covenant not to compete.

The husband's expert countered that it was not proper to include a putative non-compete in the practice value, because the husband had no plans to sell or retire. In addition, the value of non-compete amounted to the husband's post-divorce income, which was separate, non-marital property, the expert said. Finally, any value of a non-compete corresponded directly to the husband's personal (non-divisible) goodwill; i.e., \$273,000.00.

The trial court ultimately valued the husband's practice at \$500,000, which included its net tangible assets and goodwill, and also assumed the execution of a non-compete. Although there was no evidence the husband intended to sell the business, the trial court "had no doubt" that if he did, \$500,000 would be a fair asking price." Further, goodwill is more than the value of a covenant not to compete," the court said. In that regard, some of the goodwill value was attributable to the husband's active promotion of the practice made possible, in part, by the wife's efforts. Thus, after awarding the practice to the husband the trial court awarded an "offsetting judgment to the wife of \$78,524. (Note: The published court opinion does not indicate how the trial court calculated this offset.)

A concept of 'chameleon capability' on appeal, the husband asserted that the trial court incorrectly premised its valuation on the existence of a non-compete. The wife essentially resubmitted her expert's evidence and arguments, i.e., that anything above the net asset value of the practice constituted divisible enterprise goodwill.

At the outset, the appellate court noted the continuing difficulty among courts and other legal authorities in defining and determining goodwill, "a concept of chameleon capability," it said "The semantic and analytic confusions especially marked... when it comes to assessing the goodwill of a professional practice or a closely held business." Nevertheless, the precedent in its own and other states generally held that "cognizable" (or divisible) goodwill refers to the value of a business over and above the value of its assets the court explained, "irrespective of the owner's or personal service or reputation."

Against this backdrop, the court examined the issue in this case-one of first impression in the state: Did the trial court correctly premise the value of the husband's professional practice on the assumption that he would be bound by a non-compete? Although there was no Oregon case on point, courts in other jurisdictions had come down on both sides of the question. In the minority view (represented most recently by *McReath*), courts find



that a non-compete represents a divisible, marital asset. The majority however, conclude that-to the extent a non-compete corresponds to the business's future earning capacity attributable to the individual practitioner's skills, qualities, reputation, or continued presence—its value is not "cognizable" in a marital property division.

"We agree with the majority approach," the Oregon Court of Appeals held. When executed as part of the sale of a business, a non-compete ensures that the former owner will not take away customers or patients (and their related revenue stream). Its value is intrinsically tied to the practitioner's continuing presence, and thus its exclusion from the value of the practice is supported by the same rationale that excludes enhanced earnings and personal goodwill. "Each is a function of the individual's earning capacity," the court said, with the value of the noncompetition covenant corresponding to the present value of the foregone stream of future earnings."

In this case, the wife's expert claimed the entire enhanced value of the practice belonged to the entity. At the same time, he claimed that if the husband sold the business, he would be bound by a non-compete-an acknowledgment that the court found was irreconcilable with his position that the husband's personal services and presence were immaterial to the business's enhanced earnings. The husband's expert, on the other hand, correctly concluded that any enterprise goodwill was minimal. As sole shareholder, the husband generated over half the practice revenues from his preferred provider status-which was not transferable. Moreover, when he bought the practice in 1996, the husband paid substantially more for the former owner's noncompetition agreement than he did for business goodwill. Accordingly, the appellate court found the values calculated by the husband's expert, including the \$273,000 attributed to personal goodwill, were reasonable, and it adopted his \$230,000 ultimate conclusion of value.

CVS Comment: This Oregon family law case involves personal goodwill versus enterprise goodwill in relation to non-competition agreements. Most states hold that non-competition agreements are personal in nature and therefore the amounts paid for them are an offset to enterprise goodwill. There are several cases in Illinois that deal with personal goodwill versus enterprise goodwill, including *In re Marriage of Head*, 210 Ill. Dec 70, 273 Ill App. 3d 404, 652 N.E.2d 1246 (1st Dist. 1995), *In Re Marriage of Zells*, 143 Ill. 2d 251, 572 N.E. 2d 944 (1991), *In re Marriage of Talty*, 166 Ill. 2d 232, 652 N.E. 2d 330 (1995), *In re Marriage of Schneider*, 214 Ill. 2d 152, 824 N.E. 2d 177 (2005) and *In re Marriage of Alexander*, 368 Ill. App. 3d 192, 195, 857 N.E. 2d 766 (5th District 2006).