SEPTEMBER / OCTOBER 2018

ADVOCATE'S EDGE

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Delaware high court endorses deal price for fair value in appraisal actions

In a landmark decision, the Delaware Supreme Court has made clear its preference for valuations based on the deal price in appraisal proceedings. Although the state high court declined to adopt a bright-line rule, it noted that deal price — which represents "the collective judgment of many" — is generally considered superior to other valuation models.

Court applies arbitrary weighting

The case involved the sale of a payday lending company (DFC Global) that was prompted, in part, by increased regulatory scrutiny of the industry. Over two years, DFC Global was shopped around to at least 35 financial sponsors and three strategic buyers.

> "Second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."

During that time, the company repeatedly reduced its financial projections to reflect uncertainty about its future profitability due to a major regulatory overhaul. In response, potential buyers reduced their offers or dropped out of the negotiations. The company eventually sold to a private equity firm that paid $9.50 per share in the final deal, down from its earlier offer of $11.

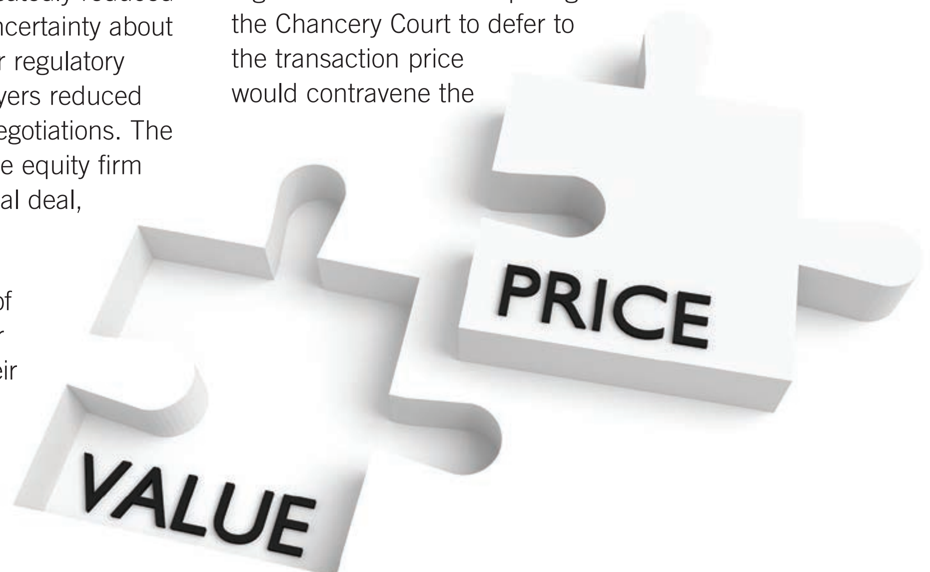
After the sale, several stockholders of DFC Global sued for appraisal under the applicable Delaware statute. Their expert calculated a fair value of $17.90 per share using the discounted cash flow (DCF) method. The company's expert blended the results of the DCF model and a market-based model to reach a fair value of $7.94 per share.

The Court of Chancery acknowledged that it often defers to a transaction price that was the product of an arm's-length process and an open-market check reflected by a robust bidding environment. But, in this case, the court opted not to because the sale had been negotiated while the company was facing significant turmoil and regulatory uncertainty. Further, the buyer focused its attention on achieving a certain internal rate of return and meeting specific financing constraints, rather than the company's fair value.

The court ultimately determined the fair value to be $10.30 per share, based on an equal weighting of three "imperfect" techniques: 1) the DCF model, 2) a market-based model, and 3) the deal price.

Supreme Court favors deal price

DFC Global appealed, arguing that the Delaware Supreme Court should establish a presumption in favor of the deal price in appraisal cases where the transaction resulted from an open-market check and certain other market conditions. However, the high court noted that requiring the Chancery Court to defer to the transaction price would contravene the



Negotiated deal price prevails … again

The Delaware Supreme Court reinforced its preference for arm's-length deal prices just a few months after its decision in *DFC Global*. (See main article.) In another statutory appraisal case, *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, it rejected the Chancery Court's valuation because no weight was given to the negotiated deal price.

The case involved a management buyout of Dell. Shareholders were paid $13.75 a share, representing a 37% premium over the company's stock price. The Chancery Court concluded that the fair value on the merger date was $17.62 per share.

On appeal, the state supreme court reversed the Chancery Court decision. Why? The lower court's reasons for disregarding the deal price weren't supported by its factual findings and "relevant, accepted financial principles." The high court criticized the Chancery Court for ignoring the "efficient market hypothesis," which suggests that the deal price produced by an efficient market generally is a more reliable assessment of fair value than the view of a single analyst.

unambiguous language of the appraisal statute. The statute requires a court to "take into account all relevant factors" when determining fair value.

The state supreme court stressed that its refusal to create a presumption favoring deal price didn't signal its "ignorance to the economic reality" that the price resulting from a robust market check is often the most reliable evidence of fair value. It cautioned that "second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."

The court went on to fault the Chancery Court's reasons for finding the deal price unreliable and giving it only one-third weight. It first rejected the Chancellor's finding that the price was unreliable because the company's future performance depended on the outcome of regulatory actions. The state supreme court found that potential buyers and the relevant debt markets were aware of and taking the regulatory risks into account in their overall analysis of value.

The high court also dismissed the assertion that the deal price wasn't reliable because the private equity firm required a specific rate of return on the transaction. It observed that all disciplined buyers have internal rates of return they expect in exchange for taking on the risk of a significant investment. A buyer's focus on its rate of return, the court said, "has no rational connection to whether the price it pays as a result of a competitive process is a fair one."

Trends vs. bright-line rules

Despite the Chancery Court's original ruling in this case, it has increasingly relied on the deal price in appraisal cases involving arm's-length transactions and robust market checks. On remand, that trend may be followed here, because the Delaware Supreme Court advised that the competitive process leading to the sale and other relevant factors suggest that the deal price was the most reliable indicator of fair value in this case. ■

How causal assumptions can lead to damages dilemmas

Whether due to time, cost or other constraints, attorneys sometimes ask damages experts to simply assume causation. However, a recent ruling by the Texas Supreme Court demonstrates how that approach can backfire.

Employees jump ship

In 2011, several members of the management team at Horizon, a health care consulting company, moved to Acadia, a competitor. The defecting managers also recruited one of Horizon's top salespeople to join the competitor.

Some of the defectors copied Horizon's documents before they left, including policies and procedures, "non-standard" contract language, financial models, monthly account listings, sales presentations, orientation materials and legal files. The defecting salesperson copied lists of sales leads, marked some of them "dead" before resigning and added those to Acadia's master contact list.

Horizon sued its former employees for several business torts. It also sued Acadia, alleging the competitor was liable for the defectors' acts and omissions. The jury awarded Horizon (the plaintiff) almost $4.2 million in damages for future lost profits, approximately $55,000 for theft of property and trade secrets, and $1.75 million in exemplary damages.

The Fort Worth Court of Appeals subsequently held that the evidence for future lost profits was insufficient to support the jury's award. It also remitted the exemplary damages to about $1.1 million based on the remaining $55,000 in compensatory damages. Horizon appealed the case to the Texas Supreme Court.

Court rejects lost profits damages

The jury's award included lost profits related to the loss of a major contract due to the defendants' misconduct. On appeal, the Texas Supreme Court noted that a plaintiff seeking lost profits damages from future business opportunities must establish that prospective customers would have done business with the plaintiff absent the misconduct.

But the state supreme court found that Horizon's damages expert simply assumed causation. He specifically stated that he had no opinion about whether the company would have won the contract at issue if not for the defendants' wrongful conduct.

In fact, the court found no evidence that the customer would have entered into a contract with Horizon, as opposed to some other company, if it hadn't signed a contract with Acadia. The evidence showed only that Acadia wouldn't have won the contract absent the individual defendants' misconduct.

Similarly, the court said, no evidence supported the conclusion that the customer would have accepted Horizon's bid if it hadn't accepted Acadia's bid. It was equally plausible that the customer would have rejected all bids in the case.

The state supreme court upheld the Court of Appeals' conclusion that the expert's testimony was insufficient. Because Horizon's expert admittedly assumed causation, the plaintiff failed to establish the fact of damages relating to the contract with reasonable certainty.

Prepare your experts

The expert's assumption in this case cost the plaintiff more than just the lost damages award. The court also held that the exemplary damages, while supported by the evidence, were excessive, in large part because of the ratio of the remaining compensatory damages of $55,000 to exemplary damages.

Don't leave your clients vulnerable to such dire consequences. Ensure your damages experts can clearly explain the causation between the defendants' acts and the clients' losses. ■

Updated survey provides insight into fraud trends and prevention methods

The Association of Certified Fraud Examiners (ACFE) has released its *Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse*. The ACFE updates this report every two years. Consistent with previous studies, the ACFE estimates that occupational fraud costs the typical organization 5% of its revenue every year.

The latest report is based on a study of 2,690 fraud cases occurring between January 2016 and October 2017. The median loss from fraud was $130,000 in the 2018 ACFE study, down from $150,000 in the 2016 study — but that's probably more than your clients want to lose. Here are more insightful statistics on fraud losses, schemes and methods of detection.

Fraud schemes

Occupational fraud is commonly defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of an employer's resources or assets. These crimes generally fall into three categories:

1. Asset misappropriation. Fraud often involves stolen assets (such as cash, equipment or inventory). In the 2018 study, asset misappropriation occurred in 89% of the cases, but the median loss from theft was the lowest of the three categories ($114,000).

> Tips have been the most common method of initial detection since the ACFE first began tracking the data in 2002.

2. Corruption. These schemes typically involve bribery or a conflict of interest by an employee who misuses his or her influence in a business transaction. In the 2018 study, 38% of the cases involved some form of corrupt act, resulting in a median loss of $250,000. Corruption is especially common in Asia, Eastern Europe, and Latin America and the Caribbean.

3. Financial statement fraud. This is the least common but most costly form of occupational fraud. In the latest ACFE study, financial results were misstated in 10% of the cases and caused a median loss of $800,000.

Frauds typically involve more than one type of occupational theft or abuse. Thieves often test the waters with a simple scheme and then graduate to more advanced ones over time.

Methods of detection

Tips have been the most common method of initial detection since the ACFE first began tracking the data in 2002. Tips were significantly more common in corruption cases (50%) than in asset misappropriation or financial statement fraud schemes (both 38%).

Most tips (53%) came from employees. But 21% of the tips came from customers and 8% from vendors. The median loss for frauds detected by tips was $126,000.

The prevalence of fraud tips is related to the availability of a reporting hotline — a requirement for public companies. Businesses with some form of hotline in place were tipped off about fraud in 46% of the cases. Those without a hotline caught fraud from a tip in just 30% of the cases. Despite these statistics, 37% of the organizations victimized didn't have a hotline in place at the time of the fraud.

Frauds discovered by more proactive measures generally caused smaller losses than those unearthed by more passive measures, including tips. For example, the median loss for schemes detected by management review was $110,000, compared with $52,000 for those revealed through account reconciliation. In contrast, frauds first detected by police notification were the costliest — with a median loss of $935,000 in the 2018 ACFE study.

Proactive approach

There's no denying the value of being proactive, not passive, about detecting and preventing fraud. In addition to investigating suspected wrongdoings, experienced fraud experts can help clients implement controls to prevent occupational fraud from occurring in the first place. Proper internal controls provide a deterrent (but not a guarantee) against fraud. ■

What's normal?

Normalization adjustments are essential in valuation

Fine-tuning financial statements helps a business valuation expert compare the subject company's performance to the financial performance of similar public or private companies. In turn, normalization is critical when gauging risk, estimating future earnings, quantifying valuation discounts and selecting guideline comparables to use in the market approach.

Types of adjustments

Normalization adjustments generally fall into four categories:

1. Adjustments for unusual and nonrecurring items. These items can temporarily distort earnings on a company's financial statement. Examples include

damages from natural disasters, litigation costs, insurance proceeds, and gains or losses from the sale of assets.

Under U.S. Generally Accepted Accounting Principles (GAAP), such items can be presented on financial statements within income from continuing operations or disclosed in notes. This can make them more difficult for an expert to identify and adjust for.

2. Adjustments for nonoperating assets. These assets aren't necessary to a company's ongoing operations. Examples include certain real property and investments in unrelated companies.

If nonoperating assets aren't part of a company's primary business operations, the expert usually will value them separately and add their fair market value to the company's estimated operating value. To avoid double counting these assets, it's important also to adjust the company's income statement for any income generated by a nonoperating asset and any expenses associated with it.

3. Adjustments for related-party transactions. Privately held corporations may pay shareholders inflated salaries in lieu of dividends — because dividends aren't tax deductible for the company, but compensation is. Compensation also can be used to disguise otherwise taxable gifts to family members or manipulated to reduce payroll taxes. And low- or no-interest loans to employees may in fact represent compensation. Experts adjust for differences between the amounts paid to related parties and amounts that would normally be paid to third parties for similar goods or services rendered.

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4. Adjustments for accounting norms. Smaller private companies might not adhere to U.S. GAAP or other industry-standard accounting methods. For example, public companies that follow GAAP might account for inventory, depreciation, intangible assets and bad debts using different methods than a smaller private business in the same industry would. To ensure meaningful comparisons with guideline companies, an expert might need to adjust the subject company's financial statements based on conventional accounting practices.

Professional judgment

Normalization adjustments require professional judgment, based on your expert's knowledge of financial reporting, taxes and relevant market data. Qualified business valuation experts can explain why specific adjustments are needed and how to adjust the subject company's performance to better align it with the comparables. ■

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