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Chancery court charts own course in appraisal action

***Gholl v. eMachines, Inc.,* 2004 Del Ch. LEXIS 171 (November 24, 2004).** *Judge Parsons.*

The issue in this appraisal action was the value of the shares of eMachines Inc., a company that provided low-cost computer goods to consumers. Charles and Michelle Gholl, owners of 339,000 shares, brought this appraisal action. Other shareholders, who combined owned 1,005,600 shares, also exercised their appraisal rights for the fair value of their shares.

Like many technology-based companies, eMachines went public in March of 2000 in a successful IPO, with the stock set at $9 a share. eMachines' business model was modified to gain revenue from initiating Internet-based consumer relationships. As a result of this change, the company sold its computer hardware for cost or less than cost. This Internet-based revenue model was later labeled a "financial disaster" by eMachines. By late 2000, eMachine stock was trading below $.50 a share.

As a result of this downturn in business, eMachines recruited new management that implemented a turnaround strategy. Despite the changes that were being made, eMachines was delisted from the NASDAQ and began being traded on the Over-the-Counter (OTC) Bulletin Board market.

The new business plan proved successful in turning the fortunes of the company around. Wayne Inouye, the new CEO, declared in an October 2004 conference call that he didn't "understand why the stock is not at least a $2 stock."

In April 2001, the board of directors considered the possibility of a sale of the company. To this end, they retained the services of Credit Suisse First Boston (CSFB). CSFB contacted 55 potential buyers and received some indications of interest ranging from $.71 a share to $.83 a share. The company rejected the offers as inadequate and never disclosed the offers publicly.

In October 2001, John Hui, a member of eMachines' board of directors, tendered an offer at $.71 a share. This began a bidding war, which concluded with Hui's offer of $1.06 per share, which was the high bid submitted to the board just prior to the November 18, 2001 deadline.

CSFB prepared a fairness opinion concerning the offer and determined it was fair. The board unanimously approved the merger and recommend it to the shareholders. Hui commenced the tender offer on November 27, and by December 27 controlled 87 percent of the shares. Hui then exercised a "top-up" option that allowed him to purchase additional shares from the company giving him the 90 percent he needed in order to complete a short-form merger, which was completed on December 31, 2001.

CSFB's fairness opinion

CSFB stated in its written report to the board that it thought the final offer was financially fair. In its valuation of the company, CSFB used several valuation methods including two discounted cash flow models. The first DCF was based on management projections, submitted in November of 2001 for 2002, and resulted in a value range of $1.41 to $2.22 per share. This method was termed "Management Case" by the court. The second DCF analysis was termed "Sensitivity Case" and was based on "much gloomier predictions" resulting in a value range of $.91 to $1.20. Although CSFB never stated which method it relied on in its opinion, the court assumed that it was based on the Sensitivity Case projections.

Shareholder's expert's valuation

Daniel Larson, ASA, testified as the expert for the Gholls. Larson used both a DCF analysis and a market analysis. Based on the 2002 budget Larson weighted the methods 75%/ 25%, respectively. His valuation resulted in a value of $2.48 per share.

Company's expert's valuation

Gregg Jarrell, a professor of economics and finance, testified as the expert for the company. In his valuation, Jarrell first used a DCF analysis using the Management Case projections and arrived at a value range of $.93 to $1.03 per share. Then Jarrell used the 2002 budget, just as the shareholder's expert did, and arrived at a range of $1.00 to $1.22 per share. Jarrell conducted two market-based analyses, but because he did not rely on them for his report, the court considered them only as a "reality check."

Court's valuation

The court, after deciding that neither party had met their burden of persuasion, conducted its own valuation of the company as of the merger date. The court agreed with both experts on methodology and used the DCF method. The court then applied a weighted average cost of capital (WACC) rate of 18.5 percent. The court used a growth rate of 5 percent and calculated the company had $162.5 million in excess cash. These figures resulted in a valuation of $1.62 per share.

Extra comment by trial judge not enough to reverse ruling

***In re Marriage of Frawley,* 2005 Wisc. App. LEXIS 7 (January 6, 2005).** *Per Curiam.*

The issue in this marital dissolution was the value of husband's dog breeding business. Wife appealed based largely on a comment from the trial judge made during his ruling.

The comment essentially was that the value of the business was lower in part because the maintenance award would be taken out of its future earnings, and, if it wasn't lowered, it would be considered double-dipping:

> *I know that Mrs. Frawley believed that Mr. Janke's projections were too low and the business will continue to grow and have an increased income post-divorce, but as long as Mr. Frawley owns it, to some extent, Mrs. Frawley shares in that in the sense of maintenance and child support through the creation of income.*
>
> *I have to value it, however, as a fixed date, and I'm considering the fact that maintenance and child support are paid by this business and we're valuing it using the income, and it's for that reason I also felt [Jeanne's expert's] figure was too high because, in a sense, we are double-dipping if we use the aggressive figures of ... [Jeanne's expert]...*

Valuation evidence

Both parties presented expert testimony. Although the court opinion did not discuss the methodologies used, it did state the conclusions of the appraisers. Kevin Janke, who testified for husband, valued the business at $310,000.

Wife's expert, Jerry Bremer, valued the business at $562,000. The court valued the business at $462,700 after discounting the value of the company by 30 percent. The discount was not labeled a discount for marketability but seemed to be one despite the lack of DLOM terminology.

The court reasoned that the discount was needed because the business was "not a readily saleable or marketable business in the normal sense as it's primarily the product of Mr. Frawley."

Holding and rationale

The court of appeals agreed that the trial court's comment was erroneous but that it was also extraneous and did not prejudice wife. The court noted that the trial judge had made a valuation that was supported by the evidence and was thus neither erroneous nor reversible.

A model to adjust the value of S corporation equity

***The S Corporation Economic Adjustment Model,* Daniel R. Van Vleet,** *Business Valuation Review,* September 2004, pp. 167-180.

In this article, you will find discussions regarding general economic characteristics of business valuation approaches, various differences in the income tax treatment of both S corporations and C corporations, and the differences in the net economic benefit that are derived by S corporation and C corporation shareholders.

The author provides a mathematical framework to be used to adjust the indicated value of S corporation equity securities when empirical studies and analyses of C corporations are used to estimate value. The discussion and analyses in this article are only relevant to S corporation equity securities that lack ownership control.

Initially, the basic differences in the tax treatment of S corporations and C corporations, along with their shareholders, are discussed. These differences comprise the first premise of this article, while the second premise lies in the fact that capital markets are efficient over the long term.

When valuing S corporation equity securities, the value indications provided by the income approach can potentially be distorted when investment rates of return of publicly traded C corporations are used. This is due to the differences in the income, capital gains, and dividend income tax treatment of S corporations and C corporations and their respective shareholders.

Also, a further distortion may arise when public company market-derived pricing multiples are calculated, or acquisition price premiums paid for publicly traded companies are used in the analysis.

Due to the difficulty of constructing accurate empirical studies of equity security transactions that specifically isolate the economic differences solely attributable to the differing income tax treatment of C and S corporations, the article discusses the “S Corporation economic adjustment” (SEA).

Here, an S corporation equity adjustment multiple can be calculated (SEAM). The SEAM provides an estimate of the percentage premium an investor would be willing to pay for an S corporation share versus an otherwise identical C corporation share.

This is a mathematical model that may be used to adjust the appraised valued of equity of an S corporation when empirical studies and analyses of C corporations are used to estimate value.

Court finds fraudulently operated companies difficult to value

***In re Marriage of Thompson,* 2005 Iowa App. LEXIS 24 (January 13, 2005).** *Judge Hecht.*

In this marital dissolution, one issue was the value of the multiple companies owned by husband. Expert testimony placed the value of the assets of these companies between $142,080 and $213,120. Husband was incarcerated for over a year on drug charges. The court stated that because of the fraudulent way in which the companies were run, it was difficult to determine their value.

The court noted that, "the assets of [the companies] are byzantine, deceptive and almost impossible to get a firm handle on." The court went on to say, "The companies inflict more fraud and financial injury on those who come into contact with them than they do good." Ultimately, the trial court determined that there was nothing to divide in terms of value in the marital estate. The court of appeals affirmed.

Nevada condemnation valuation exception explained

***State of Nevada v. Cowan,* 2004 Nev. LEXIS 124 (December 17, 2004).** *Judge Shearing.*

This condemnation case presented the issue of valuing a business to which franchise licenses for the business could no longer be obtained. Stuart and Barbra Cowan operated a Texaco gas station in Nevada that was condemned by the state to make way for a new road. The Cowans could not move their business because the oil companies were not extending any more gas station franchise agreements in the Las Vegas area. The Cowans and the state could not agree as to a value of the business, so this action followed.

Valuation approach

The Cowans' argument was that the value of the business should be determined by the lost business goodwill and the lost business opportunity. The state disagreed and argued that neither goodwill nor lost business opportunity should be considered when valuing a business for condemnation purposes.

The state argued for Nevada's traditional approach:

> Traditionally, damage to a business (as opposed to the taking or damaging of its physical assets) has been treated as a noncompensable loss, even when the damage or destruction occurs because a condemning agency takes the land on which the business is conducted. Since the business is not taken for use as a going concern, the condemnor does not acquire the going-concern value of the business and should not be required to compensate for that which is not taken. In this case, NDOT is not getting any benefit from the business, as it is acquiring only the real property.

However the Cowans argued that the exception to the traditional approach should apply:

> [T]his court has recognized that under certain exceptional circumstances, the business owner may be compensated over and above the value of the real property. In National Advertising Co. v. State, Department of Transportation, this court recognized that when the condemnation of the real property results in the business being destroyed, the business owner should be compensated. …

The court agreed:

> The Cowans were unable to relocate their business because oil companies were not extending new leases for gas station franchises in the Las Vegas area. Consequently, the lease's value was inextricably tied to the unique location of the real estate that was condemned. In this situation, we conclude that the undivided-fee rule does not adequately compensate the lessee for what was taken. The Nevada Constitution mandates that "private property shall not be taken for public use without just compensation." Therefore, the State must compensate the Cowans for the destruction of their business.

Measure of damages

The Cowans argued that the court should allow evidence of lost business opportunity. The court rejected this argument, stating that measuring damages solely on the loss of goodwill was more appropriate.

The Cowans also disagreed with the trial court's decision to disallow comparables from California but allow the original purchase price as evidence of value. They argued that the California sales were appropriate comparables but that their purchase five years prior was too outdated to be accurate as to current value.

The court ruled that the California comparables were properly excluded due to the confusion they would likely cause. In addition, the court noted that the inclusion of the original purchase price was well within the lower court's discretion.

Holding and rationale

The Supreme Court upheld the trial court's use of the exception to the traditional approach in valuing the business, specifically the inclusion of goodwill value. The court also upheld the value arrived at by the jury of $260,000, despite the Cowans' assertions for a much higher amount.

Dissenting opinions

In his dissenting opinion, Judge Maupin argued that the case should have been remanded, given the lack of local comparative sales information, and would have allowed the Cowans to present evidence of comparable sales from other states. Judge Gibbons echoed that opinion, and also added that admitting the original purchase price into evidence was an abuse of discretion, as that price would have possibly introduced unfair prejudice, confusion of the issues, and the potential to mislead the jury.

Shaky market approach prevails over improper cost approach

***In re the Marriage of Helzer,* 2004 Mont. LEXIS 619 (December 14, 2004).** *Judge Regnier.*

In this marital dissolution, the issue was the value of Northwest Precision, Inc., a machine manufacturing company owned by husband.

Husband asserted that the trial court erred in following wife's expert's valuation, which relied on the market approach. Husband claimed that no genuine comparable sales existed at the time to accurately gauge his property's value and contended the cost approach used by his expert was more comprehensive in valuing the property at $145,000 at the time of the marriage.

Wife countered that the trial court correctly considered her expert's property valuation, as her appraiser reviewed some 400 sales in the time period in an attempt to find comparable sales and reach a fair market value. Further, wife argued that husband's expert's testimony was obtained in the form of a perpetuation deposition during which wife's counsel was unable to attend and participate in due to illness. Moreover, wife contended husband's expert's testimony was based exclusively on husband's estimates regarding improvements and labor on the property.

Holding and rationale

The Montana Supreme Court concluded that the trial court had not abused its discretion in its choice of valuation. The court found that the trial court could have relied on wife's expert, because although true comparable sales were hard to find, his comparison and analysis appeared to be justified. Moreover, the court found that the trial court was justified in finding that husband's expert's approach "appeared to be unrealistic" and that its reliance on husband's calculations was improper.

Court rejects DCF and uses comparable public company method

***Doft & Co. v. Travelocity.com Inc.,* 2004 Del. Ch. LEXIS 75 (May 20, 2004).** *Judge Lamb.*

(A minority shareholder of Travelocity.com Inc. (Travelocity) brought a dissenting shareholder action contesting the $28 per share it received in a short-form merger of Travelocity and seeking a determination of the fair value of its shares.

William H. Purcell was the shareholder's expert, and Paul A. Gompers was the expert for Travelocity. Both experts used essentially the same methods to value Travelocity's stock; i.e., a discounted cash flow (DCF) analysis and a comparable company analysis. In performing their comparable company analyses, both Purcell and Gompers used Expedia-one of Travelocity's main competitors-as the single comparable company. Despite the similar approaches taken, the results arrived at by the experts varied widely. Gompers' DCF analysis returned a value between $11.38 and $21.29 per share. Purcell's DCF yielded a value between $33.70 and $59.95 as of the merger date. The two experts' comparable company analyses also yielded significantly divergent results because they disagreed about the appropriate discount to apply to reflect Travelocity's competitive disadvantages.

Court rejects DCF, finding unreliable inputs

The Delaware Chancery court, quoting that "methods of valuation, including a discounted cash flow analysis, are only as good as the inputs to the model," found that the most fundamental input used by the experts-the projections of future revenues, expenses and cash flows contained in management's five-year plan-"were not shown to be reasonably reliable." The court criticized Gompers's selective use of management projections, and observed that its conclusion that no one was able to produce a reliable set of long-range projections for Travelocity was reinforced by the fact that "Gompers's DCF produced values ranging from $11.38 to $21.29 relative to a squeeze-out merger in which Travelocity's 70 percent parent agreed to pay $28 per share to acquire the minority interest."

Court relies on comparable company method

Having rejected the DCF method, the court turned to the comparable company method. Both experts used Expedia as the single comparable company in their analyses, but disagreed on the appropriate discount to be applied to the multiples derived from their analyses of Expedia. The court agreed that Expedia was clearly comparable to Travelocity. Gompers argued for a 40 percent discount, whereas Purcell argued for a 10 percent discount. After considering numerous factors, the court concluded that a 35 percent discount to the valuation multiples was appropriate, to reflect the competitive obstacles Travelocity faced. The court used EBITDA and price-to-earnings multiples, and applied a 30 percent control premium. After conducting its comparable company analysis, the court determined that the fair value of the dissenter's shares was $32.76 per share.

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