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Involve your Business Appraiser in Discovery

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Many lawyers don't involve their business appraisal expert in the discovery process in cases involving the value of a business or practice.

In this article, I focus on the ways in which the business appraiser can provide support in the discovery process that will assist in refuting the opposing expert's position.

Preparing discovery requests

An important service of the business appraiser is the preparation of discovery requests for the information necessary for the appraisal. The appraiser usually will know what to request for companies in the industry or line of practice involved.

The lawyer does not want to get in the position of not having requested some information that would be pertinent to a good appraisal and then not being able to obtain it (a shortcoming that I have encountered all too often when the appraiser did not have input into the discovery request). On the other hand, an overly broad discovery demand gives the other side excuses for delay and objections about the request being unreasonably onerous.

Preparing deposition and interrogatory questions

Depending on the nature of the business or practice and the rules of the jurisdiction, in addition to the site visit and management interviews, there may be depositions involving employees, outside advisers (e.g., bankers, CPAs) and, especially, the opposing expert. The business appraisal expert can help formulate the initial questions to ask these individuals, as well as general lines of inquiry that will help elicit important information about the opposing expert's valuation conclusion.

Depositions generally are preferable to interrogatories because of their interactive nature. The answer to one question may well lead to another question or series of questions. In circumstances where interrogatories are the only option, however, it is even more critical that the business appraiser be involved in formulating the questions to be sure important information is obtained.

Presence at opposing expert's deposition

If you are deposing an opposing expert, having your expert present usually is a huge benefit. This will help to evaluate the other expert's valuation work product and glean the information needed for effective cross-examination and rebuttal testimony.

Your expert can go through the opposing expert's work papers (which you will have demanded be produced via subpoena) and develop questions that get at the technical nature of what was done in the appraisal. Your expert can provide follow-up questions, depending on the answers given to the basic questions that were already anticipated.

Many lawyers do not have the financial expertise to totally probe exactly what was done by the other expert, in a technical sense, in order to evaluate the strengths and weaknesses of the work and prepare effective cross-examination and rebuttal. Having your expert present should overcome this problem.

Rebutting the Opposition

The two primary ways that the expert can help refute the opposition are by:

1. helping the lawyer prepare effective cross-examination, and
2. providing rebuttal testimony.

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This issue includes...

articles on how to leverage your business appraiser during discovery to refute the opposition; recent case law determining that fair value is not the standard of value in a shareholder dispute; the circumstances under which it is a breach of an ESOP trustee's fiduciary duty to not apply a discount for lack of marketability when determining a redemption price; and a checklist ESOP trustees can use to ensure that appraisal reports meet guidelines for accuracy and thoroughness.

The weaknesses of the opposition's expert should be brought to the court's attention. Your expert can help to identify these weaknesses by listening to the other expert and helping the lawyer to formulate questions that will educate thecourt convincingly about such weaknesses.

It is often true that effective rebuttal of an opposing expert's testimony contributes more toward winning a case than your own expert's direct testimony. Having your expert hear the opposing expert and provide rebuttal testimony can be crucial in getting a fair outcome for your client. I have seen far too many valuation cases where one side's weak, or even clearly erroneous, testimony carried the day because it was allowed to stand without challenge.

Sometimes, if the case is large enough, you may want to have a rebuttal expert separate from your direct testimony expert. This provides several advantages. For one, it lessens the possibility that the court may feel a taint of bias on the part of your direct expert because of his criticism of the opponent's expert's work. Secondly, your rebuttal expert may have extra credibility with the court by "out credentialling" the opposing expert. Also, the rebuttal expert may lend extra support to the methodology employed by your direct testimony expert.

An ESOP Appraisal Checklist

What should the trustee of an Employee Stock Ownership Plan (ESOP) generally look for in an appraisal of the fair market value of the sponsor company stock? Although the ESOP trustee is ultimately responsible for the accuracy of the report as well as its conclusions, the independent appraisal should meet the following checklist (based on ASA guidance) to ensure the report's compliance. The ESOP appraisal should:

- State the effective valuation date and report preparation date.
- Clearly state the purpose of the valuation.
- Cite Revenue Ruling 59-60 factors for guidance.
- Reference Section 3(18) of ERISA regarding fair market value and adequate consideration.
- Outline stock ownership characteristics, such as degree of ownership control and marketability.
- Reference basic sponsor company information, such as its history, a description of products and services, market and competitive situations, management depth and succession issues, capital structure, and ownership distribution.
- Analyze the economy and industry outlook, as it pertains to the sponsor company.
- List all the sources of information used by the appraiser.
- Include the sponsor company's financial statements (balance sheet, income and cash flow statements, comparative financial ratio analysis, etc.), as well as the relevant time periods and the accountant's level of assurance (i.e., compiled versus reviewed versus audited).
- Compare the sponsor company's financial information to itself, to identify timeline trends.
- Use the generally accepted business valuation approaches (income, market, asset-based), with sufficient supporting detail.
- Clearly state the valuation conclusion, including a sufficient weighting of each valuation method used.

In addition, the Trustee should make sure to check off the following questions regarding any ESOP appraisal:

- If the guideline company method is used, are the selection criteria for the comparables appropriate and the population from which they are drawn clearly specified?
- If a marketability discount is used, are sufficient data provided in support?
- If a lack of control discount is used, is it applied only to valuation methods that conclude a controlling ownership interest level of value, and are sufficient data provided in support?
- If an ownership premium is used, is it applied only to valuation methods that conclude a non-controlling ownership interest level of value, and are sufficient data provided in support?

When 'Fair Value' is Not The Standard of Value in State Shareholder Disputes

Kim v. The Grover C. Coors Trust, 2007 Colo. App. LEXIS 394 (March 8, 2007)

This Colorado Court of Appeals case is a good reminder that the standard of value should be among the first points of discussion between analysts and attorneys in any litigation involving shareholder disputes.

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Shareholder alleges unfair transaction

In 1999 to 2000, a packaging company owed $525 million for a prior acquisition. It intended to fund the short-term debt by selling a paperboard mill—but when that deal fell through, the company needed a quick infusion of cash. It decided to sell 1 million shares of convertible preferred stock for $100 million to a trust for which at least two of the company's directors served as trustees.

The company formed a special committee of independent directors to evaluate the transaction. The committee obtained a fairness opinion from an investment bank, indicating that the stock sale was financially fair; after several meetings, it approved the sale. A minority shareholder sued the directors, among others, for breach of fiduciary duty in approving and executing the allegedly unfair transaction.

Fairness has a broad, fact-based definition

The shareholder claimed that by "sitting on both sides of the transaction," the company's directors had manipulated it sufficiently to dilute the value and voting rights of the minority shareholders. According to local law and statute (Colorado's version of the Model Business Corporation Act (MBCA)), the directors needed to prove the fairness of the transaction. And because the Colorado statute so closely resembles the original MBCA (as in many states), the Court looked to the Act's official comments for further definition of "fair," finding that these comments gave the term a "special, flexible meaning and wide embrace."

As many state courts have also concluded, the Colorado court found that the fairness of the transaction turned on its facts and circumstances; in particular, whether there had been earmarks of an arms'-length transaction, including the company receiving "full value." The plaintiff/shareholder urged the adoption of Delaware's "entire fairness" test, which focuses on process and price, but the Court found no "functional difference" between that test and the approach under local law, which requires reviewing the transaction "as a whole."

Best price at best value includes discounts

Applying this standard, the Court found that the shareholder had failed to provide evidence that a better price was available. By contrast, the company presented testimony that there was no public market for the convertible preferred stock and no third-party buyer; even if there were, the purchaser wouldn't have offered better terms. Likewise, the shareholder lost the arguments that the transaction lacked sufficient disclosure, independence, good faith, or price concessions.

As to the fairness of the transaction's value, the shareholder claimed that the company's expert incorrectly applied a discount, citing a Colorado case that excluded minority discounts in "dissenters' rights actions" in all but extraordinary circumstances, because the MBCA's "fair value" provisions precluded the application of marketability or minority discounts.

"However, this case is not a dissenters' rights action," the Court said. "It involves the question of whether a transaction was fair, not the 'fair value' of dissenters' shares." It was therefore proper to discount the stock value by 15% to 20% for lack of marketability, which made the $100 million sale price fair.

Is Failure to Apply DLOM A Breach of ESOPTrustee's Fiduciary Duty?

Armstrong v. LaSalle Bank Nat'l Ass'n, 2006 U.S. App. LEXIS 11077 (May 4, 2006)

A critical point in the administration of an ESOP for a privately held company is establishing the price at which departing employees may redeem their shares. If the price is set too low, employees may feel short-changed; if the price is set too high, many employees may leave, threatening the company's solvency. Adding to the difficulty is the lack of a market for closely held stock. One way for ESOP trustees to comply with their fiduciary obligations is to retain an independent appraiser to assist with pricing the shares.

Post-acquisition redemption sets record

Employees for railroad manufacturer Amsted Industries traditionally received company stock from the date of their hiring until the date of their departure, at which they could redeem all their shares for cash. The ESOP plan reset the price of company stock every September 30; employees had until the following June 30 to redeem their shares at that value.

In mid-1999, the company obtained $1 billion in unsecured credit to purchase a trucking operation for $800 million, leaving a $200 million reserve. That September, an appraisal firm valued the company at $184 per share—nearly 32% higher than the prior year's valuation. The trustee accepted the valuation, perhaps expecting employee departures to fall within the historic range of 9% to 11% of employees annually. But the 2000 redemptions turned out to be 32% of the entire workforce in one year.

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Given the excessive demands on cash flow, the trustee amended the ESOP to permit deferred eligibility and redemption. A class of plaintiffs—comprised of employees who stayed on and did not redeem their stock—sued for breach of fiduciary duty, charging the trustee with an imprudent valuation for failing to apply a discount for lack of marketability (DLOM) to the redemptions of departing employees.

Prudence vs. panache

At trial, the federal district court granted the trustee a summary judgment, applying the due deference standard (the same granted to adjudicators) and finding that the trustee had acted within its discretion by accepting the valuation without a DLOM. The company's history of redeeming employees' stock in full and for cash, as though sold on the open market, supported the finding.

On appeal, the Seventh Circuit confirmed the standard of review. Unlike entrepreneurs, in whom prudence may be less desirable than "panache," trustees are supposed to be careful, especially in their fine balancing act of competing interests. "We must not seat ESOP trustees on a razor's edge," the Court said, and their decisions merit due deference.

"But a discretionary judgment cannot be upheld when discretion has not been exercised." Although the pre-trial record was incomplete (it lacked a description of the valuation method the appraisers used, for example), it also revealed no "indication that [the trustee] considered how best to balance the interests of the various participants in the ESOP in the novel circumstances created by [the company's] acquisition," including the latter's effects on the risks borne by ESOP participants.

Instead, the trustee had acted "as though nothing had changed." The case required remand to consider whether the trustee—while exercising its discretion—had possibly abused it. One way to determine the issue (but not the only way, the Court was careful to point out) would be to review whether, under the circumstances, the trustee acted unreasonably by failing to apply a marketability discount to the redemption price.

For treatment of this case and others that address trustee fiduciary duties in the context of ESOP valuations, see Shannon Pratt and Noah Gordon, "Trustee and Appraiser Duties in ESOP Valuations—Recent Judicial Decisions," ESOP Report Magazine*, June/July 2007, pp. 65-67.*

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