

# GOING PRIVATE: CONCERNS AND ISSUES FOR THE VALUATION EXPERT

BY LAYNE H. KOTTMEIER, CPA AND EDWARD B. CORDES, CPA/ABU, CVA, CFE

*"Dissenters toast Quiznos in suit - Judge values shares at \$32.50; firm paid \$8.50 in privatization."<sup>1</sup>*

*"A pension plan representing Pennsylvania iron workers is suing Toys "R" Us to block the \$6.6 billion sale of the Wayne-based company to a trio of investors. The suit charges that the \$26.75-per-share offer for Toys "R" Us is 'grossly inadequate and unfair'.<sup>2</sup>*

News stories such as these are frequently encountered in the business press.

They serve as illustration that the valuation expert, who is involved in the appraisal of a public company being taken private, is entering a practice arena where the potential for litigation is high.

To those not schooled in the area of business valuation (i.e., most lawyers, judges and juries), it may be difficult to comprehend why there should be any controversy over the value of a publicly traded company. Given that the fair value of the company in these circumstances is often greater than its publicly traded market value, the valuator must be able to clearly articulate to the lay person why this may be the case.

The down market of the early 2000's saw an increase in the number of companies going private as a result of languishing stock values. With recent market upswings, the number of going private transactions has decreased, but there remain many persuasive reasons for small to mid cap companies to go private. The administrative costs and burdens of Sarbanes-Oxley compliance

have been recent and frequently-cited reasons for some companies to quit the public markets.

The valuator must understand and be able to explain the two main reasons why the stock of a publicly traded company may be worth more than its trading price. These reasons are (1) the inherent nature and characteristics of such companies and (2) the applicable standard of value in shareholder derivative actions.

Very often, companies that are likely to go private are in mature or out-of-favor industries, have little or no following by Wall Street analysts, and have limited trading volume. As a result, their stock values have been historically depressed, with little or no momentum. Management typically believes that the company has a better future as a private company and that operating results will improve post-privatization. If management's post-privatization projections reflect operating results that are better than the market projects them to be, a valuation using a discounted future returns methodology will reflect a value greater than the company's public "market" value.

The applicable standard of value in a shareholder derivative action is "fair value" as defined by individual state statute. It is critical that the valuator know and understand the relevant state statute. Many states have adopted the Uniform Business Corporation Act which defines "fair value" with respect to a dissenter's shares as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appre-

ciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable".<sup>3</sup>

The intent of the "fair value" statutes is generally to apply a "but for" analysis, i.e. what would the dissenting shareholder's proportionate share of the entity have been worth had it not been for the actions of management and/or the buy-out group.

The valuation analyst may find that the company's public market price is depressed because management has been working on its own behalf, rather than on behalf of the shareholders, in anticipation of taking the company private. The fair value standard attempts to provide dissenting shareholders with a value that represents their proportionate interest in the going concern as the dissenting shareholders are not "willing sellers" in the going private transaction. Thus, in many jurisdictions, discounts for lack of control and lack of marketability are not typically applied. In the often-cited Delaware case *Cavalier Oil Corp. v. Harnett*, the Court opined that

"...to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result".<sup>4</sup>

Similarly, the Colorado Court of Appeals held in *Pueblo Bancorporation v. Lindoe* that

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"...in determining the 'fair value' of a dissenter's shares in a closely held corporation, the trial court must first determine the value of the corporation and the pro rata value of each outstanding share of common or equity participating stock. In the case of a going concern, no minority discount is to be applied; and, except under 'extraordinary circumstances,' no marketability discount is to be applied".<sup>5</sup>

Although in many states discounts for lack of control and marketability are not applied in a fair value context, the valuation analyst is advised to carefully check state statutes and court cases in the applicable jurisdiction. Some states have allowed marketability discounts<sup>6</sup> and others have left discounts to the court's discretion depending on the facts and circumstances of the particular case.

Given that management is often part of the buy-out group in a privatization action, conflicts of interest are inherent in the process. There will be a significant degree of regulatory scrutiny by the SEC and state authorities, as well as the potential for shareholder lawsuits. To address these areas of concern, the company's Board will typically create an independent special committee. The committee is tasked with evaluating the fairness of the proposal, engaging the necessary legal and financial advisors, and supervising the SEC filing process.

In this context the valuation expert will want to scrutinize the backgrounds of the special committee members to ensure that they are independent from management in both appearance and fact. The dissenting shareholders' expert will want to evaluate the committee's expert in terms of his relationship to management and potential motivation in the

process. Should the matter go to trial, the company is better served by hiring an expert other than the committee's original expert. The testimony of the committee's original expert may be discounted by the court because of the potential liability the expert faces should his value conclusion be proven faulty.

Other considerations that the valuator should make when determining the fair value of a company going private include

- The valuator must understand and critically evaluate management's post-privatization operating plan and related assumptions. The SEC filings in the matter will include forward-looking projections which must be reviewed and analyzed with a degree of professional skepticism as to management's motivations. The valuator cannot simply take these projections at face value.
- The purchaser's financing or post-privatization capital structure is not relevant to the value conclusion. The company's cost of capital must be determined prior to any recapitalization.
- Valuation assumptions regarding future management of the company should include the broad market of potential management professionals, not just the current management team.
- Valuation assumptions regarding potential buyers should include all manner of potential purchasers, not only the current buy-out group. Companies going through the privatization process are "in play" and other buyers may come along and up the ante in the process.

In conclusion, if you, as a valuation expert, find yourself involved in

any aspect of valuing a company that is being taken private, be prepared for tough scrutiny of your work from all interested parties. Also know that the probability of winding up in court and on the witness stand is high. Your case just might make the headlines.

*Ms. Kottmeier is a consultant with Cordes & Company specializing in the areas of business valuation and damage measurement in civil and bankruptcy litigation. Formerly a founding partner of Laughlin & Company CPA's in Raleigh, North Carolina, she has 25 years of experience in both public accounting and senior financial management positions in industry. Ms. Kottmeier may be contacted at [lkottmeier@cordesco.com](mailto:lkottmeier@cordesco.com) or 303-796-1112.*

*Mr. Cordes is the founder of Cordes & Company in Denver Colorado, which specializes in business valuation, forensic accounting, litigation support and bankruptcy and receivership work. He has over twenty-five years of experience, with 20 years of specialization in the area of litigation support and business valuation and substantial expert witness testimony experience. Mr. Cordes lectures several days per year on various valuation and litigation topics. He can be reached at [ed@cordesco.com](mailto:ed@cordesco.com) or 303-796-1108*

1 David Milstead; "Rocky Mountain News"; January 10, 2004.

2 Joan Verdon; "The Record" (Bergen County, NJ); March 29, 2005.

3 Trugman, Gary R., "Understanding Business Valuation", 2nd Edition, p. 625.

4 *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989).

5 *Pueblo Bancorporation v. Lindoe, Inc.*, 37 P.3d 492 (Colo.App. 08/16/2001).

6 In *Emanuel Balsamides, et al. v. Protameen Chemicals, Inc., et al.*, the New Jersey Supreme Court upheld a lack of marketability discount at the entity level of 35%. For the full text of the decision, go to <http://lawlibraryrutgers.edu/courts/supreme/a-27-98.opn.html>