

Chancery Sheds Light On Finality Of Appraiser Valuation

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Matthew V. Soran



Brian T. Mangino



Aviva F. Diamant

In *PECO v. Walnut* (Dec. 30, 2015), the Delaware Court of Chancery refused to review a valuation firm’s determination of the value of a limited liability company’s preferred units when the LLC agreement provided that the value as determined by an independent valuation firm would be binding on the parties. While *PECO* related to the valuation of LLC units in connection with the exercise of a put right, the decision presumably would apply more broadly — including to post-closing adjustments and other valuations.

Background

As part of the acquisition of PECO Logistics LLC (the “company”), Walnut Investment Partners LP and Walnut Private Equity Fund LP (the “Walnut investors”) acquired, and the pre-acquisition stockholders of the company’s operating subsidiary rolled over their shares into, preferred units of the company. As a result, the Walnut investors and the pre-acquisition stockholders (together, the “investors”) became parties to the company’s LLC agreement and thereby obtained the right to put their units to the company during a window period commencing three years later.

On exercise of the put, the company was obligated to acquire the units at their “fair market value” — as determined by an independent, nationally recognized valuation firm selected by the company, applying a formula set forth in the LLC agreement. The agreement explicitly provided: “[The parties] shall be bound by the determination of the Valuation Firm” In their notice of exercise of the put, the investors purported to reserve the right to participate in the valuation process and to make their exercise of the put subject to their being satisfied with the valuation firm’s determination of fair market value — although the agreement did not provide for these rights. The company’s board selected Duff & Phelps (D&P) to perform the valuation. The Walnut investors disagreed with decisions made by D&P in applying the valuation formula and then refused to proceed to effect their exercise of the put.

The company sought declaratory relief that it had complied with the agreement and that the put had been exercised. The court held that because the LLC agreement explicitly provided that the valuation firm's determination would be binding, the court would not review D&P's judgments and the put would be effected at the value determined by D&P.

Key Points

Finality of Valuation Firm's Determination. A court will generally give effect to explicit agreement provisions stating that a valuation firm's determination of value will be binding — at least where:

- the firm is independent, and its independence was not tainted by influence from a party to the agreement; and
- the firm's judgments are regarded by the court as having been reasonable (even if not necessarily the most reasonable of the judgments that could have been made).

In PECO, the court stated that since the parties had chosen a regime in which the appraiser's valuation would be final, "the Court [would] not take mere allegations of ambiguity about the valuation methodology as an invitation to circumvent the structure of the deal to substitute its own judgment for that of the valuation firm." The decision presumably would apply broadly to various types of valuations required by agreement, including post-closing adjustments.

Nonconditionality of Exercise of Put Right. A court is not likely to regard as effective a put holder's imposing conditions on the exercise of the put (such as the holder's satisfaction with the valuation of the security) where the agreement granting the put does not provide for conditions. The issue can be avoided by the parties explicitly providing in the agreement that exercise of the put will not be subject to conditions and will be irrevocable; or, alternatively, by explicitly providing what conditions can be invoked by the party exercising the put.

Importance of Factual Context. As usual, the factual context may be critical. In PECO, the factors that appeared to have most influenced the court included:

- *Independence.* There were no allegations that D&P was not independent (indeed, a representative of the investors, who was a director of the company, had participated in and assented to the selection of D&P); and there were no allegations that the company had acted to influence D&P's process or decisions.
- *Reasonableness.* D&P's judgments in applying the valuation formula set forth in the agreement were acknowledged even by the investors to have been reasonable (although, in their view, not as reasonable as other judgments would have been).

Practice Points

Finality of a valuation firm's determination helps to avoid disputes. Providing for a valuation to be conducted by an independent valuation firm, and for that determination to be final and binding, helps

to avoid disputes with respect to the valuation. A party may wish to consider a process that provides for more input or review when what is being valued is not susceptible to a formulaic approach (e.g., when a unique or unusual industry or type of company or security, or other unusual facts or circumstances, are involved) or when the agreement provides for a valuation methodology that is more uncertain (such as an approach based on discounted cash flow as opposed to a multiple of earnings before interest, taxes, depreciation and amortization, or EBITDA).

All conditions and rights with respect to a valuation should be explicitly set forth in the agreement. A court will not generally give effect to conditions to the exercise of a put imposed by the put holder, unless the put holder's right to so condition the exercise is set forth in the underlying agreement. PECO suggests that, depending on the facts and circumstances, even a right to be informed about or to review a valuation firm's work may not result in a right to challenge the firm's determination of value if the agreement provides that the firm's determination will be final and binding. A company, if it receives a put exercise notice that includes conditions that are not provided for in the underlying agreement (or includes other terms that do not track the agreement) should consider rejecting the put exercise as ineffective. The issues in PECO would have been avoided had the agreement been explicit that the investors could not invoke conditions to the exercise of the put and that exercise of the put would be irrevocable. A put holder should seek to include in the underlying agreement the rights (if any) that will apply to the put (including, for example, knowing the valuation before having to decide whether to exercise the put).

Agreement provisions when a valuation firm is to be utilized and its determination will be binding.

When an agreement provides that value will be determined by a valuation firm and that the firm's valuation will be final and binding on the parties, the parties should explicitly and clearly set forth the following in the agreement:

1. Selection of the valuation firm:

- who may participate in, or consent to, the selection of the firm;
- any required qualifications for the firm (such as independence, national recognition, and experience in a certain industry or type of valuation); and
- who will pay the costs of the valuation firm.

2. Whether (and, if so, to what extent) the parties may participate in the valuation firm's process;

3. The formula or parameters for the firm's valuation — including, if deemed advisable in an effort to avoid disputes later:

- what valuation date should be utilized (we note that even a small difference in timing often can result in a significant difference in the determined value);
- whether it is the put holder's securities that are being valued or the put holder's pro rata interest in the enterprise (as, in the event of the former, a minority discount could be applicable; and, in the event of the latter, a control premium could be applicable);

- what economic metric should be utilized as the basis of the valuation formula (e.g., distributable cash flow, EBITDA, etc. — as appropriate, based on the facts and circumstances and taking into account possible changes over time, including what adjustments should be made (e.g., a collar on EBITDA, assumed payment of debt and other obligations, etc.); and, if a DCF analysis is used, what discount rate and terminal value methodology should be used; and
- examples that help to illustrate how the formula, or parts of it, are to be applied — which can prevent mistakes in the formula, such as the one in PECO, where the agreement erroneously provided for the EBITDA collar to be applied to the company (a holding company) rather than its operating subsidiary (although the court ruled that D&P’s decision to apply the collar to the operating subsidiary was reasonable to avoid the “nonsensical” result of a zero valuation if the collar were applied to the holding company).

Dispute resolution mechanisms if the agreement does not provide for a single appraiser whose determination will be binding. When an agreement does not provide for a single valuation firm to make a determination that will be final and binding, alternatives that could be considered include:

- both parties appointing an appraiser and the valuation being the midpoint of the difference between the competing valuations so long as the gap is within a specified percentage range; or
- if the gap is greater than the specified percentage range, the two appraisers selecting a third appraiser that would conduct a valuation; or
- if the gap is greater than the specified percentage range, the two appraisers selecting a third appraiser that would choose between the two competing valuations (this “baseball arbitration” formulation tends to encourage the parties’ appraisers not to take extreme positions in their initial valuations).

A company should seek to ensure that its course of conduct during a valuation process will neither (i) “taint” an independent valuation firm’s process nor (ii) be deemed a modification of the put agreement terms. In PECO, in determining to defer to D&P’s result, and in concluding that D&P’s judgments made in applying the agreed valuation formula were reasonable, the court emphasized that D&P was an independent third party and had made its judgments without influence from the company. A company should seek to ensure that its course of conduct during a valuation process will not be regarded as tainting the independence of the valuation firm. In addition, a company should include in the agreement boilerplate language disclaiming modification of the agreement other than as set forth in a writing signed by both parties, and, if the company accords any rights that were not provided for in the agreement, should consider documenting (through a supplemental agreement with the counterparty) that those rights will not otherwise be considered to modify the agreement. (In PECO, the court held that the company permitting the investors to participate in the selection of the valuation firm even though they did not have the right to do so under the LLC agreement, and the company hiring the valuation firm after receiving the put notice that purported to reserve to the investors a right not to proceed if they disagreed with the valuation, did not constitute a course of conduct that modified the LLC agreement so as to permit the investors to continue to participate in, review or challenge the valuation process or determination.)

Company's incurrence of significant amount of debt just prior to valuation date. In PECO, the investors challenged the company having “piled on” debt in the 11 months immediately preceding the exercisability of the investors’ put as a breach of the implied covenant of good faith and fair dealing. The court rejected the challenge, noting that there were no facts pled indicating that a legitimate business purpose was not served by the incurrence of the debt; that the incurrence of debt was part of the known business plan; that the put holders had received unaudited financials indicating the level of debt before they exercised the put; and that it was D&P, rather than the company, that selected the valuation date that resulted in the debt being included in the valuation.

—By Aviva F. Diamant, Christopher Ewan, Brian T. Mangino, David L. Shaw, Matthew V. Soran, Gail Weinstein, Fried Frank Harris Shriver & Jacobson LLP

Aviva Diamant, Christopher Ewan, David Shaw and Matthew Soran are partners in Fried Frank's New York office. Brian Mangino is a partner in the firm's Washington, D.C., office. Gail Weinstein is a senior counsel in the New York office.

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