Business Valuation Insights

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Five Reasons You Failed to Sell Your Company – and Five Fixes for Next Time

By: Max McKiernan, Analyst

Many business owners have experienced the agony of pouring immense amounts of time and effort into trying to sell their company … and then failing to close the deal. Not all companies are equally attractive and marketable, but many failed transactions could have been prevented with proactive planning, the right mindset, and experienced counsel. Here are five reasons we see M&A deals fall apart – and how to avoid them.

1. Lack of Organization

Transactions often fail because of *disorganized or inadequate succession planning*. While this value detractor may not shine through in the company's recent financial performance, lack of management continuity post-transaction and other (real or perceived) characteristics that could complicate transferring the business' success to new owners will spook buyers.

Deals also fall apart when the *sale process* lacks structure and organization. For example, we frequently see sellers serially enter discussions with a single buyer group against our advice. Sellers forfeit competitiveness in single-party negotiations, and competition forces buyers to either put their best foot forward or risk missing out on the opportunity. Plus, foregoing a formal process to pursue a one-off negotiation at the outset of the sale process usually involves a buyer that has limited familiarity with the company, has not been thoroughly vetted, and has little invested in the deal. That makes it easy for them to walk away – and they often do.

How to position for a smooth sale: Prepare your business for sale early by identifying and delegating key responsibilities to successor managers to minimize the business's dependence on you. Then, run a competitive marketing process when the time is right to sell. With multiple prospective buyers held to the same timeline, sellers keep options open for as long as possible, maintain that important competitive element, and will be significantly more likely to maximize proceeds from a sale.

2. Unrealistic Expectations

Transactions fail when the results of the process fail to meet the sellers' value expectations. Sketchy valuation analysis and failure to have transparent discussion about a company's expected market value before pursuing a sale can lead to disappointing results for buyers, sellers, and advisors alike.

Some sellers also underestimate how long a sale process takes and what it entails, and they may be unaware of the level of confidential information they will be required to disclose at each stage. Further, unprepared sellers may become frustrated with the amount of time and effort transactions consume. When sellers are, for one reason or another, hesitant or unwilling to share important information with buyers – or even their advisors – the process can grind to a painful halt.

How to ensure your expectations for process and value are reasonably achievable: Put the work in on the front end, and consult an experienced advisor to ensure your needs and expectations can be realistically met. If a sale process today is unlikely to meet your needs, discover and implement the necessary changes to your business to get it on the right path. Also, know going in that every acquisition involves comprehensive due diligence and a deep scrub of the company's history and operations from every imaginable angle. Learn early on what information will need to be shared and at what time, and consider aggregating that data early in the sale process to alleviate tomorrow's stress.

3. **Distractions**

Distractions can derail transactions. The sale process is time consuming and labor intensive, and often the business owner is the only person within a company capable of answering certain questions or aggregating sensitive information. Too frequently, we see business owners become preoccupied with the sale process, personally take on too many tasks, and lose focus on running the company. When the financial performance slips, prospective buyers will almost always demand a price adjustment, or even walk away from the deal altogether.

How to mitigate costly distractions: Hire competent advisors that will relieve you of time-consuming tasks and preliminary conversations, helping you focus on running your company effectively during the multi-month sale process. This is the most important time for your business to perform, and experienced consultants will limit unnecessary distractions and allow you to prioritize the company's performance at a critical juncture.

4. **Late Surprises**

Deals fall apart when sellers fail to disclose significant issues until late in the game. A few examples include being out of compliance with certain laws or regulations, past legal or environmental violations, or any other material misrepresentations or omissions. Buyers are justified in walking away in these scenarios.

From the other side of the table, many unfortunate sellers have received the unwelcome news that their buyer is experiencing financing issues – that is, their buyer doesn't have the money to pay. It goes without saying these deals don't get done.

How to avoid unwelcome surprises: Have the difficult conversations early, and be forthcoming with any "skeletons in the closet." While these conversations may be difficult, trust between buyer and seller is critical to any deal. Rely on your counsel for best practices when it comes to when and how to share those details.

Be thorough in vetting prospective buyers, and verify sources of financing before committing to any one group. Experienced advisors in your market will already be familiar with both the good and bad buyers, or will at least have a trained nose for sniffing out the bad ones.

5. **Emotions**

Strong emotions, particularly late in negotiations, rarely help any sale process. Buyers fear the "winner's curse," meaning they dread poor returns and worry they were selected as the winning bidder because they're overpaying. Meanwhile, sellers often have legacy concerns and deep emotional ties to their company, particularly the owners of a private family businesses that are prevalent in the lower-middle market, making them highly susceptible to second-guessing the deal.

These emotions pull buyers and sellers in opposite directions and have caused many promising transactions to flounder. Because the sale process spans multiple months, there's plenty of time for these concerns to surface, and multiple opportunities for both sides to reconsider the deal.

How to keep emotions from blowing up a fair deal: Carefully consider all your options before deciding to sell, and be certain you present yourself as a ready and willing seller at the outset. Select and consult advisors early, and put the work in on the front end to ensure your valuation and process expectations can be achieved. Rely on trusted counsel for guidance in contentious negotiations, and recall your motivations to sell in the first place. All deals pose unique challenges, but they can be overcome with rational minds and the right sense of purpose.

The M&A world is a tricky business, and there are many other reasons why deals fall apart in addition to the five deal busters we discussed today. But with a little planning before you go to market, you can control what's under your control, and will position yourself optimally for a successful result.

Getting it Right: Top Ten Hallmarks of a Credible Business Valuation

By: James A. Gravitt, CPA, CBA, ABV, CFE

Credible business valuations (or business appraisals – the terms are used interchangeably) aren't an accident – they are the result of a sound product (the components of the appraisal) and process (how the appraisal is done). The items discussed below offer some food for thought to those who rely on business valuations for making key business and personal decisions.

1. TRAINING AND EDUCATION

Credible business valuations begin with specialized training and education. While it's true that anyone CAN do a business valuation (that is, no licensing or credentialing is required), there's a right way (and many wrong ways) to value businesses and business elements, like intangible assets. Initial training and continuing education in business valuation are critical, and even those who hold valuable credentials like the CPA (Certified Public Accountant) and CFA (Chartered Financial Analyst) lack this training. There are currently several separate tracks for this specialized education – through the AICPA (American Institute of Certified Public Accountants), the ASA (American Society of Appraisers) and NACVA (National Association of Certified Valuation Analysts).

Many different business appraisal credentials are available, but only two – the ASA and the CBA (Certified Business Appraiser, offered by the Institute of Business Appraisers) require candidates to submit demonstration reports for peer review. These demonstration reports provide evidence that appraisers can apply what they have learned. The many valuation initials offered by different organizations may seem like "alphabet soup" to the consumer, but there is value in obtaining a credential that is difficult to obtain. As in any technical field, it is important to stay current by obtaining continuing education as the profession continues to advance.

2. Access (to management) and non-financial information

Business appraisal is about more than "number crunching" - in fact, IRS Revenue Ruling 59-60 lists eight different factors to consider. As the Revenue Ruling states, "The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business." Having a good understanding of the nature and history of the subject business and its strengths, weakness, threats, and opportunities is vital. Management lives with these daily, and its perspective is valuable. While access to management is important to the appraisal, company management may not fully understand this and may limit the access due to the time commitment involved (although it may be possible to work around any limitations). Valuations done in the context of disputed matters may face limitations imposed by the dispute process. In these situations, less robust valuation services can still be provided in the form of a "calculation analysis" (a term used by the AICPA). A calculation analysis is not a business valuation, however. Detailing how it varies from a valuation is beyond the scope of this article.

3. Risk assessment

A credible business appraisal needs to assess the riskiness of the business and thus the likelihood of its future returns. Risk assessment begins with an analysis of company-specific factors, both financial and operational. Risk assessment also entails not only a discussion of pertinent economic and industry trends, but the implications of them for the subject company. It is reasonable to expect an appraisal to set out the most important risk factors for the subject company and to conclude as to the overall risk an investment in the company would entail.

4. Reasonable financial projections

A key part of many valuations is a projection of future net income and net cash flows under the "income approach" to valuation. Projections may look very precise yet be internally inconsistent with the company's financial history and reasonable expectations. A credible forecast will contain detail about sales and expenses, and will be feasible in terms of debt acquisition/retirement and capital spending. Balance sheet cash flow requirements are sometimes ignored, and sufficient working capital is a missing component of projections that stop at EBITDA (earnings before interest, taxes, depreciation, and amortization) as the measure of cash flow. Credible financial projections will not include unreasonable long-term growth expectations that, if fulfilled, would have the company grow faster than the U.S. economy into perpetuity.

5. Strong connection to the market (the real world)

A critical step in valuing a business is to step back from the trees (the detailed calculations) and ask this question: "Would someone buy/sell this business in the market at this price (the determined value)?". This step is accomplished by reaching out to a business intermediary (such as an investment banker) who is active in transactions of businesses like the subject business. Markets are dynamic, and valuation multiples fluctuate over time due to factors like supply and demand, access to credit, the overall economy and industry specific factors. Business valuations can't be accurate (except by accident) without a strong link to the actual market for the business that's being appraised.

6. Knowing the appraiser's limitations

Clint Eastwood (as Dirty Harry) once said, "A man's got to know his limitations." While valuation education courses include research techniques, business appraisers may be tempted to span areas beyond their expertise. A separate industry expert may be needed for some assignments – for example, involving medical coding in valuing a health care concern, or assessing technology when valuing a start-up. In valuation, as in most professional disciplines, it is not possible to be an expert in everything. This also includes subsets of business appraisal, such as appraising intangible assets or valuations for divorce or recording the fair value of business acquisitions.

7. **Internal procedures for completion and review**

The valuation process consists of engagement definition, information gathering, analysis, and reporting results. At each step it is important to follow established procedures. Engagement acceptance procedures are meant to ensure a good "fit" of the engagement to the firm's capabilities. Process procedures are meant to ensure correctness and completeness. One of the most important procedures is review. This includes both checking for small, seemingly "inconsequential" errors (that can add up to be "big, consequential" errors), and errors of theory, judgment, and application. Because business appraisal involves the exercise of "informed judgment," it is always useful to include a procedure for peer review, – that is, having a second experienced appraiser critique the principal appraiser's work for overall reasonableness.

8. **Follow professional standards**

Consumers of valuation reports should know that (as noted above) anyone can purport to value a business, as there are no licensing requirements to qualify someone to value a business. Ultimately (especially in litigation settings), the credibility of a business appraisal can turn on the appraiser's qualifications and experience. Following a set of professional standards, however, enhances the appraiser's credibility and aids in the thought process, serving as a roadmap for getting to a reasonable result.

9. Learn from others' mistakes – professional curiosity

One of the best ways to learn how to do business valuations correctly is to see what others are doing wrong. Practitioners and the courts are constantly refining business valuation practices, and even valuation theory evolves as the profession advances. An appraiser who studies the reports of others to understand their strengths and weaknesses will learn by challenging themselves to think through the reasoning process of other appraisers.

10. Practice, practice, practice

Like anything else, valuation skills are improved by repetition. It generally makes sense to work with full-time practitioners, rather than someone who does a business valuation only occasionally outside of their regular "gig," be it tax preparation, auditing, or general consulting. The analogy here is to medicine: Who is best to perform your heart surgery? A specialist who does many procedures a year, or a general practitioner who has read the books on heart surgery and practiced once on a cadaver during her residency? The answer is obvious but bears reminding.

Conclusion

A credible business valuation results from a sound product and process – it stems from a commitment to doing things the right way. The above discussion of "ingredients" may provide useful guidance for business owners and their advisors who are seeking valuation services.

Note This Well: There's More to Valuing Promissory Notes Than You Might Think

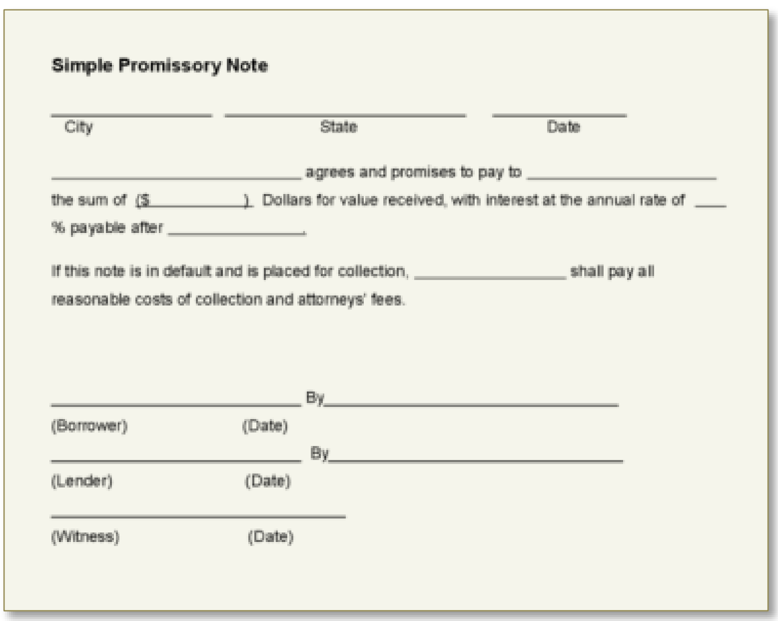
By: Nicholas J. Ahlers, Investment Banking Intern

Valuing a promissory note can be surprisingly complex. Business appraisers are sometimes asked to determine the value of a promissory note for estate or tax planning purposes. Note valuations may also be vital in business litigation and divorce disputes.

Below, we'll consider what a promissory note is, address valuation issues, and discuss the underlying risk factors used to approximate the required rate of return. We'll also analyze a promissory note whose interest rate is less than the market interest rate.

Promissory Note: Definition and Example

A *promissory note* is a contractual promise to pay a certain amount of money on demand at a specified time. (A very simple promissory note appears below.)


Simple Promissory Note

__________ City __________ State __________ Date

__________ agrees and promises to pay to __________ the sum of ($__________) Dollars for value received, with interest at the annual rate of ____ % payable after __________.

If this note is in default and is placed for collection, __________ shall pay all reasonable costs of collection and attorneys' fees.

__________ By__________
(Borrower) (Date)

__________ By__________
(Lender) (Date)

____
(Witness) (Date)

That seems trivial – but the process often is neither the same as nor as easy as calculating the value of a simple debt instrument, which is equal to the estimated value of future cash flows, discounted back to the present based on the debt instrument's underlying risk profile.

Note valuation typically starts with a thorough examination of the debtor's financial situation. If there is reason to believe the debtor will be able to repay the note in full within the stated period, the calculation should be simple – using market interest rate comparables as guides with corresponding adjustments, and then approximating the required rate of return by using the discounted-net-cash-flows approach.

By contrast, if the debtor's ability to repay the full amount is doubtful, then the value of the note is equal to the expected proceeds to be received through a liquidation or default of the debtor. This case creates more complexity, as the appraiser must now attempt to project the term in which the debtor will be able to pay in full. But promissory notes can also normally be endorsed and transferred to another party, depending on the contract provisions. This possibility adds uncertainty, because not only would the appraiser have to consider the financial condition of the debtor, but he or she would also have to consider the financial condition of the potential note transferee.

Other issues may arise. For example, in many instances, a promissory note may be collateralized by an asset that is difficult to value, and there generally isn't a marketplace of private notes readily accessible to the public. Furthermore, promissory notes are sometimes issued with contract terms that are uncommon in the marketplace, complicating the search for appropriate comparable notes.

The appraiser should also keep in mind the relationship between the required rate of return and the value of the collateral. Intuitively, the higher the quality of collateral, the lower the required rate of return will be. Factors that influence the value of the collateral include the ratio of debt to equity, the lien position, and liquidity.

Accompanying Risk Factors under Consideration

When employing discounted-net-cash-flow analysis to value the note, the required rate of return must be constructed judiciously. Most appraisers will consider, at the very least, risk features such as the time value of money, the underlying risk profile in the investment, and the liquidity/marketability of the investment. Some of these factors were mentioned in more detail above; this section is meant to summarize the important aspects of obtaining the discount rate.

Time value of money is the proposition that money today will be worth less tomorrow. Since money can earn interest on debt and equity securities, the investor, depending on whether one is a lender or borrower, will receive (or lose) supplementary compensation in the form of interest payments in exchange for forgone time.

With respect to the underlying risk profile in the investment, the appropriate interest rate will take into account the risk-free rate, specific note risk, and market risk premium.

1. The risk-free rate can be described as the rate of return investors would expect to receive with zero risk on the investment such as the 20- or 30-year U.S. Treasury Bond yield as of the valuation date.

2. To formulate specific note risk, the appraiser should consider the following risk measures (and even more depending on the assignment): subordinated debt, note repayment risk, the debtor's financial condition, lack of marketability, lack of collateralized assets, presence or lack of protective covenants, and the interest rate and term of the note.
   - **Subordinated debt** – debt not secured by collateral; has a lower priority of repayment in the case of liquidation during bankruptcy
   - **Note default risk** – the debtor's ability to pay the note off under the terms of the agreement
   - **Debtor's financial condition** – the expectation that the debtor will be able to meet the financial obligation of the note
   - **Liquidity / Marketability** – the ability to sell the note in the marketplace
   - **Collateralized assets** – property or security attached to the note giving the debtor an incentive to repay the note
   - **Protective covenants** – written limitations or actions that a debtor may or may not take during the term of the note – for example, grant a personal guarantee or enter a written contract
   - **Interest rate** – refers to potential fluctuations in the market interest rate
   - **Note term** – the agreed period of time in the contractual provisions

3. The market risk premium will consider comparable companies with similar debt characteristics as the subject company. The appraiser may choose to bucket the guideline companies within specific "time to call" ranges, by the credit quality, etc. This will allow the appraiser to select yield-to-call buckets consistent with the subject's characteristics. An average of the yield-to-call buckets less the risk-free rate produces the risk premium.

Lastly, liquidity describes how quickly the note can be bought or sold in the marketplace, and is usually contingent on the type of contracts or lack of contracts linked to the note.

Impact of Revenue Ruling 67-276 on Valuation Methodologies

For 50 years, the Internal Revenue Service has relied on its Revenue Ruling 67-276, which states that, absent convincing proof to the contrary, a promissory note's value is assumed to be its unpaid principal plus accrued interest. According to the ruling, the appraiser can't rely solely on market data as indications of value. The appraiser will likely be asked to provide an indication of value using additional methods, such as a discounted net cash flow analysis.

A classic flaw in promissory note valuation is that notes can be overstated if the appraiser doesn't apply the proper market and note-specific discount rates when calculating the discounted cash flows. In some cases, the appraiser can provide substantial evidence that the fair market value of the note is much lower than the unpaid principal and accrued interest as of the valuation date. For example, if the market interest rate were to increase substantially from the time that the note was executed, the natural affect would be a decrease in the value of the note. The appraiser would then need to take this affect into account in the valuation. This scenario is set out below.

Assumptions

Stated Interest Rate	5.0%
Market Interest Rate	6.0%
Principal Balance	$ 50,000

Period	Payment Amount	Interest	Cumulative Interest	Principal	Principal Paid	PV Factor	PV of Payment
1	$ 14,101	$ 2,500	$ 2,500	$ 11,601	$ 11,601	0.94	$ 13,302
2	14,101	1,920	4,420	12,181	23,781	0.89	12,549
3	14,101	1,311	5,731	12,790	36,571	0.84	11,839
4	14,101	671	6,402	13,429	50,000	0.79	11,169
	$ 56,402		**$ 6,402**		**$ 50,000**		**$ 48,860**
							-2.3%

From the example, one can see that the borrower will be required to pay four equal payments of $14,101 over the period. The payments can be found by applying the formula:

$$P = \frac{r(PV)}{1-(1+r)^{-n}}$$

$$P = Payment$$
$$PV = Present\ Value$$
$$r = rate\ per\ period$$
$$n = number\ of\ periods$$

Next, the interest payments are computed by multiplying the stated interest rate by the beginning balance of each period (Period 1: $50,000*5.0%, Period 2: $38,388*5.0%,…), and the principal for each period is computed as the payment less the interest. The present value of each payment is computed using the market interest rate. As a result, the present value of all four payment periods summed equals $48,860, or a -2.3% discount of the original principal amount. Therefore, the borrower will be paying less back on the note in real terms, so the note is of less value to the lender.

Market Dynamics

Since the 2008–2009 financial crisis, investors and professionals alike have been wary of public policy and financial markets. Despite the uncertainty, the U.S. economy has experienced eight consecutive years of moderate but positive growth. Since 1945, expansions have averaged almost six years in length. This does not mean that a cyclical economic downturn is imminent. But downturns tend to increase systemic risk in the credit markets as borrowers get squeezed by higher interest rates; therefore, the borrower is less likely to pay back any remaining debt leftover on a note. In a scenario like this, adverse market conditions would allow for promissory notes to be valued for less than just simply the unpaid principal and accrued interest, because they are much riskier for lenders. During economic expansions such as the one in which the U.S. currently resides, the opposite is true. Default tends to be less of a risk.

N.B. (*Nota Bene*)

Promissory note valuation is influenced by many factors, including contractual obligations to either the lender or borrower that directly affect risk. There is not a “one size fits all” promissory note valuation model, but the guidelines set out above should provide some aid to consumers of valuation services in their quest for a well-defined and defensible conclusion of value.

Court Case Insights

Can some business assets be active and others be passive for purposes of business valuation for divorce? The following Florida case tackles this question.

Bair v. Bair, 2017 Fla. App. LEXIS 3737 (May 22, 2017)

In this dispute over marital property division, the business to be valued was the husband's minority interest in a boat dealership. The parties agreed that the husband's efforts had contributed to an increase in the company's value during the marriage. But they disagreed on just how much the company had appreciated in value, and how much of the appreciation was the result of the husband's marital labor versus passive appreciation (which is not a divisible marital asset).

The trial court adopted the company valuation the wife's expert proposed, which was about $1 million higher than the value determination of the husband's expert. Further, the court largely adopted the wife's expert's calculation of the marital component. The corporation owned real property whose value had dropped significantly during the relevant period. The wife's expert did not include the value of the real property in his company valuation, arguing that the change in value of this asset was passive in nature, a result of market forces rather than the husband's management. On appeal, the husband contested several of the trial court's findings.

The husband contended that excluding a major asset of the corporation from the valuation was a serious error of law that necessitated a reversal of the equitable distribution decision. The appeals court agreed, stating that Florida law requires that the valuation of a company include all of its assets and liabilities. "In other words, the sum of all parts, not a select few, is what encompasses a business's 'value,'" the court explained.

The appeals court also determined that it was improper to exclude some company assets (in this case the real estate) as "passive" when one party's marital labor contributed to the change in value of the company. If the husband, rather than the company, had owned the real estate, the concept of active or passive appreciation might apply, the appeals court said. In that case, the passive appreciation or depreciation might be excluded from the marital assets. But here, the owner *was* the company, which the husband's marital labor "indubitably" increased its value. By excluding the real estate from the valuation of the company, the trial court overvalued the company by almost $1 million, the appeals court said, remanding the case for a new valuation and new spousal support calculations.

Can a professional services firm have goodwill in the absence of non-compete agreements? This question was at the heart of a recent judicial dissolution case.

Perry v. Sackett, 2017 Cal. App. Unpub. LEXIS 1329 (Feb. 24, 2017)

The subject of this case was an accounting firm owned equally by four partners. Following disagreements between one shareholder and the remaining three and anticipating a buyout of the dissenting shareholder, the partners retained a CPA, who valued the company as a going concern under the fair market value (FMV) standard of value at $1.9 million, including goodwill of $981,000. The value was premised on there being non-compete covenants in place, but the partners had never executed them.

When the partners could not agree on a buyout price, they petitioned the court for a voluntary dissolution of the corporation under California law. The appointed receiver proposed to sell the company's assets at auction, setting a minimum bid at $450,000, but the dissenting partner objected. He noted that the receiver assigned just $116,000 to corporate goodwill, which included the firm's client list. The receiver increased the minimum bid to $505,000, and the petitioners' new corporation bought the firm's assets for that price. The dissenting partner appealed the trial court's confirmation of the sale.

In its findings, the Court of Appeals noted that he appraiser who performed the FMV appraisal acknowledged that FMV was not the standard applicable to an auction sale, and that the earlier goodwill value calculation rested on the assumption (which turned out to be unfounded) that there were non- competes in place. The court also rejected the dissenting partner's argument that the lack of non- competes should not affect the goodwill valuation. That argument was persuasive in a case involving a "fair value" determination brought under a different statutory provision but not in the instant case, the court said. Finally, the dissenting partner argued that, even though the corporation was sold as a going concern, the sales price in effect assumed its liquidation value. The appeals court disagreed, noting that the dissenting shareholder failed to specify what element of a going concern the sales price did not consider. The appeals court thus affirmed the trial court's findings.

The following ESOP (employee stock ownership plan) litigation emphasizes the careful scrutiny and extensive due diligence that these transactions require.

Brundle v. Wilmington Trust N.A., 2017 U.S. Dist. LEXIS 35811 (March 13, 2017).

The sellers to the ESOP were the principal owners of a private security firm whose primary clients were the U.S. Departments of State and Defense. About 70% of the company's revenue was tied to just two contracts. The company's board decided to pursue an ESOP, but instead of a sale of 100% of the company, the investment bank advising the board proposed a structure under which the sellers would sell 90% of their shares to the ESOP and exchange the remaining 10% for warrants. The warrants would ensure the sellers could keep control of the company by appointing a majority of the board of directors. Management and the sellers hired Wilmington Trust as the independent trustee of the ESOP, which, in turn, hired Stout Risius Ross (SRR) as the ESOP's financial advisor.

The company had an annual valuation of the company used to price employee stock options and for financial reporting. This appraisal relied on a discounted net cash flow (DCF) analysis that used a weighted average cost of capital (WACC) rate of 15% including a 7% industry/specific company risk factor. The appraiser reasoned the elevated risk rate was justified because the company's "heavily concentrated backlog" made the company a greater risk for potential investors than the industry as a whole.

SRR's valuation for sale to the ESOP relied on both the DCF and guideline public company methods. With time in short supply to capture the tax benefit related to the ESOP, the trustee committee members asked few questions related to SRR's draft valuation and no one discussed the most recent annual valuation. The company soon experienced financial concerns that led management to pursue a sale of the company to a major competitor.

Ultimately, the Department of Labor opened an investigation into the conduct of the parties and the trustee. The issue was whether the trustee had engaged in a prohibited transaction and, if so, whether it had an "adequate consideration" defense – meaning the ESOP paid no more than fair market value for the company's stock, "as determined in good faith by the trustee or named fiduciary."

To assess the trustee's performance, the court relied on testimony from two seasoned financial experts, ultimately ruling was that the trustee allowed the ESOP to pay more than FMV for the company's stock. Had the trustee performed a more thorough review of the SRR report, it would have noted deficiencies in the analysis and questioned the value conclusion. A few lapses stand out:

- For example, no one asked to see the annual valuation report. Had the committee members looked at that valuation, they would have seen it stated an enterprise value that was almost $100 million below the value SRR determined only 11 months later. This discrepancy should have been a red flag. A prudent trustee would have wanted to see the projections SRR used and looked at the assumptions underlying the SRR analysis.
- Also, the trustee should have known management projections were not necessarily reliable since management personnel were to receive a cash bonus and stock appreciation rights based on the total purchase price.
- A minor issue, but one that brought into relief the trustee's other lapses, was its failure to question SRR's generous and consistent rounding up in estimating values.

The ESOP fiduciary's concern should be with getting the lowest possible purchase price, the court said. In terms of damages, the issue was how much the ESOP overpaid for the company's stock. The plaintiff's expert identified specific errors in SRR's valuation and estimated how much each error inflated the purchase price. The court excluded some estimates and adjusted others to conclude the ESOP overpaid by about $28 million owing to the trustee's failure to adequately vet SRR's valuation report.

Daubert motions to exclude expert testimony have become commonplace but aren't always successful, as the following case illustrates.

Packgen v. Berry Plastics Corp., 2017 U.S. App. LEXIS 1793 (Feb. 1, 2017)

In 2007, the plaintiff, the maker of specialty containers used for petroleum products, lost sales to refineries due to a supplier's (the defendant's) allegedly defective containers. The plaintiff sued, alleging various breaches and negligence. The defendant unsuccessfully challenged the plaintiff's expert testimony under *Daubert,* and the jury subsequently awarded the plaintiff over $7.2 million in damages at trial. The defendants appealed the outcome with the First Circuit Court of Appeals, claiming that the expert testimony failed the *Daubert* reliability requirement and, therefore, should never have been admitted.

Specifically, the defendant's appeal argued that the expert failed to show the defendants' conduct caused the claimed losses and failed to explore alternative reasons for why the containers failed. Also, instead of doing a market survey to find out which refineries in fact would have bought the containers, the expert simply assumed that all would have done so based on the plaintiff's statements.

The appeals court observed that a market survey was only one way for an expert to gather facts; the expert relied on a different set of facts, and the latter were sufficient to meet the minimum standard of relevance and reliance. Also, the court opined that there was sufficient causation evidence to support the expert's testimony. The expert adequately accounted for alternative explanations, was able to show that the competitive market had not changed and that, when the containers failed for reasons unconnected to the defendants' product, they caused minor incidents.

The expert assumed a 10-year loss period based on company statements that it would take five years to overcome the effect of the incidents, and five years to restore sales to the level they would have achieved but for the defendants' actions. The Court of Appeals emphasized the expert was not in effect forecasting market conditions for a full 10 years but only for four years, since the incidents happened in 2008 and the *Daubert* hearing was in 2014. Looking back, it was clear that the intervening six years bore out certain expert assumptions, the court noted. The 10-year loss period was reasonable.

As for the damages model quantifying the loss of the longtime customer, the defendants objected that it projected losses 10 years into the future based on the six month sales immediately preceding the container incidents. The damages did not account for future contingencies, the defendants explained. The appeals court said there was enough evidence to assume the quantity of sales would at least remain steady. "Additional data would have been helpful," the court acknowledged. But the defendants had an opportunity to make that argument to the jury, and it had no traction with jury members. The trial court did not abuse its discretion in admitting the expert's lost profits testimony, the appeals court concluded, upholding the award.