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The Franchise Valuations Reporter

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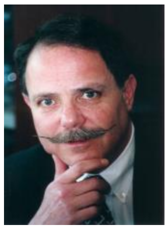

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Bruce S. Schaeffer, Editor
Bruce@FranchiseValuations.com
212.689.0400

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Bruce S. Schaeffer, Editor
Bruce@FranchiseValuations.com
212.689.0400

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Fair Value Appraisal Rights: The Dell Case - A Monster or a Monstrosity?

First Things First: Michael Dell is Absolutely a Good Guy and No Cheat

The history of Delaware appraisal rights cases was borne of corporate management engaging in shareholder buyouts at deflated prices to steal companies. As an example, those old enough may remember Meshulam Riklis and his Rapid American Company during the 1980s being regularly accused of such chicanery. But now the shoe is on the other foot and it is management that is being attacked by so-called "appraisal arbitragers" looking to make quick killings. These people don't buy stock until there's a merger or going-private announcement. Then they sue after the deal is consummated saying the buyout price is inadequate.

The Issues

Michael Dell, boy wonder and monstrously successful businessman, got sick and tired of the Street not recognizing that his company was not just a computer maker facing a future of declining margins but was instead an enterprise company entitled to a much higher valuation multiple. He did everything in his power to educate the market and lift his stock price but did not succeed. Finally, when nobody would listen, he effectively said, "To hell with it; I'll buy the company myself." He engaged in as open and transparent a bidding process as can be imagined (though there were some critics) and then bought it himself at a higher price than any other suitor would offer. But the appraisal arbitragers claimed that wasn't good enough and they took him to court.

The Delaware Court in *In Re: Appraisal of Dell Inc*. [1] just ruled that Michael Dell has to pay more to the very few shareholders who have standing.[2] There were many issues that came up in the 115- page decision that are worthy of note: the qualifications of the experts, the vast difference in their conclusions, the method both used i.e. DCF, the 'tax affecting' implications, the FIN 48 contingent reserve, the WACC methodology, and the appropriate discount rate determined by the Court.

The Experts

Dell's expert was Glenn Hubbard, the dean of Columbia's Graduate School of Business and former chairman of the Council of Economic Advisers under President George W. Bush. Dr. Bradford Cornell, a professor at the University of California, Los Angeles, was the expert for the dissident shareholders. It is noteworthy that neither expert was an accountant and neither had any accreditation from any of the valuation certifying organizations.

The Vast Difference Between The Experts Valuations Is Not Unusual

As the Court noted, "The petitioners' expert, Professor Bradford Cornell, used a DCF analysis to opine that the Company had a fair value of $28.61 per share on the closing date. The respondent's expert, Professor Glenn Hubbard, used a DCF analysis to opine that the Company had a fair value of $12.68 per share on the closing date. Two highly distinguished scholars of valuation science, applying similar valuation principles, thus generated the Wolters Kluwer Law & Business web page here.

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opinions that differed by 126%, or approximately $28 billion. This is a recurring problem. See Modern Appraisal Litigation, supra, at 19-20 (reviewing appraisal decisions and finding that for respondents' experts, the median valuation was 16% below the merger price, and the mean was 22% below. For petitioners' experts, the median valuation was 78% above the merger price, and the mean was 186% above.)"

The DCF Methodology For Determining Fair Value

The Court wrote, "The DCF analysis is a well-established method of determining the going concern value of a corporation. [T]he DCF . . . methodology has featured prominently in this Court because it is the approach that merits the greatest confidence within the financial community. *Owen v. Cannon*, 2015 WL 3819204, at *16 (Del. Ch. June 17, 2015) (quotation marks omitted)."

Put in very simple terms, the basic DCF method involves several discrete steps. First, one estimates the values of future cash flows for a discrete period . . . . Then, the value of the entity attributable to cash flows expected after the end of the discrete period must be estimated to produce a so-called terminal value, preferably using a perpetual growth model. Finally, the value of the cash flows for the discrete period and the terminal value must be discounted back . . . .

The 'Tax Effecting' Implications

A controversial topic among valuation organizations since the Millennium has been "tax effecting", a technique which basically applies a valuation discount to pass through entities like LLCs or S corporations on the assumption that they are getting away with something by not paying corporate taxes but will soon suffer a comeuppance and be forced to pay such taxes. In this writer's opinion the theory is foolish. Almost two-thirds of current entities are formed as LLCs to avoid paying corporate taxes. Why is it rational to think they will give up that benefit if acquired?

Until 1999, tax effecting was accepted basically without comment. But in 1999, in *Gross v. Commissioner,* the Service put on an expert who testified that tax effecting at normal corporate rates was inappropriate. "Dr. Bajaj determined that a zero percent corporate tax rate was an appropriate assumption to make in determining the earnings . . . available for distribution."[3] The issue has come up many times since but the Tax Court has followed *Gross* in *Estate of Gallagher v. Commissioner*[4] and since all valuation law is originally derived from tax law, we feel tax effecting is an issue looking for a rationale. What is wrong with valuing a going concern enterprise as it is actually operating? Why impose an imaginary fictional layer of taxes, that they have no plan to ever pay, to discount the company in a valuation? Other than additional employment for "valuators" it makes no sense.

In the Dell case the Court addressed a similar "tax effecting"[5] argument. Dell has many successful overseas operations and has about $19 billion in profits held outside the US. The Court addressed the issue as follows:

The experts disagree about the appropriate tax rate to apply to the Company's cash flows. Cornell used a 21% tax rate throughout his forecast period . . . Hubbard used two different tax rates. He used a 17.8% tax rate during the projection and transition periods . . . [and] He used the 35.8% marginal tax rate for the terminal period, which he justified with citations to academic literature.

The Company has not paid taxes at the marginal rate since at least 2000. In the five years leading up to the Merger, the Company paid taxes at effective rates that varied between 16.5% and 29.2%. For the same period, the

Company's cash tax rates (i.e., the amount of taxes actually paid in cash) ranged from 9.6% to 24.1%.

The Company's low effective tax rate is due, in part, to its ability to defer payment of domestic taxes on income earned overseas. The Company has made an indefinite reinvestment election, meaning that it has represented to its auditors that it intends to indefinitely reinvest its earnings overseas. The election allows the Company to defer paying U.S. taxes on approximately $19 billion in overseas profits. . .

The Company has not deviated from its representation that it will continue to reinvest its overseas earnings indefinitely in foreign projects. . . Hubbard's model implies that, beginning in 2023, Dell will begin paying taxes on all of its global profits at the U.S. marginal tax rate of 35.8% and will continue doing so perpetually. The factual record establishes the opposite. In fact, it would be highly speculative for this court to choose a date when, contrary to its historical practice, the Company would begin to repatriate foreign earnings.

To this writer's mind, making an indefinite reinvestment election is no different from stating that the company intends to maintain its status as a pass-through entity. Thus, tax effecting should be dealt another blow for its tenuous connection to reality.

The FIN 48 Contingent Reserve

As we have noted in this newsletter (*See* "Income Tax Nexus and FIN 48: Franchisor Accounting for Uncertain Tax Position," February 2015), FIN 48 requires companies to set aside reserves in case "uncertain" tax positions that they have taken are disallowed. But companies are only allowed to take the positions if, in their opinion, it is more likely than not that their positions will be sustained. In the Dell case there was an argument that the Company's value should be discounted for the full amount of such potential FIN 48 liabilities. Once again, the Court rejected the notion of using a fiction to establish a discount saying, "Subtracting the $3.01 billion from the DCF would imply that this court better understands the merits of the Company's tax positions than the Company does-without even having the opportunity to look at the underlying tax positions. The more persuasive view is that the Company and its auditors correctly determined the Company's tax positions."

The WACC Methodology and the Appropriate Discount Rate

This is another contentious issue - and fairly so - among experts. As the Court noted, "To discount the cash flow projections to their present value, the experts computed the Company's weighted average cost of capital (WACC). The parties dispute every input except for the risk-free rate of 3.31%."[6] The inputs chosen by the Court in arriving at the WACC were 1) cost of debt, 2) capital structure, 3) Beta, and 4) equity risk premium. The Court arrived at a WACC of 9.46%.[7]

What It All Means

Like Meshulam Riklis, Michael Dell took his company private but that's where the similarity ends. The Court decision makes overwhelmingly clear that he is nothing like Riklis.

The law firm of Wachtell, Lipton, Rosen & Katz has criticized the decision for forcing a buyer to pay a 30 percent higher price in a "fully shopped" deal. They argue that the decision may lead to shareholders' "losing out" as private equity firms won't do deals out of fear that hedge funds may win big on appraisal awards.

In conclusion, one has to admit that this is pretty complicated stuff. As *The New York Times* asked, "What is a judge, who is not an expert in valuations, to do?"

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[1]Delaware Chancery Court C.A. No. 9322-VCL, Decided: May 31, 2016, LASTER, Vice Chancellor

[2]T Rowe Price's mutual funds negligently voted for the merger even though they announced against it and ended paying their shareholders more than $194 million out of their own pocket for their error.

[3]78 T.C.M. (CCH) 201 (1999), at p. 203

[4]101 T.C.M. (CCH) 1702 (2011)

[5]The literature uses the terms "tax effecting" and "tax affecting" interchangeably. We have used "tax effecting" throughout as a convention.

[6]At p. 107-8.

[7] In the Planet Fitness case I used a discount rate of 9% assuming the entire cost of capital would be 150% the cost of debt capital.