Valuation & Litigation Briefing

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In re Tesla Motors, Inc. Stockholder Litigation

SolarCity acquisition satisfies "entire fairness" review

Boards of directors are ordinarily protected by the business judgment rule. Under that rule, courts generally defer to a board's decisions regarding corporate transactions. However, if a plaintiff can show that a board acted in bad faith, engaged in illegal acts, was grossly negligent or had a conflict of interest, courts will generally apply the more stringent "entire fairness" test to evaluate the board's actions. To satisfy this test, the company must prove that the board's decision was the product of fair dealing and a fair price.

A recent case demonstrates how this test works. In *In re Tesla Motors, Inc. Stockholder Litigation*, the Delaware Supreme Court upheld the Delaware Chancery Court's ruling that Tesla's 2016 acquisition of SolarCity Corporation was entirely fair — even though the process was imperfect.

Applying the test to controlling stockholders

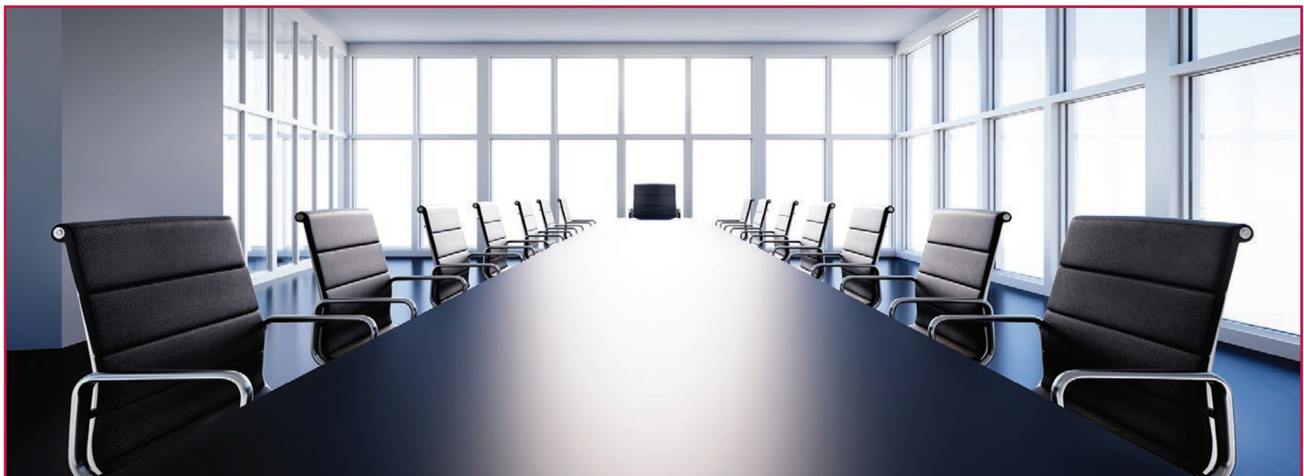
The entire fairness test also may apply when a controlling stockholder has a conflict of interest. In this case, the plaintiffs alleged that Tesla's CEO and board chair at the time was a controlling stockholder who breached his fiduciary duties to the other stockholders. At the time of the transaction, Tesla's CEO was also chair of SolarCity's board and its largest stockholder.

Although Tesla's CEO owned 22% of its stock, the plaintiffs alleged that he was a controlling stockholder by virtue of his "domination and control" of Tesla's board and, in that role, caused Tesla to overpay for SolarCity. However, it should be noted that Tesla's CEO and certain other conflicted directors apparently recused themselves from voting on the transaction in their capacity as directors.

The Chancery Court assumed, without deciding, that Tesla's CEO was a controlling stockholder. However, because the court concluded that the transaction was entirely fair, it didn't need to reach a finding on that issue.

Evaluating fairness

The Delaware Supreme Court affirmed the Chancery Court's decision that the transaction was



How fairness opinions can help avoid valuation disputes

One effective tool businesses can use to avoid litigation over merger and acquisition transactions is to obtain a fairness opinion. This is a written opinion by an independent financial advisor stating that a proposed transaction is fair from a financial perspective to the company's shareholders or a particular group of shareholders.

Even if a business goes out of its way to arrive at a fair price, dissatisfied shareholders may resort to litigation, delaying or even derailing the transaction. A fairness opinion from a reputable, independent expert can help avoid these disputes by providing shareholders with objective assurance that they're being treated fairly.

Fairness opinions are often prepared by investment bankers, but business valuation professionals are also well-equipped to opine on a deal's fairness. And they may be more objective than an investment banker — particularly one who's also providing other services in connection with the transaction.

entirely fair. It pointed to the following facts, which support the conclusion that the board's decision was based on fair dealing:

- Tesla's negotiation team was led by an independent director and focused on the bona fides of the acquisition, effectively neutralizing the CEO's attempts to wield control.
- Tesla engaged independent, expert advisors who helped the company negotiate a lower price than initially offered. "Vigorous and spirited" negotiations are an indication of fair dealing.
- The record showed several instances where the board refused to follow the CEO's wishes, including declining to explore an acquisition of SolarCity when the CEO first proposed it.
- Although the plaintiffs argued that the CEO "bailed out SolarCity on a schedule that worked for him," the facts indicated that the timing was ideal for Tesla, as "solar company stocks were trading at historic lows."
- A majority of the disinterested minority stockholders were required to approve the transaction.

There was no error in the Chancery Court's "determination that the directors, following a rigorous negotiation process led by [the independent director], were not 'dominated' or 'controlled' by [Tesla's CEO] when they voted to approve the Acquisition," stated the Delaware Supreme Court. On a similar note, it found that the lower court reasonably concluded that the stockholders were fully informed when voting to approve the transaction.

> *One procedural shortcoming was the board's failure to employ a special, independent negotiating committee.*

One procedural shortcoming noted by the Delaware Supreme Court was the board's failure to employ a special, independent negotiating committee. In a previous case — *Kahn v. M & F Worldwide Corp.* — the court held that a company would enjoy the protection of the business judgment rule if it used such a committee upfront and conditioned approval on a fully informed "majority-of-the minority" vote. But, while Tesla could have avoided an entire fairness review by forming a special committee, failure to do so didn't require a finding of liability.

The Delaware Supreme Court did criticize the Chancery Court's reliance on SolarCity's pre-transaction stock price. However, other evidence amply supported its finding that the price was fair, including a fairness opinion by an independent financial advisor. The opinion incorporated seven different valuation analyses, including the discounted cash flow method. Moreover, the plaintiffs' argument that SolarCity was insolvent wasn't credible.

Process matters

Although the defendants ultimately prevailed, they could have avoided the onerous entire fairness review if they'd formed a special negotiating committee. In such cases, following the right procedures can be just as important as arriving at a fair price. ■

Using structured settlements to finance business sales

Structured settlements are commonly used to pay claims and damage awards in personal injury lawsuits. However, these arrangements — composed of annuity payments from an insurance company — can also be used to finance the sale of some closely held businesses. Here's how this creative strategy works.

The mechanics

A structured settlement is an agreement made to settle a monetary claim or lawsuit. It provides for a series of payments to be made over several years, rather than in one lump sum. The future payments are secured by an insurance company annuity or U.S. government obligation.

Structured settlements were first used in the 1960s to settle a rash of cases resulting from the drug thalidomide. These arrangements became more common after 1982, when the federal government formally recognized and encouraged their use in personal injury cases. Congress passed legislation that made periodic payments, and any investment earnings from the underlying annuity, tax-free.

A novel twist

Over the years, the use of structured settlements has expanded to business sales. Although payments from these non-personal injury cases aren't tax-exempt, the recipient (the seller of the business) owes taxes on only the amount of money received each year.

To illustrate when structured settlements might work, suppose a buyer of a private business is unable to obtain financing from a bank. One option to finance the deal is an installment sale, where the buyer puts up a percentage of the purchase price and the seller receives a promissory note for the balance. Payments are to be made monthly or quarterly.

Because the seller may be concerned about default, the loan may be secured by company stock

or assets and involve a personal guarantee. But the seller must ultimately rely on the buyer's ability to make the payments.

> *The tax consequences are likely to be more favorable with a structured settlement than a 100% cash sale.*

A structured settlement might be a less risky financing alternative. Here, the buyer purchases an annuity from an insurance company, which makes monthly payments to the seller. The transaction reduces the seller's risk of not getting paid, because the annuity provides guaranteed and predictable payments. Plus, those payments can be tailored to meet specific events — or even inflation.

In addition, the tax consequences are likely to be more favorable with a structured settlement than a 100% cash sale. However, this technique works only if the buyer has the cash to buy the annuity.

Another factor to consider in deciding whether to choose a structured settlement over a lump sum distribution is that a structured settlement gives the recipient a right to receive money only in accordance with the schedule set out in the settlement document. It also doesn't give the recipient or payer any ownership interest in the funding asset, thus preventing creditors of either party from levying upon the structured settlement funds.

Time value of money

Cost savings can make the use of structured settlements attractive, too. Because the underlying annuity or government obligation is bought with today's dollars, the out-of-pocket cost is less than the total amount of money that the structured settlement will pay out over time.

Of course, with any structured settlement offer, it's important to know the present value of the future payments. This allows the parties to compare the offer with an immediate cash payment. The present cost of a structured settlement also depends on the amount of the future payments and their timing. So, it's important for a financial expert to crunch the numbers.

One option among many

Annuity payments are only one way to finance business sales. A business valuation professional can help structure a sale or merger that generates the best after-tax financial return. ■

Valuation of conservation easement leads to battle of experts

A recent U.S. Tax Court case — *Champions Retreat Golf Founders, LLC v. Commissioner* — provides guidance on the method used to value a conservation easement for charitable deduction purposes. It also offers valuable insight into the court's role in evaluating expert testimony.

Case facts

The taxpayer acquired just over 460 acres of land in 2001 and built a 27-hole golf club. It consisted of three 9-hole courses and an adjacent residential neighborhood. The golf club included a pro shop, a restaurant, a locker room, a driving range and other

facilities. In 2010, the taxpayer granted a conservation easement to the North American Land Trust. The easement covered most of the golf courses and driving range. The easement prohibited the taxpayer from, among other things, subdividing the easement area into residential lots.

The taxpayer claimed a charitable deduction for a conservation easement of approximately $10.4 million on its 2010 income tax return. The IRS disallowed the deduction altogether, arguing that the donation wasn't a qualified conservation easement. The IRS lost on that issue in earlier litigation, so the only issue left for the Tax Court to determine was the easement's value.

Before and after

Conservation easements aren't bought and sold in arm's-length transactions, so typically they're valued using the before-and-after method. This method involves determining the property's fair market value immediately before and immediately after the easement is granted. The difference is the value of the easement.

Each party offered expert witnesses to help the court determine value. The main disagreement between the two sides was the property's highest-and-best use before the easement. The taxpayer argued that its highest-and-best use before the grant was as a partial residential subdivision (on one of the 9-hole courses) with an 18-hole golf course. Conversely, the IRS argued that it was as a 27-hole golf course.

Both sides agreed that, given the restrictions on subdivision, the highest-and-best use after the grant was as a 27-hole golf course. Using the before-and-after method, the taxpayer's primary expert valued the easement at around $10.8 million. However, the IRS valued it at only $20,000.

The Tax Court rejected the IRS expert's arguments that a partial subdivision of the property would have been practically and financially unfeasible. However, it also disagreed with some of the taxpayer's expert's assumptions and lowered the easement's value to approximately $7.8 million.

Experts' shortcomings

The court ruled that the taxpayer's expert was "not a compelling witness," finding much of his opinion to be flawed — even commenting that he seemed to be serving as an advocate. On the other hand, the IRS's expert didn't offer "a viable alternative" and provided few specific criticisms of his opponent's valuation. The court explained that it could only adjust an expert's valuation or fashion its own valuation to the extent the record permits.

The court determined that the taxpayer's expert provided more specific support and, therefore, was "sufficiently more convincing." If the IRS's expert had offered an alternative calculation of the property's value after the easement was granted — based on its use as a residential subdivision with an 18-hole golf course — the court might have reached a different conclusion.

Support is key

Judges aren't valuation experts. Their role is to weigh the evidence on the record and determine the value of property based on expert opinions. So, it's essential for experts to provide an objective, detailed analysis backed by relevant empirical evidence to assist courts in making their final decisions. ■

Building blocks for the cost of capital

How interest rates and market volatility affect business valuations

Today's market conditions are uncertain. Higher interest rates and stock market volatility generally translate into *lower* business values. It's important to understand how negative market conditions impact value and ways to counteract those effects.

Discounting future earnings

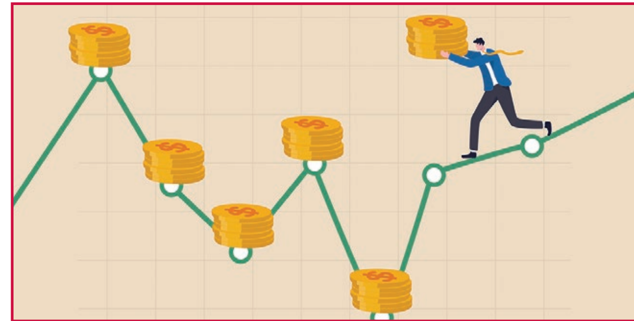
Under the income approach, business value is typically derived from the net present value of expected future cash flows. To convert future cash flows to present value, valuators use a discount rate that reflects the risk associated with realizing those cash flows from the perspective of a hypothetical investor.

When valuing invested capital (the sum of the business's debt and equity), the discount rate is usually based on a company's weighted average cost of capital. This is a blend of the cost of debt and cost of equity, weighted according to their relative percentages of total capital. Typically, the cost of debt is based on the company's actual borrowing costs.

Estimating the cost of equity

There are several methods available to calculate the cost of equity. In general, the starting point is a "risk-free" rate, such as long-term yields on U.S. Treasury bonds. Then the valuator adds amounts to capture the additional risk associated with an investment in the subject company. For example, the build-up method starts with a risk-free rate and adds the following components:

- An equity risk premium (ERP) that reflects the additional risk inherent in equity investments,
- A size premium that reflects the heightened risk associated with smaller companies, and
- A company-specific risk premium that reflects risk factors specific to the subject business.



In some cases, an industry-specific risk premium may also be appropriate.

Connecting the dots

How could uncertain market conditions affect business value? Rising interest rates increase the cost of capital in two ways: 1) by increasing the cost of debt, and 2) by increasing the risk-free rate used to calculate the cost of equity. A higher cost of capital means a higher discount rate and, therefore, a lower business value.

Volatility and uncertainty in the stock market make equity investments riskier, thereby increasing the ERP. In turn, this increases the cost of capital, also resulting in a lower business value.

Softening the blow

It may be possible to reduce, or even offset, the impact of rising interest rates and market volatility on business value by demonstrating improvements in a company's fundamentals. This could effectively lower the company-specific risk premium in a build-up model.

For example, the business could implement improvements in financial performance, growth, management quality, product development, market share or customer base diversity. Contact a valuation professional to determine the appropriate discount rate for a particular business. ■

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