STOUT

Due Diligence: A Lasting Memory in Scrapbooking Company's ESOP Dispute

Proper due diligence and contemporaneous market research can go a long way in supporting valuations when hindsight is 20/20.

The Antioch Company ("Antioch" or the "Company"), a manufacturer of scrapbooking supplies and materials, consummated a transaction in December 2003 that resulted in the Company becoming 100% employee stock ownership plan (ESOP)-owned (the "ESOP Transaction"). The Company filed for bankruptcy in 2008, prompting certain ESOP participants, who blamed an overpayment in the ESOP Transaction for the Company's deteriorating financial performance, to sue the founders. However, thorough, contemporaneous due diligence and market research, as well as sound fundamental valuation analyses, proved to be important factors in defending the valuation of the Company in the ESOP Transaction.

Overview of the Company and the ESOP

In the late 1990s and early 2000s, the core business of Antioch was the direct marketing of scrapbooks and accessories through its largest division, Creative Memories. The Company sold its products primarily through the party-plan, direct sales method, using thousands of independent sales consultants. Antioch experienced significant growth during this time, with revenue increasing from $164 million in 1998 to $351 million in 2002. During this same period, earnings before interest, taxes, depreciation, and amortization increased from $32 million to $85 million.

Antioch established an ESOP in 1979 to invest primarily in its stock. In light of certain legal issues surrounding the Internal Revenue Service's position on dividend allocation, Antioch began exploring the possibility of becoming a 100% ESOP-owned company in the early 2000s. In December 2003, after months of due diligence, Antioch redeemed all outstanding shares of its stock held outside the ESOP as part of a tender offer transaction that left the Company 100% ESOP-owned. In the years following the ESOP Transaction, Antioch's financial performance began to decline amid industry and macroeconomic headwinds. In late 2008, Antioch reorganized its capital structure through a Chapter 11 bankruptcy. As a result, certain ESOP participants brought legal action against the founders, contending that the stock of Antioch became worthless due to the ESOP Transaction.

Overview of the Financial Advisors' Roles in the ESOP Transaction

In January 2003, Antioch held a meeting known as the "ESOP Summit," at which time Deloitte & Touche LLP ("Deloitte") proposed that the ESOP become the 100% owner of Antioch's stock. Shortly after the ESOP Summit, the Company retained Deloitte as a financial advisor to assist the Company in executing the ESOP Transaction. Duff & Phelps LLC ("Duff") was engaged as an independent financial advisor to the ESOP trustee for the purposes of the ESOP Transaction. Duff's role was to determine, among other things, whether the ESOP Transaction was fair to the ESOP from a financial point of view. Finally, Antioch engaged Houlihan Lokey Howard & Zukin ("Houlihan") as a financial advisor to determine whether the consideration to be paid for the non-ESOP shares was fair to the non-ESOP shareholders from a financial point of view. Both Duff and Houlihan issued independent fairness opinions stating that the ESOP Transaction, and the consideration to be paid, was financially fair to their respective clients.

Key Issues During Trial

The case was tried in a bench trial that lasted 34 trial days during late 2015 and early 2016. While there were many significant issues addressed during trial, some of the most contentious valuation issues pertained to whether Duff employed reasonable valuation methodologies and relied on reasonable inputs at the time of the ESOP Transaction. Specifically, this article will address the court's ruling in regard to: 1) whether the projected financial statements relied on by Duff were reasonable, 2) whether a company-specific risk premium (CSRP) was appropriate in the weighted average cost of capital (WACC) analysis performed by Duff, and 3) whether Duff appropriately accounted for Antioch's repurchase obligation.

Projected Financial Statements

Based on his testimony, the valuation expert for the plaintiffs (the "Plaintiffs' Expert") did not believe that the projections relied on by Duff were reasonable to use for the valuation of Antioch. The Plaintiffs' Expert developed five different discounted cash flow (DCF) analyses based on five different sets of projected financial statements as potential indications of value. One of the Plaintiffs' Expert's DCF analyses relied on the same projected financial statements used by Duff, but applied a higher discount rate to this set of projections based on a CSRP supported by qualitative factors. Two sets of projections relied on by the Plaintiffs' Expert were developed by another expert who specialized in short-term forecasts. Specifically, this expert developed 10-year sales projections using a combination of autoregressive integrated moving average (ARIMA) time-series statistical analysis for domestic sales and a non-ARIMA-based extrapolation for international sales. The remaining two sets of projections used by the Plaintiffs' Expert came from downside sensitivity models that Deloitte prepared for the Company, which were labeled "Downside" and "Big Downside" projections.

Unlike the Plaintiffs' Expert, the valuation expert for the defendants (the "Defendants' Expert") did not perform an independent valuation of Antioch. Rather, the Defendants' Expert opined that Duff's analysis, including the projected financial statements used in its DCF analysis, were reasonable and, in fact, conservative. The Defendants' Expert noted that management demonstrated a historical track record of preparing reasonable projections when compared with actual results. In addition, the Defendants' Expert pointed out that Duff, Houlihan, Deloitte, and the syndicate of lenders in the ESOP Transaction found no reason not to rely on management's projections during their contemporaneous due diligence for the ESOP Transaction. Most notably, during real-world due diligence outside the context of litigation, the Company's lenders assessed the potential risks to Antioch's business, noted mitigating factors for each risk, and ultimately concluded that management's projections were conservative. The Defendants' Expert pointed out that Duff independently developed projected financial statements that were even lower (from both sales and earnings perspectives) than both management's projections and what the Company's historical trend would have suggested for the future. Based on the Defendants' Expert's own independent analysis and research, the Defendants' Expert opined that Duff's downward adjustments to management's projected financial statements led to a very conservative valuation of Antioch.

> **The court was persuaded by the testimony of the Defendants' Expert that when a company is redeeming and retiring shares from terminating ESOP participants at fair market value (as Antioch did), the future repurchase obligation generally has no impact on the per-share value and that the Plaintiffs' Expert's opinion on this matter was not credible.**

When reaching a decision with respect to the projections used by Duff, the court noted that in the five years prior to the ESOP Transaction, the Company demonstrated an ability to reasonably and accurately forecast its financial performance, achieving results sometimes above and sometimes below forecast. As it relates to the Plaintiffs' Expert's reliance on the two sets of projections developed from the ARIMA analysis, the court noted that the Plaintiffs' Expert could not recall a single engagement or transaction in his experience where ARIMA projections were used in the valuation of a company, and he had never contracted for a statistician or other professional to use an ARIMA analysis to project corporate sales in any engagement or transaction on which he worked. Further, the court noted that every other witness who was asked testified that they had never seen an ARIMA or ARIMA-type methodology used to project corporate sales for 10 years into the future. Therefore, the court concluded that an ARIMA analysis is not a reliable methodology to project sales for a multiyear period. Finally, the court noted that the use of the "Downside" and "Big Downside" projections by the Plaintiffs' Expert was inappropriate, as those projections were never meant to be used as the basis for a DCF analysis. Specifically, the court noted that it would be inappropriate to use these projections with the same discount rate on which Duff concluded in its analysis, as this would result in the double-counting of risk factors. Therefore, the court found these two DCFs unreliable as well. The court's findings with respect to the Plaintiffs' Expert's final DCF analysis using a CSRP can be found in the following section.

In summary, the court found the projections used by Duff, and supported by the Defendants' Expert, to be reasonable based on management's track record and the contemporaneous research performed at the time of the ESOP Transaction. In addition, the court found the Plaintiffs' Expert's projections to be unreasonable based on the methodologies employed to develop them. This decision provides guidance that a valuation analyst should be aware of with respect to how the court views projections developed using an ARIMA analysis. Furthermore, the court made it clear that downside projections used to evaluate sensitivity analyses cannot simply be made into base case projections and used in a DCF analysis with the same discount rate.

It is clear based on the court's ruling that the court was impressed with the due diligence performed and methodologies employed at the time of the ESOP Transaction by the financial advisors and lenders, and by the Defendants' Expert's support for these analyses.

Company-Specific Risk Premium

Four of the Plaintiffs' Expert's DCF analyses used a WACC that was within the range of what Duff concluded in its fairness opinion, but with materially lower projections. For his DCF analysis, which relied on the same projected financial statements that Duff used, the Plaintiffs' Expert added a 5% CSRP to the WACC. In general, a CSRP accounts for risk factors specific to the subject company (i.e., unsystematic risk factors) not captured in the equity risk premium, beta, or small stock risk premium. The Plaintiffs' Expert testified that this 5% CSRP was not based on any specific formula or quantification of the specific risk factors he claimed Duff failed to sufficiently account for in its analysis, nor was it based on any generally accepted methodology.

Conversely, the Defendants' Expert testified that Duff's WACC calculation was reasonable and methodologically sound. The Defendants' Expert conducted his own independent WACC calculation as well, arriving at an 11.9% WACC compared with Duff's concluded range of 12% to 14%. All else held constant, a lower WACC results in a higher company value. Thus, the Defendants' Expert testified that Duff's concluded WACC was conservative from a valuation perspective. The Defendant's Expert also testified that based on Duff's lower projections compared with management, and the general optimism surrounding the scrapbooking industry at the time of the ESOP Transaction, Duff's exclusion of a CSRP was appropriate. The Defendants' Expert testified that applying a CSRP of any magnitude to the projected financial results used by Duff, as the Plaintiffs' Expert did, would have been a textbook case of double-counting of risk, and the court agreed.

The court rejected as unreliable the Plaintiffs' Expert's valuation derived from his fifth DCF that was driven by this subjective 5% CSRP. In reaching its opinions, the court noted that the Plaintiffs' Expert's 5% CSRP was not supported by any reliable formula or quantitative analysis. Furthermore, the court noted that the Plaintiffs' Expert was unable to explain, on cross-examination, why he chose a 5% CSRP as opposed to some other CSRP percentage, other than admitting it was entirely a matter of judgment. Finally, the court stated that regardless of whether the analyst chooses to account for company-specific risk by altering the discount rate or by adjusting the cash flows, making adjustments to ***both*** the discount rate ***and*** future cash flows, in the way the Plaintiffs' Expert did, amounts to inappropriate double-counting of risk.

The inclusion of a CSRP has been a debated topic in a number of litigious business valuation matters. Even if a CSRP is accepted, the courts tend to require that some level of analysis be done, as opposed to adding an arbitrary premium with no explanation or quantification. In addition, when considering the application of a CSRP, a valuation analyst should make sure to consider the cash flows to which this CSRP will be applied. If the cash flow projections have already been adjusted to account for risk specific to the subject company, the application of the CSRP may be duplicative.

Repurchase Obligation

An ESOP repurchase obligation refers to an ESOP sponsor company's obligation to either redeem shares of departing ESOP participants at fair market value upon certain qualifying events or to ensure the ESOP has the necessary funds to do so. The Plaintiffs' Expert contended that the Company's discounted future repurchase obligation should be deducted from the value of Antioch when determining the appropriate per-share value of the stock of the Company. Conversely, the Defendants' Expert (and all the contemporaneous valuation advisors) contended that, from a valuation perspective, it is inappropriate to subtract a company's projected future repurchase obligation when a company is redeeming shares of departing ESOP participants at fair market value, as it would have no impact on per-share value. Specifically, the Defendants' Expert gave an example of a company with an equity value of $100, 10 shares outstanding, and thus a per-share value of $10. If an employee of that company with one share retires and the company redeems that share for $10, the company would be left with an equity value of $90 and nine shares outstanding. Consequently, the Company's per-share value would still be $10.

In reaching its decision, the court found the Defendants' Expert's testimony more compelling. The court noted that while the Plaintiffs' Expert took a direct deduction from the value of the Company for the projected repurchase obligation, he made no reduction to the number of outstanding shares that would have been purchased and retired. Furthermore, the court noted that the Plaintiffs' Expert admitted that no other valuation professional in this case accounted for the projected future repurchase obligation in this manner in the contemporaneous, non-litigation-based valuations of Antioch. Ultimately, the court was persuaded by the testimony of the Defendants' Expert that when a company is redeeming and retiring shares from terminating ESOP participants at fair market value (as Antioch did), the future repurchase obligation generally has no impact on the per-share value and that the Plaintiffs' Expert's opinion on this matter was not credible.

The Importance of Due Diligence and Contemporaneous Documentation

While the court addressed many important valuation concepts in this case not covered in this article, perhaps the most important takeaway is the importance of performing proper due diligence in a valuation and documenting your analysis with contemporaneous market research so that your valuation will stand up to the scrutiny of potential reviewers down the road who will have the benefit of hindsight. As the court noted, the ultimate outcome of an investment is not proof that a fiduciary acted imprudently, as the fiduciary's duty of care requires prudence, not prescience. The appropriateness of an investment is supposed to be determined from the perspective of the time the investment was made, not from hindsight.

It is clear based on the court's ruling that the court was impressed with the due diligence performed and methodologies employed at the time of the ESOP Transaction by the financial advisors and lenders, and by the Defendants' Expert's support for these analyses. On the other hand, the court was not convinced by the Plaintiffs' Expert's analyses, which were biased by hindsight and used improper valuation methodologies and assumptions. Specifically, the court did not find credible the Plaintiffs' Expert's support for his five DCF analyses that relied on unreasonable projections, application of a CSRP to conservative cash flows, and the treatment of the repurchase obligation in a manner that was inconsistent with all other financial advisors at the time of the ESOP Transaction and generally accepted valuation procedures.

This case provides a good example of the importance of performing contemporaneous, thorough due diligence when undertaking a valuation and analyzing the fairness of a transaction.

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