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Delaware court gives guidance on valuation

By Marc Boiron

In *PECO Logistics LLC v. Walnut Investment Partners LP*, the Delaware Court of Chancery granted PECO Logistics' request for declaratory relief that it had complied with the terms of its LLC agreement in valuing PECO's preferred units and that the holders of the preferred units were bound by the appraiser's valuation of such units.

In connection with a merger involving PECO in March 2011, Walnut Investment Partners LP and Walnut Private Equity Fund LP became parties to PECO's LLC agreement, which gave the holders of preferred units a put right for a specified period of time. Upon exercise of the put right, PECO would be required to purchase the preferred units for their fair market value, as determined by a valuation firm that PECO would select. The LLC agreement did not provide a method to review the valuation firm's determination.

Upon exercise of the put right, the purchase price for the preferred units would be distributed to the holders of such units based on each unit's pro rata share of PECO's total equity value. This was defined to mean the aggregate proceeds that all holders of PECO units would receive upon a sale of all of PECO's assets for fair market value in an arm's length transaction, where all of PECO's obligations and liabilities would be satisfied with the proceeds of such sale and the net proceeds would be distributed in accordance with the LLC agreement's distribution provisions. In addition, the value of the assets determined as set forth above would be subject to upper and lower limits based on certain EBITDA multiples.

In late 2013, the Walnut entities exercised their put right pursuant to a notice reserving rights to participate in any valuation firm's process and to object to its determination of the preferred units' value. PECO engaged Duff & Phelps to perform a valuation of the preferred units, which resulted in a total equity value distributable to the holders of preferred units equal to approximately $93.12 million. The Walnut entities disagreed with the Duff & Phelps' valuation and refused to execute documents to transfer their preferred units.

PECO sought a declaration that it complied with the terms of the LLC agreement in connection with the preferred units' valuation and that the Walnut entities were bound by Duff & Phelps' valuation. The Walnut entities argued that there were issues of material fact that, as a matter of law, precluded granting PECO declaratory relief because the reservation of rights in the put notice modified the LLC agreement and the agreement's valuation provisions were ambiguous.

The court held that the Walnut entities' reservation of rights did not modify the LLC agreement because the agreement provided that its provisions could be amended, modified or waived only with the written consent of PECO's board of managers, consent which was not obtained. The court found that the Walnut entities gave no consideration in exchange for the purported modification to the agreement. As drafted, the agreement required PECO to engage a nationally recognized valuation firm following receipt of a written notice exercising the put right. When PECO engaged Duff & Phelps after receiving the put notice, the Walnut entities did not provide any benefit to PECO or suffer any detriment; instead, they reserved all of their rights.

In addition, the court rejected the Walnut entities' argument that ambiguity in the LLC agreement caused Duff & Phelps to favor PECO with respect to three issues. First, Duff & Phelps decided to deduct long-term debt from PECO's equity value. The court concluded that the deduction was not the result of ambiguity in the LLC agreement; rather, the definition of total equity value, by its terms, required that all of PECO's debt be treated as having been paid in full.

Second, Duff & Phelps used June 1, 2014, instead of Dec. 31, 2013, to determine the upper and lower limits applied to the fair market value of PECO's assets based on certain EBITDA multiples. The court again concluded that Duff & Phelps' decision was not the result of ambiguity in the LLC agreement because it stated that the fair market value of the preferred units was to be calculated as of the valuation's date, for which Duff & Phelps used June 1, 2014, to have access to the latest financial information available for the valuation.

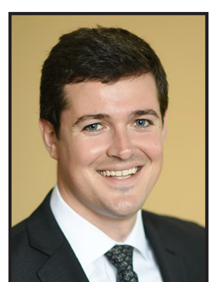
Third, Duff & Phelps applied the upper and lower limits to the value of PECO's assets based on certain EBITDA multiples using the EBITDA of PECO's operating subsidiary rather than PECO's EBITDA. The court determined that Duff & Phelps had no choice but to use the operating subsidiary's EBITDA because PECO did not have an EBITDA given that the subsidiary was its only asset.

The court noted that, under *Senior Housing Capital LLC v. SHP Senior Housing Fund LLC*, three levels of review exist to review valuations: (i) de novo judicial review, (ii) appointment of an appraiser who, in case of any disputes regarding the valuation, serves as an arbitrator with the arbitration being governed by any statutory or private regime that the parties choose, or (iii) appointment of an appraiser whose decision is final and not subject to any review. Given that the parties elected the third level of review, the court held that any ambiguity regarding the application of the valuation methodology was not subject to judicial review; only the provision delegating authority to the valuation firm was subject to review.

Relying on *Senior Housing*, the court also found that parties subject to a binding appraisal may challenge the appraiser's conclusions to ensure they were the product of a good faith, independent judgment by determining whether a party breached the implied covenant of good faith and fair dealing. The could found that PECO did not breach such covenant because it selected a nationally recognized valuation firm as required by the LLC agreement that was independent and did not act unreasonably or arbitrarily when conducting the valuation.

This decision provides guidance for drafting LLC agreements governed by Delaware law that contain valuation provisions. Especially small- and middle-market companies should strongly consider a binding appraisal process, which generally minimizes costs, especially where courts have shown a willingness to uphold an explicit provision that makes an appraisal binding so long as the appraiser is independent, the parties did not influence the appraiser's conclusions, and the appraiser's conduct was neither arbitrary nor unreasonable. Although use of a single appraiser likely will be the most cost-effective approach to a valuation, parties may prefer to use a mechanism that requires two or three appraisers to conduct an appraisal or to subject the appraisal to review. Any procedures establishing a review process by mediation, arbitration, litigation or a combination of the foregoing should be detailed to avoid additional disputes.

In addition, any formula established in the LLC agreement should be specific and components thereof should be established in a manner consistent with past practice. The parties should consider potential judgment calls that the appraiser may need to make with respect to any component of the formula and agree to the desired treatment thereof. Moreover, any accounting methods and the treatment of certain items in financial statements should be consistent with past practice or be adjusted based on terms agreed to at the time the LLC agreement is drafted.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