

Must-read Opinion from Chancery Court on Tax Affecting, DCF Discounts, and More

Delaware Open MRI Radiology Associates, P.A. v. Kessler, et al., 2006 Del. Ch. LEXIS 84 (April 26, 2006)

Business valuers often wish they could read the expert reports underlying a court's decision, to view the data and analysis—but in this case, there is no need. The latest valuation opinion to issue from the Delaware Chancery Court reads like a veritable treatise on the fair pricing of a closely-held business, and includes the Vice Chancellor Strine's own valuation analysis, derived not only from the expert evidence in the case but also leading texts by Shannon Pratt, Z. Christopher Mercer and Franklin Fisher, as well as key case law. In short, the *Kessler* opinion is a must-read for any BV analyst, both entry-level and experienced; we've hit on the highlights below.

Radiologists form company to own and operate MRI centers

A group of practicing radiologists formed a company ("Delaware Radiology") to capture additional revenues by owning the centers at which patients received MRI scans. Various disputes among the doctors led them to split up, which turned the Delaware Radiology stockholders into two discrete blocks: the majority "Broder" group, which controlled 62.5% of the company, and the minority "Kessler" group, which owned the remaining 37%. Further competition among the shareholders led to the majority forming an acquisition company to "squeeze-out" the minority in a forced merger. The majority did hire a valuation analyst to calculate a price for the minority shares—but it was the fairness of the price as well as the merger itself which later became the focus of litigation.

Or as the Vice Chancellor phrased it, "This case is another progeny of one of our law's hybrid varieties: the combined appraisal and entire fairness action." The question for both claims essentially came down to one—the financial fairness of the merger:

Put simply, I must determine the fair value of Delaware radiology's shares on the merger date and award the Kessler Group a per-share amount consistent with their pro rata share of that value.

As "fair value" is, by now, "a jurisprudential concept that draws more from judicial writings than the appraisal statute itself," the Court would examine the company as a going concern on the merger date, considering all relevant, non-speculative data. That included the respective expert opinions offered by both parties—which contained "widely divergent" estimates of value while "supposedly using the same well-established principles of corporate finance."

Such a judicial exercise, particularly insofar as it requires the valuation of a small, private company whose shares do not trade in a liquid and deep securities market, using a record shaped by adversaries whose objectives have little to do with reaching a reliable valuation, has, at best, the virtues of a good faith attempt at estimation. That is what I endeavor here.

Expert valuations nearly \$20 million apart

Three disputed valuation issues accounted for the "wide divergence" of expert valuations: (1) the treatment of MRI "reading" and management fees; (2) the company's expansion plans, at the time of the merger, from two to five MRI centers; and (3) the treatment of the company as an S Corporation.

At trial, the Broder (majority) group had relied on the same expert it had used to set the merger price. Timothy Reed, CPA, CVA of Diversified Medical Management (division of McCrory & McDowell, LLC;

Pittsburgh) used a discounted cash flow analysis that: (1) accepted the reading and management fees as proper expenses of the company; (2) attributed “no value” to the company’s known expansion plans; and (3) tax-affected its earnings as if it were a C Corp rather than an S Corp. Applying “high” discount rates of 21.4% and 22.4% to the two MRI centers, Reed came to a value of \$6.8 million for the company, or \$17,039 per share.

For the Kessler (minority) Group, John Mitchell, CPA, CVA (Gocial Gerstein, LLC; Jenkintown, PA) also relied on a DCF analysis. But Mitchell: (1) reduced excessive management fees and treated the majority of reading fees as profit to the company rather than expenses to the MRI centers; (2) included an estimate of the two proposed new centers (without estimating the fifth and most speculative); and (3) did not tax affect the company’s earnings at all. Mitchell also used a lower discount rate to arrive at a value of \$26.4 million for the company, or \$66,074 per share. The Court reviewed each element as follows:

1. *Reading and management fees.* As part of its plan to cut the minority shareholders from the company, the majority had cut them from MRI read fees by paying fees in the range of 15%-20% of revenues to another group. Although the majority tried to argue that this range represented fair market value, the Court ultimately looked to Medicare reimbursement rates for MRI services, finding fees closer to 13.7%. (Note to health care analysts: The Court called the “objective” Medicare data “the more reliable evidence of a market rate in the record, which is premised on what is paid by one of the most important market payers in American health care.”)

As to the management fees, the Court also found that the majority had acted unfairly to the minority interests, and reduced the 2% fees by half.

2. *Should the merger price have included the company’s expansion plans?* The Court found it “abundantly clear” that the “operative reality” of the company included plans to expand from two to four MRI centers. More difficult was whether it could attribute any non-speculative value to the fifth center, which at the time of the merger was mostly in the “idea” stage, but was nevertheless an element of the company’s overall strategy to “go statewide.” The question was clouded by the majority stockholders’ “resistance” to discovery about the fifth center, which left the Vice Chancellor “harboring serious doubts” about the bona fides of its document production, but few doubts about including some value for the fifth center in its ultimate conclusion.

More troublesome still was the majority expert’s complete exclusion of all three projected centers from his valuation report, testifying that it was his “fundamental belief” that the projections were not relevant if the entities hadn’t opened their doors by the merger. “It never really occurred to [him] that there was any value there at all,” the Court quotes him as saying, and adds, “if that is true, [he] has a jarringly novel view of corporate finance, in which the value of McDonald’s does not include the revenues it expects to make from the new franchises it will open.”

3. *Is it appropriate to tax affect the earnings of the S Corp?* In treating the company as if it were a C Corp, the majority’s expert made the “standard move” of applying a 40% corporate tax rate to its earnings. The problem: There was absolutely no evidence that the small but highly profitable company would ever convert to a C Corp. Its shareholders—all in premium tax brackets—placed a substantial value on the company’s tax status as an S Corp. The merger had deprived them of these benefits; and the majority’s valuation approach “denied [them] the value they would have received as continuing S Corp stockholders,” ensuring the merger price was lower than fair value.

By contrast, in relying on the “operative reality” of the S Corp company, the minority expert did not tax affect its earnings as a going concern. However, this approach overstated the value of the S Corp at the stockholder level, as upon its sale an S Corp receives no premium over a C Corp from “a universe” of C Corp buyers, and a market-based analysis using C Corporation comparables is misleading. “In other words,” the Court

explained, “I am not trying to quantify the value at which [the company] would sell to a C corporation; I am trying to quantify [its] value. . . as a going concern with an S corporation structure.”

Treatise on tax affecting

To capture the precise advantage of the S Corp to the minority shareholders, the Court considered the difference between the value that a minority member would receive if the company was a C Corp, and the value received as an S Corp. In its undertaking, the Court “embraced” the leading Tax Court cases (*Gross*, *Heck* and *Adams*), which have “given life to the advantages of S corporation status by refusing to tax affect the... earnings at all.” It also relied on the factual realities to depart from precedent:

My difference with these prior decisions is at the level of implementation rather than at the level of principle. Certainly, in this context when minority stockholders have been forcibly denied the future benefits of S corporation status, they should receive compensation for those expected benefits and not an artificially discounted value that disregards the favorable tax treatment...But the minority should not receive more than a fair S corporation valuation. Refusing to tax affect at all produces such a windfall...The amount that should be the basis for an appraisal or entire fairness award is the amount that estimates the company’s value to the [minority] as S corporation stockholders paying individual income taxes at the highest rates—an amount that is materially more...than if the [company] were a C corporation.

To accurately capture this value, the Vice Chancellor estimated what an equivalent, hypothetical “pre-dividend” S corporation tax rate would be, assuming annual earnings of \$100 and highest marginal tax rates, according to this table:

	C Corp	S Corp	S Corp Valuation
Income before tax	\$100	\$100	\$100
Corporate tax rate	40%	--	29.4%
Available earnings	\$60	\$100	\$70.60
Dividend/personal income tax rate	15%	40%	15%
Total, post-tax distributions	\$51	\$60	\$60

This calculation allowed the Court to treat the S corporation shareholder as receiving the full benefit of untaxed dividends by equating its after-tax return to the after-tax dividend to a C corporation shareholder. “I will therefore apply an effective tax rate of 29.4% to the earnings of Delaware Radiology to measure with the greatest practicable precision the fair value of the [minority’s] interest in the going concern value.”

Court performs its own DCF analysis—with a last word for analysts

Having determined the major inputs to a DCF analysis, the Court proceeded to compute its own, noting additional facts that influenced its approach as well as the more influential texts (such as Shannon Pratt’s *Valuing a Business*, 4th Ed., 2000). In its detailed and thorough calculations, including the “challenges” of

computing a “proper” weighted average cost of capital, the Court also considered the two expert valuations in the case, using only those portions which were “credible and well-grounded in finance and fact.”

The Court’s independent analysis forms the last of essential reading of this case, which concludes with a \$13.3 million valuation for the company, or a per-share value of \$33,232; and a finding that the merger was unfair. Of equal import is the Court’s ultimate conclusion regarding the “value” of the two appraisals.

In finding the minority’s expert more credible, the Vice Chancellor praised him for approaching his task “in a conservative and restrained manner that, although still reflecting a desire to advance his clients’ objectives, reasonably took into account factors limiting the value” of their company. By contrast, the majority’s expert:

...seemed more aggressively driven by his goal of reducing what the [majority] would be ordered to pay. Moreover, [he] was given his marching orders in his work before and after the merger that led him to undervalue [the company]. . . Put simply, this did not instill confidence in me. . . [His] knowledge of the relevant facts regarding [the company] seemed unduly constrained by his clients, and his blinkered view of the business impaired his ability to reach a reasoned determination of value.

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