

Chancery Court Refuses to Review Binding Third-Party Valuation

By **Robert B. Little** and **Mark Jackson**

The Delaware Court of Chancery recently issued an opinion that offers useful guidance for parties wishing to include a binding third-party valuation feature in an agreement. In *PECO Logistics v. Walnut Investment Partners*, C.A. No. 9978-CB (Del. Ch. Dec. 30, 2015), the court refused to review an independent valuation firm's valuation of a business where the agreement provided that such determination would be binding. The decision reaffirms the court's general deference to the contractual choices of sophisticated parties and offers a road map for practitioners to reduce potential disputes over third-party valuations in a variety of contexts, including purchase price adjustments in merger and acquisition agreements.

The dispute in *PECO Logistics* arose when Walnut Investment Partners L.P. and Walnut Private Equity Fund L.P. (together, the Walnut investors) exercised a voluntary right (the put right) to sell their preferred units in PECO Logistics LLC to the company pursuant to the company's LLC agreement.

The LLC agreement detailed the procedures for exercising the put right. Upon receiving a written exercise notice of the put right, the company was required to engage "a nationally recognized valuation firm" to value

the company. The valuation firm had to determine the fair market value of the company's assets and apply a collar to that amount. The collar set the upper and lower bounds of the valuation based on certain earnings multiples and was calculated based on year-end financial information. Once the collar was applied, the valuation firm had to reduce the valuation by the company's outstanding obligations and liabilities. While the LLC agreement provided a specific date for calculating the collar, it gave no parameters for calculating the company's assets or obligations and liabilities. Finally, the total value of the company was allocated to each preferred unit. The valuation firm's determination was binding on the parties, and the LLC agreement did not provide for any form of review for this determination.

The Walnut investors submitted an exercise notice for their put right in May 2014, pursuant to which they claimed to "reserve their rights," including rights to participate in the valuation process and to object to the valuation firm's determination. These rights did not appear in the LLC agreement. After discussing potential conflicts, the company's board of managers, in conjunction with company management, chose Duff & Phelps Corp. as the valuation firm. When applying the collar,



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Duff & Phelps used year-end financial information. But when valuing the company's assets, obligations and liabilities, the valuation firm used the latest financial information available, from June. After accounting for these adjustments, including the company's long-term debt, the company's valuation dropped from \$275 million to \$93 million.

The Walnut investors disagreed with the valuation and refused to tender their preferred units to the company. When the company brought suit to compel tender, the Walnut investors counterclaimed that the reservation of rights in their exercise notice had amended the LLC agreement after the

company proceeded without noting any objections. Further, the Walnut investors claimed the company had breached the implied covenant of good faith and fair dealing.

The court rejected the Walnut investors' claims and granted judgment on the pleadings against them. Their decision to make the valuation firm's calculation binding was determinative: "When parties to a contract agree to be bound by a contractually established valuation methodology, this court will respect their right to order their affairs as they wish and refrain from second-guessing the substantive determination of value."

According to the court, the reservation of rights did not amount to an amendment as a matter of law because there was no consideration. By proceeding with the valuation process, the company was simply honoring a pre-existing obligation, which does not constitute consideration to support any modification to the LLC agreement.

Moreover, the court found that judgment on the pleadings was appropriate because there was no ambiguity in the valuation procedures in the LLC agreement, despite the fact that Duff & Phelps had to make "judgment calls" and assumptions when valuing the company. The Walnut investors argued that Duff & Phelps erred in reducing the company's value by long-term debt and in using the most recent financial information to value the company's assets, obligations and liabilities instead of the year-end information used for the collar. The court noted that Duff & Phelps' choice of the most recently available financial information was not "irrational on its

face" and, regarding the collar, "the parties were free to pick whatever metric they wished."

In addressing the implied covenant of good faith and fair dealing, the court stressed that the Walnut investors did not allege that Duff & Phelps was not independent, nor did they allege that the company tainted the valuation process. Instead, the Walnut investors made two arguments: First, that the use of the most recent financial information to value the company was unauthorized by the LLC agreement, and second, that it was "unreasonable and arbitrary" for the company to "pile on debt." The court responded that "a decision to select one (even the lesser) of two admittedly reasonable options available under the LLC agreement does not, by definition, constitute arbitrary or unreasonable conduct." Additionally, there was no indication that the company's debt did not serve a legitimate business purpose.

PECO Logistics confirms that Delaware courts will generally respect a binding third-party valuation. If the parties want the firm's valuation to be binding and not subject to review, they should so state unambiguously, avoiding language, for example, stating that the firm is functioning as an expert and not an arbitrator, which could be interpreted as bestowing less than final authority on the matter. To avoid ambiguities, the parties should expressly state that the valuation is "final, binding on and not appealable by the parties." If the parties desire for the valuation to be subject to any kind of review process, they must so specify, and they should describe whether any deference in such review should be

granted to the determination of the valuation firm (such as deferring to its valuation absent fraud or a clear mathematical error) or whether such review can re-open all issues. The case is also instructive for what factors will protect such a valuation if it is challenged. The independence of the valuation firm was crucial, as was the reasonableness of the firm's choices. At the same time, parties should carefully consider any valuation methodology to ensure it meets their expectations. Otherwise, they may not have any recourse in the event of an unfavorable valuation.

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