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Page printed from: *New York Law Journal*

Treatment of Deal-Related 'Synergy' Takes Center Stage

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May 18, 2015

The U.S. economy is back; well kind-of. While we're not talking about the expansion witnessed through 1998-1999, the U.S. economy is gaining momentum after a prolonged slow recovery from the 2007 economic recession. This economic growth has triggered an increase in both merger and acquisition (M&A) activity and litigation. With companies paying premiums for synergies, the treatment of these synergies in valuations in the litigation context has raised interesting questions. This article summarizes the current state of the U.S. economy and discusses its impact on M&A and litigation activity, as well as provides insight into the treatment of deal-related synergies in the fair market value and/or fair value setting.

The economic growth in the United States can be seen through increases in the gross domestic product in 2014 and into 2015. According to the Livingston Survey, real GDP grew at an approximate 3.1 percent rate in the second half of 2014 and was projected to grow at a 2.9 percent rate in the first half of 2015 and 2.7 percent in the second half of 2015. Additionally, the Livingston Survey provided that real GDP grew by 2.3 percent in 2013 and was projected to grow by 3.0 percent in 2014 and 2.8 percent in 2016. This is a significantly more positive outlook than the earlier post-recession years of 2010 and 2011.

The economic recovery has also been evident in the U.S. stock markets. The S&P 500, Dow Jones Industrial Average and NASDAQ indices have surpassed pre-recessionary levels and continue to establish new highs. This indicates that equity valuations are on the rise, making acquisition targets ever more attractive.

The strengthening economy has also triggered an increase in M&A activity. The reasons are twofold. First, companies shied away from making large acquisitions after 2007, as the recession was damaging at almost every level of the economy, and as a result, companies and investors alike were either unable to invest or were extremely cautious about investing. Bad balance sheets were the norm, and plenty of companies failed during this timeframe. This resulted in a significant amount of cash sitting on the sidelines, waiting for economic stability and more sound investment opportunities to arise. It appears from the recent uptick in M&A activity that this cash is finally being put to use. Second, the markets have seen a loosening of credit restrictions that were implemented by banks and regulators following the

real estate meltdown and subsequent economic recession that began in 2007. Outside the traditional lending areas, investors were not willing to take on certain levels of risk until the economy stabilized. So we have large amounts of investable cash, coupled with increasing availability of credit, concurrent with economic growth and increasing equity valuations. This indicates that the time is ripe for the deployment of this capital in the M&A space. There is some concern that the peak of opportunity may have already passed, due to the strong finish of 2014 and strong start of 2015. Nonetheless, we expect robust deal volume to continue in 2015.

At Marcum, throughout 2014 and continuing in 2015, we are seeing an increase in advisory-related activity, especially with respect to small- to mid-size companies. Due diligence engagements saw a spike in 2014, and we are seeing this trend continue in the first half of 2015. M&A activity has also increased, and we found ourselves at the deal-table more often in 2014 and early 2015 than the last five years combined. One thing that we gleaned from our experience is that sellers, typically due to the inability to unload investments through the economic recession and slow recovery, are more willing to exit investments at lower valuations. Also, on the buy-side, while we are seeing a willingness to acquire companies and service lines and a willingness to pay up for synergies, we are finding that buyers' thriftiness in deal making typically rules the day. We expect an increase in cautious investing to continue through 2015.

Another area where there has been increased activity has been in the litigation space. According to Alix Partners,[1] there was an overall increase in corporate litigation activity in the United States and Europe in 2014. The primary areas of litigation activity have been in contract disputes, intellectual property and the class action space.

At Marcum we have also seen an increase in litigation activity over the recessionary and post-recessionary periods leading up to 2015. Particularly, owner disputes have been on the rise, and with the increase in M&A activity discussed above, exit events have caused a flurry of shareholder dissent litigation.

This brings up an interesting issue. Valuations have been contested in these litigations. Most states employ either a fair market value or fair value standard for the valuation of business interests in the context of corporate litigation. Fair market value is typically defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[2] Fair value is typically state-specific and usually results in a standard of value that is similar to that of fair market value (discounts and other items may be different than those under the fair market value standard). However, under the fair market value standard, "synergistic value," or the value of an investment to a particular buyer who can increase the value of a particular investment, either by increasing revenues or cutting costs (or a combination of both), that would not be experienced by other market participants, is usually not included in valuations. With the increase in M&A activity and buyers making strategic acquisitions and paying premiums for synergies, how should these synergies be treated in the context of fair market value, or fair value, in the litigation setting?

Well, as in the case with most valuation issues, the answer is not a prevalent one, applicable to all cases at all times, but rather should be analyzed on a case-by-case, facts-by-facts, basis. For instance, if you have a situation where there is an actual transaction, between

unrelated third parties, and this transaction and the terms thereof were known or knowable as of a valuation date, it will be difficult for a trier of fact to ignore the actual proceeds received by a company via a transaction due to the existence of any synergies that may exist in that transaction. Let us not forget that an arm's length transaction within a company's own stock, between unrelated third parties, typically is most indicative of the value of that company.

On the contrary, as discussed in the recent AriZona Iced Tea dissolution case,[3] the mere existence of offers to purchase a company, or letters of intent to purchase a company (synergies included), would not provide a reliable indication of the market value of such an entity if those deals never closed. Per the court:

Nor can the court determine AriZona's value based on the expressions of interest in the company from other entities such as Tata and Nestle, much less the assessment of the investment bankers at Merrill Lynch, Rabo or Morgan Stanley. Indeed, neither Tata nor Nestle received anywhere near the voluminous documents and information that are requisite to the rigorous due diligence process that typically preceded transactions of this magnitude.

The existence of synergies was part of the fact pattern in the two examples cited above. In the absence of any transactions or letters of intent, we would not expect an analyst to consider synergies under a litigation-based standard of value when arriving at a valuation opinion.

The two examples offer widely differing situations regarding valuations involving synergistic transactions. Therefore, it is critical that the analyst examine the facts and circumstances surrounding each case in order to provide a reliable indication of value.

The economic recovery in the United States has fueled strong M&A activity, with synergies being one of the main reasons for acquisitions. The economic recovery has resulted in an increase in litigation given the acceptability of the cost to litigate and potentially higher damages associated with it. The need to address synergies in the context of the fair market value or fair value standards is being dealt with seriously in the valuation community as well as in the courts and other judicial venues. Experts must understand the factors affecting each individual transaction, or lack thereof, in preparing valuation for a litigation in order to be able to assess the impact of the synergies within these standards of value. As the economy continues to grow, we expect valuation synergies to continue to be a hotly contested subject.

Endnotes:

1. Alix Partners 2014 Litigation and Corporate Compliance Survey.

2. IRS Revenue Ruling 59-60

3. John M. Ferolito and JMF Investments Holdings, Plaintiffs, against, Arizona Beverages USA LLC, AZ National Distributors, Arizona Beverage Company, Arizona International, Defendants.

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