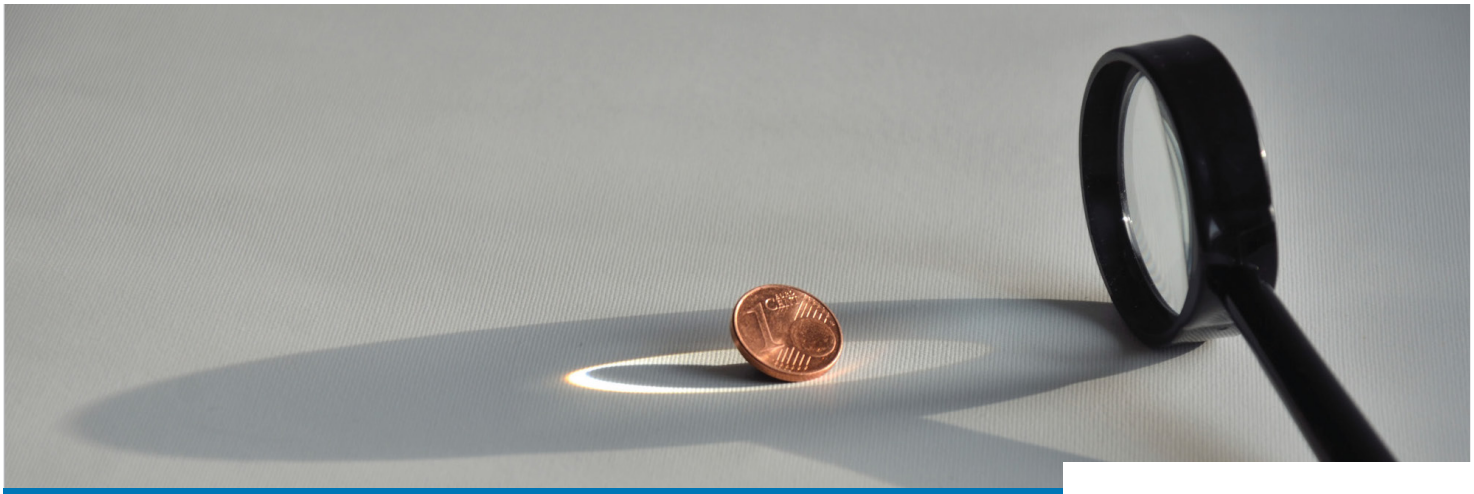

Private Equity Disputes Through An Expert's Lens

Private equity ("PE") refers to investments in shares of companies that are not publicly traded. PE investments are commonly perceived by investors as an alternative to conventional asset classes (such as public equity, fixed income and cash). PE investors and PE funds typically provide financing by purchasing controlling or minority shareholdings in a private company or buying out public companies, which results in their delisting.

Recent global events including the COVID-19 pandemic and conflict in Ukraine have had (and will likely continue to have) macroeconomic repercussions. These may result in investments underperforming against expectations or being distressed, which is often exacerbated in PE investments given the high levels of debt used to fund these investments and limited timelines for generating returns. These factors may, in turn, lead to an increase in PE disputes.

In this article, we first provide a brief overview of the key stakeholders and the PE investment life cycle. We then discuss common types of disputes at each stage of the life cycle. Finally, we discuss issues based on our experience as quantum experts.

Key stakeholders and investment life cycle

PE investors typically invest in shares of privately held businesses by acquiring these shares directly, or through a PE investment firm. PE firms usually comprise several funds that own shares in multiple companies (or 'portfolio companies'). PE funds are typically structured as partnerships comprising: (1) a general partner, who is responsible for managing the fund; and (2) several limited partners, the investors who provide capital but have little influence over investment decisions.

Broadly speaking, the life cycle of a PE investment consists of the following three stages: pre-closing, postclosing and exit.

At the pre-closing stage, the potential investor performs due diligence and negotiates the terms of the acquisition with the seller of the shareholding. These terms are crystallised in share purchase agreements ("SPAs"). Among other things, SPAs set out:

— how the purchase price may be determined or subsequently adjusted based on: (1) completion accounts, which state how the purchase price may be adjusted depending on the asset and liability balance as at the acquisition date or closing (which may occur several months after signing the SPA); and (2) earnout agreements, which set out contingent payments that the seller receives from the buyer if specific performance targets are met;

— the obligations of the purchaser and seller prior to closing; and

— warranties made by the seller about the financial and operational state of the company.

At the post-closing stage, the investor has acquired the shareholding. Their relationship with the company and its other shareholders is governed by the company's articles of association and shareholders' agreements. Where investments are made indirectly via a PE firm, the investor would have an agreement with the PE firm. These agreements set out, among other things, the investment mandate of the specific PE fund in question and the fees payable to the PE firm in return for its management of the investments.1[1]

At the exit stage, PE investors seek to realise returns on their investments by selling their shareholding. This stage is important – PE investors' primary objective is to realise returns on their investments. PE exits are typically achieved by listing the company on the public market (eg, via an initial public offering ("IPO") or selling the stake to another financial or strategic investor. These sales can take several forms, such as:

— a straightforward sale to another buyer;

— the exercise of a put option (that is, an option to sell the investment in question a an agreed price on or before a specific date or event);

— the exercise of 'tag-along' rights, which, in the event of a sale of the majority shareholding, grant minority shareholders the right to sell their shareholding to the buyers at a stipulated price; and

— the exercise of 'drag-along' rights, which, in the event of a sale of the majority shareholding, grant the buyer the right to purchase the remaining minority shareholdings at a stipulated price.

Realised returns may differ significantly from the aspired returns targeted by the PE investor. While the former depends on the actual performance of the investment, the latter depends on ex ante expectations of the investment's prospects and risks.

PE disputes can arise in relation to each stage of the investment life cycle. Based on our experience, we discuss below the common types of disputes that relate to each stage of the investment life cycle.

Types of disputes

Pre-closing disputes

Pre-closing disputes can arise from disagreements about the appropriate purchase price of the shareholding in question. Where the final purchase price may be affected by completion accounts or earnout arrangements, disputes may arise about how these accounts or agreements should be prepared or interpreted when calculating the final purchase price. In such disputes, accounting or valuation experts may be instructed to assess the purchase price based on their interpretation of these agreements, in accordance with the accounting principles specified in the SPA.

Post-closing disputes

Post-closing disputes may arise from alleged warranty breaches (discovered after closing) or disagreements between the PE investor and (1) other shareholders of the firm or (2) the PE firm responsible for managing the investment in question. Below, we discuss three types of post-closing disputes, arising from alleged warranty breaches; claims of minority shareholder oppression; and breaches in investment mandates agreed between PE investors and PE firms.

Breach of warranty

SPAs typically contain warranties made by the seller about the financial, operational and legal position of the subject company. Breaches of these warranties can arise for a variety of reasons, including where:

— the accounting information on which the purchase price was based is not reliable;

— the subject company has not completely or correctly disclosed its liabilities;

— the subject company does not have undisputed ownership of significant assets or properties as warranted;

— the condition of material assets is significantly poorer than as warranted; and

— the subject company has concealed fraudulent activities.

Where warranty breaches have been alleged, valuation experts may be instructed to assess the loss arising from these breaches. The relevant measure of loss is usually the ex ante difference between the value of the purchased shares in two financial positions at closing:

— the 'as warranted' position, being the state that the subject company was warranted to be in; and

— the 'as is' (or 'as was') position, being the true state of the subject company at closing.

Minority oppression

As we understand it, claims of minority oppression usually arise when minority investors in a company have suffered harm due to the actions of controlling shareholders that are 'unfair' (or illegal). Whether an action is both harmful and unfair or illegal is ultimately a matter for courts and tribunals. In our experience, actions that have been found to be unfairly prejudicial include:

— serious mismanagement of the company;

— misuse of company funds;

— paying excessive remuneration to directors; and

— deliberate actions to devalue the minority shareholding.

A remedy to unfairly prejudiced minority shareholders, which courts or tribunals may order, is for the controlling shareholders to purchase the shares of those minority shareholders at an appropriate price. This price is typically determined by a valuation expert.

Investment mandate disputest

Investment mandates govern how PE funds should invest the monies of their investors (ie, the limited partners). These mandates may impose a variety of restrictions on the investments a PE fund can make. These include restrictions on industry or sector, geographical location and level of risk.

In disputes arising from alleged breaches in investment mandates, investment management experts and forensic accounting experts may be appointed to: (1) assist the court with determining whether there was, in fact, a breach in the investment mandate as alleged; and (2) assess any damage that may have arisen from the alleged breach.

Exit disputes

Exit disputes may arise when a PE investor exits their investment by choice or compulsion. We focus on two types of exit mechanisms.

The first exit mechanism is where shareholders' agreements between the investor and controlling shareholder give the investor the right to exit by selling their shareholding at a stipulated price (ie, via a put option) if certain conditions are not fulfilled. In our experience, put options may be triggered for a variety of reasons. These include where the company:

— does not achieve an alternative form of exit for investors (eg, IPO) within a certain time period;

— fails to make certain investments into the business as promised; and

— does not achieve a certain level of financial performance or target valuation.

Disputes relating to put option mechanisms may arise for a variety of reasons including:

— questions around the enforceability of the mechanism;

— whether conditions that would have triggered the put option agreement have been met; or

— ambiguity about how the stipulated price payable to the PE investor should be calculated.

The second exit mechanism is where minority PE investors are forced to exit their investment (ie, squeezed out) by other (controlling) shareholders. Squeeze-outs may be legal (eg, the exercise of drag-along rights set out in shareholders' agreements) or illegal. Disputes may arise where elements of a squeeze-out are considered illegal by the minority shareholder.

In both categories of disputes, courts or tribunals may require expert assistance with the valuation of the shareholding to be sold or transferred on exit. One example would be if the stipulated price under the put option agreement depends on an assessment of the shareholding's market value.

Expert-related issues

Below, we discuss a number of issues we have encountered in our role as quantum experts. These can be broadly categorised into: (1) accounting issues; (2) valuation issues; and (3) investment management issues. While these issues have implications on the work of the appointed expert, some may originate from questions of law and fact. When discussing these issues, we refer (where available) to public judgments or awards, some of which may not relate directly to PE investments but are nonetheless illustrative of the issues.

Accounting issues

Disagreements may arise about the appropriate interpretation of accounting principles or the calculation of financial metrics. These questions may arise in the context of purchase price disputes, breaches of warranties or where lost profits need to be calculated (eg, when assessing losses arising from a breach in investment mandates).

Where completion accounts determine the final purchase price based on the balance sheet of the company at a stipulated date (such as closing), disagreements may arise as to how certain items should be accounted for on a balance sheet. For example, disagreements may arise about how certain assets or liabilities should be accounted for or calculated. This may in turn depend on the appropriate accounting standard or principles which apply. Ideally, such standards or principles will have been clearly stipulated in the SPA, with references to specific accounting policies to be used when preparing the completion accounts. However, if there is any ambiguity in their written expression, this may result in additional complexity in the accounting expert's opinion.

Where earnout accounts determine the final purchase price based on the financial performance of the company in question, disagreements may arise as to the appropriate method of calculating the relevant financial metric (such as earnings before interest, depreciation and amortisation ("EBITDA"). For example, disagreements may arise about which costs or items should be deducted when calculating the reference EBITDA used to assess the amount of contingent payment due to the seller (eg, the SPA may stipulate that items deemed 'exceptional' in nature should not be deducted).

Where it is alleged that the accounting information on which the purchase price was based is not reliable (thereby resulting in a breach of warranty), accounting experts may be asked to assess whether the presentation of such accounting information is in line with the relevant accounting standards. Accounting experts may also comment on whether any errors in the accounting information presented are material (which in itself is an expert issue). When doing so, experts may rely on various benchmarks for materiality including materiality thresholds set out in guidelines for auditors and accountant, and materiality thresholds for claims that are stipulated in the SPA.

Where lost profits arising from alleged breaches in investment mandates have to be assessed, a forensic accounting expert may be appointed to calculate the profits generated from: the actual investment portfolio (which may not comply with the mandate); and a 'benchmark' portfolio that complied with the mandate. The calculation of profits from an investment profile may, in principle, be straightforward. However, there may be practical difficulties with understanding numerous and seemingly disparate fund documents over the period of loss (such as investment reports and statements of balance) when calculating the investor's profits.

Valuation issues

Questions of value may arise where warranty breaches have been alleged, minority shareholders claim they have been unfairly prejudiced or PE investors do not agree with the price they are being paid at exit. Below, we discuss a number of valuation-related issues that can be relevant in PE disputes.

Date of assessment and hindsight

The correct assessment date is a legal issue that may depend on the facts of the case. In our experience, this is one of the first issues discussed between a valuation expert and instructing counsel. This is because the date of assessment has a direct effect on the factual matrix that should be considered in any valuation.

In principle, the value of shares in a company at a particular date depends on contemporaneous expectations of the company's prospects and risks. However, in practice, there may be little contemporaneous evidence about these expectations and courts or tribunals may, depending on the specific facts and circumstances of the case, allow the use of hindsight.[2]

In many situations damages are assessed as at the date of assessment (without the benefit of hindsight). However, this is not true in every case, and courts and tribunals take into account subsequent events when they deem it appropriate to do so. In some instances, this can occur in breach of warranty disputes. Ordinarily, losses in such cases are assessed at the date of breach, without the benefit of hindsight. However, for practical purposes sometimes hindsight can be brought to bear in assessing losses.

There is likely to be sufficient contemporaneous information about the prospects and risks of the subject company in the 'as warranted' position (which would have been used to inform the purchase price).

However, in the absence of contemporaneous information about the 'as is' position (such as reliable forecasts), quantum experts may, under some circumstances, find it necessary to rely on the subject company's actual experience since closing, as a proxy for what might have been expected at closing. For example, with the benefit of hindsight it might be shown that warranty breaches have increased future costs of the subject company by US$100 million per year. When assessing the 'as is' position, the expert may take these cash outflows into account as a proxy for what might have been anticipated at closing, had the true state of the business been known.

Basis of valuation

There are several bases on which valuation experts can be instructed to value a shareholding. Some of these are terms of art defined in international valuation standards, some are specified in shareholders' agreements and others may be defined by courts and tribunals based on the specific facts of the dispute.

One common term of art with which most valuation experts are familiar is 'market value', as defined by the International Valuation Standards Council.[2] From an expert's perspective, market value is an objective measure of the value of an asset, which is independent of the identity or circumstances of the actual buyers and sellers.

In contrast, a valuation expert may be instructed to consider the specific circumstances of the buyer or seller of the shareholding in question. For example, in Byers & Ors v Samba Financial Group (2021),[3] the English High Court discussed, in principle, how the right basis of value should be determined:

> I do not accept that market value is automatically the appropriate basis of value [...] the purpose of the valuation must be borne in mind and, subject to that any assumptions explicitly required, there is a valuation judgment to be made about the right basis of value. [...] The reason why market value will not always be the right basis of value is that it excludes special circumstances or any element of value available only to a specific owner or purchaser, and excludes from the applicable market those with a special interest in purchasing. To use a commonplace example, 'marriage value', or 'synergistic value' is sometimes released when two assets in different ownership are brought together. This often arises with two parcels of land or different interests in a single parcel, which together enable a valuable development to be carried out; or with shareholdings that individually are minority holdings with no control but together may give a single holder control of the company in general meeting or a 75% share of the votes. The two parcels or holdings together are worth more (by the amount of the marriage value) than the sum of the individual parts. Thus, land or a shareholding might have special value to one buyer.[4]

The valuation basis has important implications for the valuation exercise. It is related to the issue of minority discounts (discussed further below), which is particularly relevant to matters where minority oppression has been alleged. As shown in the hypothetical example used by the English High Court above, the value of a minority shareholding may differ depending on whether it is considered (1) in isolation or (2) in the hands of a buyer who is able to combine this shareholding with another and gain control of the company. The minority discount applicable to this shareholding will likely be higher in (1) than (2).

Valuation approaches

Several valuation approaches can be used to value the entire share capital of a company. These include:

- by reference to transactions or proposed transactions in shares of the subject company;
- discounted cash flow ("DCF") analysis;
- by reference to transactions in shares of comparable companies; and
- by reference to the net asset value of a company recorded in its financial accounts.
- When selecting the appropriate approach to apply, valuation experts typically have regard for whether:
- there are recent transactions in shares of the subject company that have occurred at arm's length – if so, these are often a reliable guide to the company's value because they reflect the view of actual buyers and sellers;
- sufficient information is available to reliably forecast the future cash flows of the subject company – if so a DCF analysis may be appropriate;

— there are observable transactions in suitably comparable companies – typically, comparable companies are those faced with similar prospects and risks; and

— the accounts of the subject company properly reflect the net value that can be realised from selling the business – if so, a net asset valuation may be appropriate.

Valuation experts may rely on more than one approach and present their assessment as a range. The expert may explain on which approach they place the most reliance and, consequently, the part of the range they consider to be most appropriate. When presented with differing evidence from opposing experts about the appropriate approach to adopt and the inputs to these approaches, the court or tribunal will typically make a finding on the appropriate weight to be given to each approach, given the specific facts of the case.

For example, in Re Nord Anglia Education, Inc (a matter in which minority shareholders dissented against the price offered in a take-private transaction, under section 238 of the Cayman Islands Companies Act), the court found that the fair value of company should be calculated by assigning weights of: (1) 60 per cent to the price offered in the take-private transaction; and (2) 40 per cent to the value calculated using a DCF analysis. Based on the specific facts of the case, the judge commented: "I have adopted a blended approach which was not proposed by either Expert because I found that the Transaction Price and, to a lesser but significant extent, a DCF valuation provided more reliable indications of the fair value of the Shares than [the trading price of publicly listed shares in the company]."[5]

Minority discounts

Where the shareholding in question (such as in cases involving minority oppression) is a minority shareholding, discounts may be applied to its pro rata value to account for these shareholdings[6] being generally less liquid or marketable and conferring limited (if any) control or influence over the company. Given these characteristics, valuation experts often value minority shareholdings by reference to two discounts (both of which are expressed by reference to the pro rata value of the share capital):

— a discount for lack of marketability ("DLOM"); and

— a discount for lack of control or influence ("DLOC").[7]The DLOM relates to difficulties with selling or converting the minority shareholding into cash quickly. The DLOC relates to factors such as the minority shareholder's lack of influence over business operations, strategy and financial policy (eg, the paying of dividends), lack of access to information on the business and risk of being unfairly prejudiced without relief.The two discounts above are different but related. Control, for example, gives the opportunity to pay a dividend or sell the business. This potentially remedies a lack of marketability. Accordingly, some valuation experts prefer to assess the overall discount to apply rather than assessing the DLOC and DLOM separately.There are several reference points for minority discounts, and experts typically refer to one or more of the following:

— available transactions in minority interests;

— custom and practice, as set out in valuation literature and guidance from tax authorities;[8]

— studies of discounts observed from transactions in restricted stocks that cannot be sold for a short period of time;

— pre-IPO studies that measure the direct and indirect costs of attaining liquidity through an IPO; and

— option pricing models that estimate the cost of obtaining an option to sell the shareholding in question.[9]

Ultimately, estimating the appropriate minority discount is a subjective exercise that depends on the facts and circumstances relating to the subject shareholding. Therefore, while most experts agree that a discount should be applied when valuing a minority shareholding, there is less consensus about the size of the discount. Consequently, valuation experts appointed by opposing parties may arrive at valuations of the same shareholding that differ significantly, primarily because they have applied different minority discounts.

For instance, in Wright v Rowland & Anor (2017)[10], the claimant claimed that he had a contractual right to purchase up to 5 per cent of the shares in Banque Havilland SA (a private company) at a fixed price. When quantifying this claim, the claimant's expert applied a DLOM of 30 to 40 per cent to the pro rata value of a 5 per cent shareholding in Banque Havilland SA, whereas the defendants' expert applied a higher DLOM of 60 to 70 per cent. Given the facts of the case, the court found that a DLOM of 30 to 40 per cent was applicable and agreed with the claimant's expert's reliance on restricted stock and pre-IPO studies.

Investment management issues

Questions of investment management expertise may arise when there is a breach in the investment mandate. In these circumstances, a court or tribunal can be guided by evidence from an expert in investment management. Among other issues, the expert may assist by assessing, based on the investment mandate: the risk profile of the actual portfolio; whether certain positions are over (or under) concentrated (eg, whether an excessively high (or low) proportion of the portfolio is invested in any individual company); and the suitability of the investments in question.

Investment management experts may also be asked to opine on an appropriate counterfactual 'benchmark' portfolio that would most closely resemble an appropriate portfolio that complies with the investment mandate. This benchmark portfolio may then be used by an accounting expert when calculating the counterfactual profits of the fund in question.

Conclusion

In this article, we have outlined a number of expertrelated issues that we have encountered in PE disputes. The appropriate approach to considering these issues is often subjective and dependent on the specific facts and circumstances of the case. While some of these issues originate from questions of law or fact (eg, the appropriate assessment date or valuation basis), these may have important implications on a quantum expert's assessment and conclusions.

Accounting, valuation and investment management are overlapping fields. This means that an expert may be able to assist the court or tribunal with expert issues from multiple fields. Ultimately, the appropriate expert to appoint to address a particular issue will depend on their specific expertise and professional experience.

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Endnotes

[1] In this article, we focus on financial private equity (PE) investors. These differ from strategic investors. While financial investors are primarily concerned with the financial returns generated on their investment, strategic investors are concerned with acquiring strategic advantages (such as synergies between the target company and other companies held by them) rather than obtaining only financial returns.

[2] Contemporaneous expectations are those that do not rely on the benefit of hindsight.

[3] According to the International Valuation Standards (International Valuation Standards Council, 2020), "Market value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently, and without compulsion."

Reference: International Valuation Standards Council. (2020). International valuation standards (IVS 2020). IVSC.

[4] Byers & Ors v Samba Financial Group, [2021] EWHC 60 (Ch) (15 January 2021). England and Wales High Court (Chancery Division).

[5] In this matter, the Court ultimately decided that, given the specific facts and circumstances of the case, market value was the correct valuation basis to adopt.

[6] In the matter of Nord Anglia Education, Inc, Cause No. FSD 235 of 2017 (IKJ). Cayman Islands Grand Court (Financial Services Division).

[7] For example, a 30 per cent shareholding may be worth significantly less than 30 per cent of the value of a 100 per cent shareholding.

[8] The control or influence that a shareholder has over a company is not only dependent on the size of their shareholding. For example, a shareholder who holds 5 per cent of a company's shares may still be able to exert a degree of influence over the financial and operational decisions of the company if they serve on the board of directors.

[9] Tax authorities typically provide guidance on minority discounts, given the frequency with which minority shareholdings are transferred in taxable transactions between individuals—for example, by way of inheritance (which incurs estate tax).

[10] Wright v Rowland & Anor, [2017] EWHC 2478 (Comm) (9 October 2017). England and Wales High Court (Commercial Court).