



PECO Logistics v. Walnut Investment Partners **Beware of business valuation provisions**

A recent Delaware Court of Chancery case demonstrates how courts give substantial weight to business valuation provisions in owners' agreements, especially when the experts maintain their independence and follow the terms of these agreements. Here are the details of how some minority investors were forced to sell their units after exercising a put option, even though the investors objected to the purchase price determined under an owners' agreement.

Business Valuation provisions of LLC agreement

In 2011, two minority investors acquired preferred equity units in PECO Logistics, a limited liability company (LLC). The company's sole asset was an interest in a pallet rental company. The investors became parties to an LLC agreement, granting them a voluntary "put option" to sell their preferred units back to PECO Logistics over a three-year period.

If the investors exercised the put option, the LLC agreement required the company to "retain a nationally recognized valuation firm to determine the fair market value of the preferred units in accordance with a specified formula." Under the LLC agreement, the value of the investors' units would be based on the pro rata value of the entire company, expressly excluding discounts for lack of control or marketability.

Within 45 days of the completion of the valuation, the agreement required the company to repurchase the preferred units at the appraised value. The LLC agreement also stated that both the company and the investors "shall be bound by the determination" of the valuation firm. A potential shortcoming was that the LLC agreement included no mechanism that allowed the owners to review the determination of value.

Lawsuits over appraised value

In 2014, the investors exercised the put option and the board hired a nationally recognized valuation firm to value their interests. When the company attempted to repurchase their interests at the appraised value, the investors objected, and the company sued the investors for the right to purchase their units.

The investors subsequently filed counterclaims that PECO Logistics had breached the implied covenant of good faith and fair dealing. The investors also claimed that the letter of intent unilaterally "reserved their rights" to participate in the valuation process and review the determination of value.

Independence and reasonableness

The valuation expert determined a total enterprise value of approximately \$275 million, using the discounted cash flow and merger and acquisition methods. Because this value exceeded the prescribed cap under the EBITDA collar, as defined by the LLC agreement, the total enterprise value was reduced to approximately \$209 million. The total equity available for distribution to owners — after adjusting for debt, cash and cash equivalents, and hypothetical transaction, legal and accounting fees — was approximately \$93 million.

The court abstained from questioning this methodology, because:

1. The appraisal firm maintained its independence from both the company and its investors, and
2. The assumptions underlying the valuation were reasonable.

The court concluded, “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.” Accordingly, the court ordered the investors to sell their units to PECO Logistics at the appraised value.

Lessons learned

This case shows that courts typically defer to agreements that owners enter into before disputes arise. So, when drafting valuation provisions for owners’ agreements, it’s important to be detailed and comprehensive. For instance, if the parties expect to participate in the selection of a valuation firm or in the valuation process — or if they want to retain the right to review the appraised value before initiating a buyout — the agreement should specifically provide for those rights.

To help cover all the appraisal-related bases, contact a valuation professional when you’re writing or reviewing an owners’ agreement. If you wait until a dispute arises to define or test the valuation provisions, it may be too late.

Do you have a
Question?
or want to speak to

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