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Valuing a Consulting Firm After a Key Person Departure

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Article By Annamarie C. Larson
Scott E. WaxmanK&L Gates
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In a post-trial Memorandum Opinion, *Neil Smith and NTS, LLC v. Promontory Financial Group, LLC and Promontory Growth and Innovation, LLC*, C.A. No. 11255-VCG (Del. Ch. April 30, 2019), the Delaware Court of Chancery rejected both the asset accumulation and the discounted cash flow methods of valuation, instead adopting the buyout value the parties tentatively negotiated prior to the key person's departure.

Neil Smith formed the Delaware limited liability company Promontory Growth and Innovation, LLC ("PGI") with Eugene Ludwig in order to provide management consulting services to enhance earnings and business performance of financial services companies. Smith was considered an expert in the field of profit improvement and had experience at another consulting firm. Ludwig previously served as the United States Comptroller of the Currency and was considered a "rainmaker" given his extensive contacts at financial institutions.

There were two members of PGI, each with a 50% economic interest: (1) Smith, who assigned his interest to his wholly owned limited liability company, and (2) Promontory Financial Group, LLC ("Promontory"), founded by Ludwig, who served as Promontory's chief executive officer. Smith and Ludwig signed a Letter of Intent and, after failed attempts to negotiate a formal operating agreement, they agreed in writing that the Letter of Intent would serve as PGI's operating agreement.

Under the Letter of Intent, Promontory was to provide working capital advances for PGI's operating expenses and, after such advances were repaid, PGI could make distributions to its members. Other provisions in the Letter of Intent allowed PGI to make distributions less than $1M per year to Smith if certain conditions were met, and allowed Smith a non-refundable draw of $500,000 per year charged to his economic interest. By 2012, PGI owed Promontory more than $5.4M, including marketing expenses for a book Smith published.

The business of PGI was sparce, as finding the right executive at the right time was like "finding a needle in a haystack". Also, customers only required a single application of PGI's consulting services, so PGI did not generate returning customers. Nonetheless, PGI engaged two customers in 2010 for approximately $6M, and engaged Bank of America in 2011 for approximately $137M.

After the Bank of America engagement, PGI (under Smith) did not receive any new projects. Promontory's Chief Operating Officer, Alfred Moses, asked Smith about PGI's increasing debt. Smith had a strong idiosyncratic aversion to investing more capital into PGI, and he was in an illiquid position as he had recently purchased two properties in cash for $25M.

Smith proposed that Promontory write off his proportion of PGI's debt in return for reducing Smith's economic interest from 50% to 30% (the "Debt/Equity Deal"). In the email proposal, Smith valued PGI at $16.25M with himself still in place, but he conditioned the offer on advice from his tax accountant. Moses and Ludwig both agreed to the proposal. After consulting with his legal counsel, Smith backed out of the proposal. Promontory cut off the cash advances, and Smith resigned. PGI kept operating for a few more years under the other managing directors, and then ceased operations. Smith and his wholly owned company initiated this suit against Promontory and PGI.

Under the Letter of Intent, if Smith withdrew after three years from the date PGI commenced its first engagement, then Smith was entitled to receive "over a period of 5 years 50% of the then going business value of [PGI] minus [Smith's] services, the value to be decided between the parties at the time thereof." The Court was asked to determine such value.

The defendants' expert used the asset accumulation method of valuation and determined that, because PGI's liabilities exceeded the fair market value of its tangible assets, PGI's value was zero. However, the Court found this method to be inappropriate as PGI's primary assets, such as workforce and goodwill, were intangible and difficult to value, especially with the episodic nature of PGI's hunter/gatherer business model.

Smith's valuation expert used a discounted cash flow method to value PGI at $37.5M and relied on Promontory's long term projections for PGI. However, the Court found the projections unreliable, as they were created by Smith (who had no prior experience creating projections), and they were inaccurate. For example, when the 2012 projections failed to materialize, they were simply copied-and-pasted out for the following year.

Instead, the Court adopted the value of $16.25M that the parties conditionally agreed on in the Debt/Equity Deal. It was the best indicator of PGI's value because it was a near-contemporaneous agreement before Smith's withdrawal. The Court disagreed with that the value should be adjusted to account for change of control and lack of marketability, or that Smith was under duress. Smith proposed it, and Ludwig agreed to it.

Then, in order to calculate the value of PGI without Smith (as required in the Letter of Intent), the Court simply split the $16.25M in half. Both Smith and Ludwig (through Promontory) shared the economic interests of PGI 50/50, and both brought unique attributes to the table. Finally, Smith's 50% share of the PGI value without himself was further reduced by the amount he owed Promontory.

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