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Valuing **Investments** in Companies That Have **Gone Dark**

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Valuation of investor securities is a necessary process for almost all securities litigations commenced by an investor. Whether the investor seeks redress for being squeezed out of a company through insider-led schemes to conceal operations or financial information, or the investor is precluded from engaging in a corporate takeover by an intermediary such as a broker dealer, the investor will need to show what it would have been entitled to "but for" the misconduct of his defendants.

Presenting that "but for" in a manner that will convince a judge or jury is always a complex task—and all the more so when essential information is not readily available in public sources. This article will explore the proofs that an investor must develop to win a damage award accepting the investor's "but for" calculation—even when obtaining the underlying information requires unusual diligence.

The standard mechanical damage models that are accepted in various fora—courts, arbitrations, mediations, or the more exotic—have long been understood as discounted cash flow, market capitalization, the comparable methods, and the asset-based valuation method. All of these methods rely on valid and reliable inputs. Such inputs include accurate historical and current income statements and balance sheets produced by the company or comparable companies; comparable transactions (for the market capitalization technique); and operations reports identifying assets owned by the enterprise as well as comparable assets.

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History of the 'Going Dark' Phenomenon

These data inputs have been readily available for most public companies because of the SEC requirement and investor expectation that publicly traded companies will regularly file all such information for public consumption. In recent years, however—particularly since 2011—certain offshore and onshore enterprises that had raised capital on the U.S. markets stopped reporting their operations and financial reports to the SEC and public investors. Consequently, public investors found themselves in a position similar to that of a passive or minority investor squeezed out of the corporate know. For the first time public investors could no longer value positions purchased in some companies.

Accordingly, such public investors followed the path of many squeezed-out private investors and sought recourse in the courts—and, like their private market predecessors, started such actions with no ability to value what might be awarded if the court ruled in their favor. Without inputs such as current financial data and operations reports, it seems impossible to assess the value of an equity position with certainty.

Many of the public companies that had "gone dark" and not reported to the markets operate and maintain all their assets in the People's Republic of China. This phenomenon commenced in or about 2008 when Chinese companies reverse-merged through a series of wholly owned subsidiaries. Often, the mainland China-based entity was wholly owned by a Hong Kong subsidiary, which was in turn owned by subsidiary in the British Virgin Islands (BVI), which ultimately was owned by a U.S. or Cayman Island parent company. These reverse mergers enabled the Chinese subsidiary to access the U.S. capital markets and raise capital through debt or equity offerings. However, many such companies did not recognize the intense scrutiny and requirements for audit that U.S. public companies are subject to and subsequently delisted.

While some of the companies that went dark doubtless simply decided that continued communications to the U.S. markets were too difficult, others allegedly stopped reporting as part of more nefarious efforts to manipulate the U.S. share price downward in preparation for an insider-led privatization. The plan in such cases was allegedly to buy back the capital raised in U.S. markets for pennies on the dollar—or, simply to abscond with investor cash. Such apparent schemes provided an interesting testing ground for innovative valuation techniques.

Blanks to Fill in: Standard Valuation Methods

In seeking to value companies that have gone dark, the challenge is to obtain by indirect means information that will satisfy traditional valuation methods. The next section reviews the means of obtaining the information demanded by the following methods.

Comparable company methodology is a relative valuation technique used to value a company by comparing that company's valuation multiples to those of its peers with similar operations. In particular, a group of comparable companies includes companies from the same industry as the company that is being valued with similar products, customers, geography, and distribution channel. Typically, the multiples are a ratio of some valuation metric (such as equity market capitalization or enterprise value) to some financial performance metric (such as earnings/earnings per share, sales, or EBITDA). The rationale behind this methodology is that companies with similar characteristics should trade at similar multiples, holding all other variables constant.

Under a ***discounted cash flow (DCF)*** analysis, a company's worth is equal to the current value of the cash that it will generate in the future. DCF is an application of the time-value-of-money concept—the idea that money to be received or paid at some time in the future should be treated as having less value, today, than an equal amount actually received or paid today. Thus, the DCF calculation determines the value appropriate today (the present value) for the future cash flow. DCF analysis uses future cash flow projections and discounts them, most often using the weighted average cost of capital, to arrive at the present value of the company.

An ***asset-based approach*** is a business valuation method that focuses on a company's net asset value, or the fair-market value of its total assets minus its total liabilities. This approach is used where a business is not a going concern, or where a business is a going concern, but its value is tied directly to the liquidation value of its underlying assets and investments. The asset-based approach also provides a useful reasonableness check when reviewing the value conclusions derived from other valuation methods.

Collecting Data in Emerging Markets

When dealing with companies with principle operations in China or other emerging markets trading in U.S. markets, finding comparable companies and comparable transactions is a real challenge. Good comps are essential, however, to performing an adequate valuation pursuant to the market capitalization approach.[1] It is possible to investigate and discover enough information to flesh out this or other traditional damage methods and so prove the most important part of any plaintiff's case—its claimed damage award.

To do this, the investor will need to engage a diligence firm with local operations in the province, city, or county of the operational arm of the enterprise in which it invested. Working with counsel, the diligence firm should be able to identify financial and operational components of the company. Ultimately, the financial and operational data gathered should be compiled into a report, and testimony should be elicited in a hearing or trial from someone familiar with the investigation and the facts it uncovered.

Gathering reliable financial information from a non-reporting entity is often difficult. However, it is possible. An overseas company that fails to report its financial data to the U.S. markets is probably reporting to the government in the region in which its operations are ongoing. In China, for instance, corporations that have long since gone dark in the United States will file yearly financial data with the State Administration for Industry & Commerce (the SAIC) as well as tax returns. The same is true for companies with principle operations in Cayman, Hong Kong, BVI, Brazil, and many other countries. A well-connected investigator will be able to use local knowledge to obtain such financial data. Moreover, a skilled investigator with strong local ties may be able to obtain internal management accounts.

Gathering reliable operations data is likewise possible, if tedious. A strong diligence firm and investigator will work with counsel to identify the relevant governmental agencies in the place of operation in order to check their records. Again, while not reporting to the SEC, the operations arm of the entity more than likely is reporting to various governmental agencies. For instance, intellectual property is usually registered with the government, as are business registrations, licenses, and real estate filings, among other essential corporate assets.

In seeking to value companies that have gone dark, **the challenge** is to obtain by **indirect means** information that will **satisfy traditional valuation methods.**

The diligence expert and counsel should also interview suppliers, customers, vendors, and other parties with business or investment relationships to the firms to investigate their contracts and verify the financial data gathered through the mechanisms discussed herein.

In addition to operational and financial data, information about competitive companies in the same geographic region and known comparable transactions is essential to produce a reliable fair value or strategic value. Such information can sometimes be obtained from Bloomberg terminals, if the market in question and transactions within it are relatively transparent. However, in certain markets—including emerging and "dark" markets— you will again need to enlist the assistance of local experts to find and establish a marketplace of competitive enterprises and transactions of the type similar to the transaction contemplated in your "but for" world. Investment bankers working in the area are often an excellent source for this kind of information.

If you are a minority investor, the core question is: What would the market bear for other minority interest sales in a comparable industry and comparable transaction type? Once known, multiples can be generated and applied back to a particular metric. For instance, earnings from the target company can be applied to the price-to-earnings multiple generated from the list of comparable transactions, and this application may approximate a strategic value for the enterprise. Likewise, once your investigator has generated a group of comparable companies, a multiple such as price to earnings or price to revenue can be calculated and applied back against a metric from the target company to derive fair value.

At a hearing or trial on damages, your investigatory expert will have to attest to the type of business or transaction at issue, in detail, to demonstrate that they are putting forward appropriate comparable transactions or companies. The transactions are generally investigated by company size, position sold in the company, and the industry and geo-region the company competes in as compared to the target transaction. As discussed herein, the trading comparables and company comparables are generally assessed by the size, geographic location, and type of company by industry as compared to the target company.

Case Study: Valuing China Nutrifruit

An example of how such investigations may lead to a valuation upheld in U.S. courts can be found in *Schiff v. China Nutrifruit Group*,[2] a case in which the author represented the plaintiff investors in China Nutrifuit (CNGL). a Nevada corporation with operations in China. In September 2009, Euro Pacific, a broker-dealer led by Mr. Schiff, purchased a minority position in CNGL. CNGL "went dark" in mid-2012, violating the SPA by which the company was required to keep available adequate and current public information. In February 2014, Euro Pacific, Schiff and associated investors filed a complaint against CNGL in New York, seeking, inter alia, relief entitling the plaintiffs the option to "put" their shares in CNGL at fair market value. On Feb. 3, 2015, the N.Y. Supreme Court awarded the "put" option for $7.13, accepting the plaintiffs' book value and comparable company analysis. On behalf of the plaintiffs, the authors and the team of experts they assembled used the last reported financial statements to determine CNGL's last reported book value per share. The plaintiff's team also took 16 comparable companies in the same industry as CNGL, and found their average price-to-book value. They then took the average price-to-book, and multiplied that value by CNGL's last reported book value, yielding an assumed price per share of $7.13 for CNGL. The court also awarded $1,000,000 in reputational damages to Euro Pacific, predicated on the economic losses caused by investor dissatisfaction and diminution of intangible assets, including goodwill.

Debunking the Attacks on Your Valuation

A party opponent will often attack your valuation. As proponent of the model, the plaintiff will need to put on significant proofs and survive aggressive cross-examination. The presentation of comparable transactions should create the impression of a robust market where the securities would in fact have been saleable. To prove the transactions are real and verifiable, the underlying documents on the transaction should be submitted through your banking expert to the extent possible.

Your opponent is likely to argue that various hurdles would have derailed your investment strategy. If the defense falls short of proving that the investment strategy was not executable, the defense will likely argue that hurdles amount to risk, and risk discounts the value of your damage model.

For example, if the plaintiff's damage model posits that the investor sought to take over the corporation and was wrongfully prevented, the defense may argue that the bylaws of the company have anti-takeover provisions that would have prevented the plaintiff from obtaining the shares required to change the composition of the boards and complete the takeover. If the corporation is an offshore entity, the takeover proponent will want to use a lawyer with expertise and licensing in that foreign jurisdiction to demonstrate that for specific reasons applicable under foreign law, the "poison pill" would not have worked as alleged to stop the takeover.

The defendant may also allege that offshore subsidiaries (such as those in the China-based foreign owned entity discussed earlier) have transferred ownership in part or whole. Of course, this would discount the value of the entity because it goes to its ownership and cash flow. Here, the proponent of the takeover and attendant damage model will need to use facts gathered through its investigator and foreign counsel to prove that the transfer did not occur—or that if it did occur, it is not enforceable.

A well-prepared plaintiff presenting a damage model will seek in advance to identify potential discount factors and call the appropriate witnesses to debunk them—e.g., a quantitative financial analyst or mathematician discussing availability of shares in the marketplace for a takeover; a market analyst demonstrating the suitability of certain investments; and/or a legal expert or financial industry specialist to discuss the conversion of American Depository Shares to ordinary shares for voting purposes.

While it may at first blush seem impossible to value companies that have failed to report and are operating in opaque markets, building an appropriate international team of professionals to assist with diligence and market building will enable persistent plaintiffs, and their lawyers, to pursue litigation that will make them whole.

1. The author has represented plaintiffs who have presented valuations of dark companies that have been accepted by courts in Delaware, Nevada and New York.

2. *Schiff v. China Nutrifruit Group*, Index No. 151540/2014 (N.Y. Sup. Ct. Feb. 3, 2015).