Litigation Facing the Private Equity Industry

By Atreya Chakraborty, Michael Weisbach, and Bin Zhou

Introduction

The spectacular leveraged buyout (LBO) boom between 2005 and early 2007 went bust soon after the start of the subprime crisis. The glamorous ascent and abrupt halt of buyout activities have brought many tactics employed by the buyout firms, old and new, under regulatory and legal scrutiny. This newsletter reviews general litigation issues facing the private equity (PE) industry and focuses on several economic and financial issues highlighted in recent litigation involving LBO activities.
There are many ways to categorize litigation risks facing the private equity industry. Here we organize them into several broad categories through the structure of a PE firm (Figure 1) and over the life cycle of an LBO transaction (Figure 2).

Figure 1 depicts the general organizational structure of a PE firm. The firm typically raises equity capital through a PE fund, which is structured as a finite-life (around ten years) limited partnership consisting of limited partners (LP) and a general partner (GP). The PE firm usually serves as the GP and manages the fund. The LPs, consisting of pensions, foundations, wealthy individuals and the like, are passive investors in the fund and are committed to providing 90 percent or more of the capital during the life of the fund. Their relationship with the GP is governed by various investment and management agreements.

Well-established firms manage several different funds, each raised at a different time and with its own LPs. Each fund could follow distinct strategies in pursuit of different objectives. Although sharing the same equity investors, each of the portfolio companies (the companies acquired by the PE fund) has its own board of directors and its unique debt financing.

The equity returns are distributed between the GP and LPs. GPs are compensated from three sources — about two percent of assets under management (management fees), about 20 percent of profits (carried interest), and certain transaction and monitoring fees.

Figure 2 illustrates the typical life cycle of a successful LBO transaction under the management of a PE fund. With an average leverage ratio of 75 percent debt in the latest boom, the fund invests $25 million to acquire a portfolio company worth $100 million. After a holding period of five years, the portfolio company is sold at $150 million. This could be achieved through an IPO of the portfolio company, a private sale to a corporate buyer, or increasingly through a secondary LBO to another fund. Paying off the debt, the private equity fund receives $75 million (three times the initial investment) for a 20 percent annualized rate of return.
Clearly, the success of an LBO transaction can depend positively on the financial leverage, holding period, and disposal prices, and negatively on the initial purchase price. A portfolio company that is unsuccessful has to be restructured, and remains longer under the PE ownership. In some cases, the company is forced to seek bankruptcy protection, which typically wipes out the investment of both the LPs and the GP in the company.

Figure 2: Typical Funding and Life Cycle of a Successful LBO Transaction

LEVERAGE AND PRICING IN BUYOUTS: AN EMPIRICAL ANALYSIS

How are LBO transactions financed? Is there a causal link between the financial leverage and prices that LBO funds paid for the target company?

In a recent research paper, Professor Weisbach, a Brattle senior advisor, and his co-authors address these two issues. The authors gathered financing and pricing information for 153 LBO transactions sponsored by five of the most prominent PE firms (TPG, Blackstone, KKR, Carlyle, and Bain Capital) in eight countries between 1985 and 2006. The authors found that the LBO companies, averaged across different years and different transactions, are financed predominantly by debt (about 75 percent), almost the exact opposite to that of an average publicly traded company. The majority of the leverage is bank debt — senior secured as well as subordinated or junior debt (such as mezzanine or 2nd lien debt). Both senior and junior debt are often split into separate tranches, with differing seniority, amortization, and interest rates, and sometimes currencies. The conventional factors (such as profitability, size, and R&D intensity) that explain the capital structure of public companies do not explain the LBO capital structure. Instead, the key determinant of LBO leverage is the real interest cost of the loans. The lower this cost, the higher the level of leverage.

Next, the authors examined the causal relation between LBO leverage and pricing, and attempted to estimate the extent to which the credit market impacts the transaction prices. Industry practitioners often claim that leverage “drives” pricing in buyouts, and that buyout activity largely depends on the liquidity of the market for corporate debt.

The authors confirmed that low interest rates appear to drive PE firms to use more leverage and pay higher prices in their LBO transactions. However, they could not conclusively address the leverage-pricing relation in LBOs because both leverage and pricing can be driven by the same unobserved or uncontrolled factors. Nevertheless, the authors concluded that their results “are consistent with a view in which the availability of financing impacts booms and busts in the private equity market.” (See Axelson, Strömberg, Jenkinson, and Weisbach, “Leverage and Pricing in Buyouts: An Empirical Analysis,” SSRN Working Paper Series, 2009.)
PRIVATE EQUITY-RELATED LITIGATION

Litigation has arisen from many aspects of a private equity transaction, over any stage of its life cycle, and within different layers of a buyout firm’s organizational structure. Using Figures 1 and 2 as a guide, litigation falls into several broad, but not mutually exclusive, areas:

**Contract Litigation**

Litigation arises from the contractual relationship between general partners, limited partners, portfolio company management, and various debt investors. Disputes can range from misrepresentation of investment performance, violation of investment guidelines or of debt investors’ rights, disputes over compensation and fees, or breach of fiduciary duty.

**Governance Litigation**

As buyout firms and their executives are involved in many intricate relationships between different classes of equity investors, debt holders, and portfolio companies, they are at the center of numerous potential conflicts of interest.

These inevitable conflicts lead to litigation over related-party transactions, differential investment interest in the buyout funds (e.g., funds with different start dates and different investment objectives), and differing claims in a portfolio company (e.g., buyout firms setting up new funds to buy back distressed LBO debt issued by their own portfolio companies).

The recently settled case by Carl Icahn and The Bank of New York Mellon against Apollo-backed real estate company Realogy over its debt exchange offer is a good example of the conflict of interest inherent in the management of a portfolio company.

**Merger & Acquisition Litigation**

At the bidding stage, minority shareholders in the target companies may challenge the buyout prices as being too low. Investors may sue the board of directors for breach of fiduciary duty, and/or for conflict of interests in management-led LBO transactions. Often the investors in public companies may question the level and timeliness of disclosure in proxy statements filed with the U.S. Securities and Exchange Commission. A recent case is the Topps Company Shareholders Litigation (2007 WL 1732586, Del. Ch. June 14, 2007).

**Securities Litigation**

Securities litigation can ensue if financial securities such as LBO debt and equity in a subsequent IPO of the portfolio companies are issued. Litigation issues involve allegations of material misstatement and omission in the offering documents; inadequate due diligence by third-party auditors, financial advisors, and law firms in preparing documents and arranging the security issuance; and breach of fiduciary duty. See the ongoing litigation of the Refco Shareholders against Thomas H. Lee Partners, LP as an example.

**Bankruptcy Litigation**

When the portfolio companies run into financial difficulties or go bankrupt, creditors, including employees, can sue the PE firms, financial advisors, lenders, and auditors over claims of fraudulent conveyance, breach of fiduciary duty, self-dealing, or aiding and abetting.

As is often the case in these types of litigation, the facts of the cases are complicated because deal structures are complex and the parties’ motivations and risk-reward tradeoffs are multifaceted. A solid economic analysis, coupled with a good understanding of institutional and industry practice, will help the various parties make their cases clearer and stronger.
ECONOMIC ISSUES IN RECENT PRIVATE EQUITY LITIGATION

Between 2005 and early 2007 there was enormous growth in leveraged buyout activities, both in terms of the number and size of transactions. The size of many large deals closed in 2006 and 2007 exceeded the previous record of $30 billion set by KKR’s acquisition of RJR Nabisco in 1989. Many of the acquisitions were made by a group of PE firms.

The buyout funds frequently paid between 10 to 50 percent premiums for publicly-traded target companies, and loaded the portfolio companies up with debt, up to 15 times the cash flow in early 2007. This deal frenzy brought about several evolving practices and tactics employed by the private equity industry, which continue to generate litigation.

Issue 1: Termination

In recognition of the sellers’ market between 2005 and mid-2007, the debt financing risk was increasingly shifted from the target companies (sellers) to the PE firms (buyers).

Under the traditional arrangement, PE funds acquire target companies through newly-formed and thinly-capitalized acquisition vehicles (shell buyers) and are protected by the “financing out” provision (like a mortgage contingency for buying a house). As such, they can walk away from the acquisitions if the debt financing is unavailable on the expected terms at closing.

Beginning in 2005, the funds narrowed or even relinquished the right to walk away from the acquisition. In return they obtained a termination option at a pre-specified price (as penalty or damage) should the debt funding be unavailable. Often sellers agree to waive their ability to seek specific performance or pursue other equitable remedies, including corporate veil piercing. The price for the termination option usually takes the form of a reverse termination fee, between two and three percent of the equity value of the buyout, and/or a capped amount of the target company’s damages.

CASE STUDY:
Hexion v. Huntsman

The contingencies and intricacies of termination protection rights between the buyer and seller were in full display in the legal saga pitching Hexion against Huntsman, two chemical companies. Hexion, a portfolio company of Apollo, agreed to acquire Huntsman in July 2007. The merger agreement included a no “financing out” condition at closing, i.e., Hexion was not excused from performing under the contract if the financing was not available at the closing.

In June 2008, Hexion filed a complaint asking the court to declare that:

1. The merger should not be consummated since the combined entity would be insolvent and Hexion’s maximum exposure is capped at the $325 million reverse termination fee.

2. Huntsman suffered a material adverse effect (MAE).

3. Hexion had no liability to Huntsman, if Huntsman suffered an MAE.

Huntsman counter-sued Hexion, Apollo, and its executives for fraud and tortuous interference and demanded specific performance by Hexion. According to Huntsman, if the deal failed to close due to financing and in the absence of a company MAE, Hexion’s liability to Huntsman was not limited to the $325 million and instead was uncapped.

The court’s decision addressed the MAE analysis. Importantly, the court bifurcated the analysis into two steps; first, whether an MAE had occurred, and then second, if it had, whether the particular MAE had been carved out in the contract to allow Hexion to walk away free.

The court ultimately ruled that Huntsman did not suffer an MAE, and ordered Hexion to close the deal. Huntsman and Hexion recently settled their suits, but the suit against the financing banks continues.
The buyers retain some rights to walk away without penalty if, for example, they can successfully convince the court that a material adverse change or effect (MAC/MAE) has occurred.\(^5\)

Dramatic changes in the availability and cost of debt financing and other market conditions since mid-2007 has made the termination option tempting. It is more economically viable for the buyout firms to walk away from the deal for free if the MAC/MAE clauses can be successfully invoked. However, recent court decisions (e.g., Sallie Mae v. J. C. Flowers, et al., and Cerberus v. United Rentals) show that determination of a MAC remains ambiguous and difficult, despite both the MAC’s important role in risk-allocation between the buyers and sellers and intensive negotiation over the MAC clauses.

**Issue 2: Club Deals**

In a club or consortium deal, more than one PE firm joins forces to bid for control of a target company. Although this practice dates back to the 1980s, it did not gain visibility until 2005. Arguably, club deals enable the buyout firms to:

1. Bid on large target companies when they could not do so individually
2. Diversify deal risk to each individual firm
3. Obtain better financing opportunities

Despite these economic efficiencies, the practice can also reduce competition by reducing the number of firms bidding on target companies and fostering a collusive environment.

According to a 2005 article in *The New York Times*, when asked about whether club deals diminish bid prices, one legendary investor responded “[y]ou’re not going to get me to say that aloud, but let’s just say that you’re not wrong.”\(^6\) Indeed some large club deals led to inquiries by the U.S. Department of Justice’s Antitrust Division and were the subject of several shareholder lawsuits,\(^7\) in which almost all the prominent buy-out firms (KKR, Blackstone, Carlyle, TPG, Bain Capital) have been listed as defendants.

The deals identified by the plaintiffs include Freescale (2006), Kinder Morgan (2006), HCA (2006), SunGard (2005), Neiman (2005), and several others. As is common in antitrust matters, these lawsuits allege a conspiracy among PE firms to acquire companies in LBOs at artificially depressed prices. In some cases, firms allegedly agreed not to compete in return for *quid pro quo* in future deals. In other deals, rival bidding clubs allegedly submitted “inferior sham bids” to create the appearance of competition. In addition, target companies’ management and investment banks involved in the deals were also sued for their roles in perpetuating and facilitating the conspiracy.

The cases are still at an early stage. However, the empirical evidence on the club deals’ impact on LBO pricing is mixed. One paper cited in the lawsuits finds that:

1. Target shareholders receive approximately 10 percent less in club deals than in sole-sponsor LBOs.
2. The lower returns were stronger before club deals began to receive heightened media and government scrutiny in 2005.
3. There is little to no support that club deals alleviate capital constraints, diversify deal risks, or allow the clubs to obtain favorable financing terms.\(^8\)

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**The empirical evidence on the club deals’ impact on LBO pricing is mixed. More work needs to be done to sort out the contradictory results.**
However, two other studies reach the opposite conclusions. While one study finds some evidence that the target company’s abnormal returns are lower in club deals, these smaller abnormal returns only hold for a narrow time period around the initial takeover-related announcement (seven weeks prior and six months after). The difference in returns disappears during longer periods (up to a year prior to the announcement date) that better account for differences in the takeover process across various types of bidders.

Moreover, both studies find other evidence that the corporate takeover market is sufficiently competitive. More work needs to be done to sort out the contradictory results. If these cases move forward, intensive factual discovery and economic analysis will be required to understand the specific situation of each allegedly rigged deal.

**Issue 3: Financial Distress and Bankruptcy**

Almost by design, more PE-backed firms will experience financial distress or go bankrupt in economic downturns. Creditors of financially-distressed portfolio companies could sue the firms over the standard bankruptcy claims of fraudulent conveyance, breach of fiduciary duty, and other claims such as self-dealing and aiding and abetting.

In borrowing and paying at levels close to a historical record during the latest boom and bust cycle, the PE firms were essentially betting that nothing would go wrong. Moreover, firms increasingly employed a number of controversial strategies, such as flipping as quickly as possible and dividend recapitalization soon after the initial LBO, to boost returns. These strategies could backfire and attract legal scrutiny.

Bankruptcy-related litigation in the LBO arena will inevitably be focused on the central corporate finance question: does financial leverage increase, decrease, or have no impact on the company’s value? In a frictionless market where there are no taxes, no bankruptcy costs, no information barriers, and no principal-agent problems, financial leverage is independent of, or irrelevant to, the value of a company.

However, when market frictions are introduced, while the basic irrelevance result largely remains intact, there are circumstances where financial leverage could have an impact on a company’s value. Of particular interest for LBO bankruptcies is the agency cost theory of debt, which has been used in previous lawsuits as a causal link from leverage to bankruptcy.

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**The Brattle Group’s Capabilities**

We provide expert testimony, analyses, and financial economic consulting in matters concerning private equity, capital requirements, due diligence, structured finance, risk management, asset valuation, pricing of services, and the cost of capital.

Our experts present analyses and information clearly and defend principled economic and finance arguments while exposing the flaws in opposing opinions. We provide reconstruction and evaluation in the form of expert reports and have appeared before federal and state courts and arbitrators around the world.

Brattle has been retained in a range of litigation including matters involving asset valuation, securities fraud, broker/client investment suitability, bankruptcy and ability to pay, and contract analysis.

We also support leading academics with whom we work and have relationships with a network of academic advisors, including several former chief economists at the U.S. Securities and Exchange Commission and former officers at global investment banks and brokerage houses.

Our clients include law firms, commercial banks, savings and loans, insurance companies, broker-dealers, investment banks, mutual funds, hedge funds, finance companies, and special board committees.

Our expertise is grounded in an understanding of finance and economic theory, accounting, financial products, capital markets, regulation, and industry custom and practice. Over the last twenty years we have been involved in some of the most contentious and visible cases in the industry.
**CASE STUDY:**
**Mervyn’s v. Cerberus et al.**

*Mervyn's v. Cerberus et al.* brought to harsh light some of these controversial tactics. In this case, Mervyn’s, a bankrupt California department store chain, filed a lawsuit against its former owners, Cerberus, Sun Capital Partners, and others, for fraudulent conveyance. Like many department store chains, prior to the buyout Mervyn’s owned real estate properties on which the stores were located. Aiming to realize the value from the real estate, Cerberus, Sun, and others structured the 2004 Mervyn’s acquisition in two separate purchases (see Figure 3). One was for the retail operations, and one for the chain’s real estate holdings.

After the LBO, the property company nearly doubled Mervyn’s rents which, together with “the amputation of the real-estate legs from the body of the retail operations,” allegedly led to Mervyn’s bankruptcy. Further, as reported by *The Wall Street Journal* recently, Mervyn’s retail operation made more than $50 million in earnings before interest, taxes, depreciation, and amortization in the first year under its new owners, which allowed Cerberus et al. to pay themselves a one-time dividend from the retail operation’s cash flow.

As of the publication of this newsletter, we do not yet know how Cerberus will defend its deal structure and counter Mervyn’s fraud claims. But the structure illustrated in Figure 3 has been used elsewhere, *e.g.*, to arbitrage the cost differentials of a real estate debt and general corporate debt. No matter what the rationale for the deal structure, however, it would be unlikely that the structure was designed to withstand the sharp economic downturn we are currently experiencing. In a “but for” world where real estate and retail operations stay together after an LBO, whether creditors could fare better remains an open question.
CONCLUSION

This newsletter highlights a number of emerging litigation issues pertinent to the PE industry. As the global economy descends into a recession, if history is a guide, PE-backed companies will have a higher probability of default, leading to more bankruptcy and liquidation filings from these companies. As some PE-backed companies attempt to restructure their current ownership and capital structure, contractual disputes between the LBO participants and conflict of interest issues will arise as well.

Some of the financial and economic analytical tools behind such litigation are standard and have been used in similar contexts (e.g., the MACs clause determination is also used in general M&A litigation). However, the complexity of the LBO deal structure, coupled with a myriad of financial instruments used and divergence in incentives and rights of the parties involved, make PE-related litigation more challenging. Complicated issues warrant a thorough review of facts, fresh insights from cutting-edge research, and close coordination of expertise from multiple disciplines.

ENDNOTES


3. GP’s compensations are also subject to claw-back and high-water mark. High-water mark ensures that GPs earn performance fees only when the value of the PE fund exceeds the previous high-water mark. LPs also have the ability to claw-back previous performance fees to the GP if the fund’s subsequent performance is unable to return LPs’ initial investment.

4. For more in-depth coverage of these litigations, see Davidoff, “The Failure of Private Equity,” Southern California Law Review, forthcoming.

5. For an overview from the legal perspective, see Kozlov and Moyer, “Deal Termination Litigation: The ‘Material Adverse Change Clause’ and Other Escape Clauses in a Tightening Deal Market,” ReedSmith Bulletin 08-002, 2008.


VC Expert Josh Lerner Joins Brattle as Senior Advisor

Josh Lerner is the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and the Entrepreneurial Management units. Much of his research focuses on the structure and role of venture capital and private equity organizations.

He also examines the impact of intellectual property protection, particularly patents, on the competitive strategies of firms in high-technology industries.

Prior to his position at Harvard Business School, Dr. Lerner worked for several years on issues concerning technological innovation and public policy at the Brookings Institution, as well as for a public-private task force in Chicago and on Capitol Hill. He recently led an international team of scholars in a study on the economic impact of private equity for the World Economic Forum.

American Finance Association Announces 2008 Recipients of The Brattle Group Prize

The Brattle Group Prizes for best papers in corporate finance for 2008 were awarded on January 4, 2009 at the American Finance Association’s Annual Meeting in San Francisco, CA. The prizes, handed out annually, are funded through a grant from The Brattle Group. The winners of the first prize receive $10,000 and two runner-up papers receive $5,000. The papers are judged to be exceptional by the editors of The Journal of Finance. Brattle congratulates the winners for their achievement.

First Prize Paper: Heitor Almeida and Thomas Philippon

Distinguished Paper: Michael L. Lemmon, Michael R. Roberts, and Jaime F. Zender

Distinguished Paper: Daniel Paravisini

Senior Advisor René M. Stulz Awarded the 2008 Risk Manager of the Year Award

René Stulz, a senior advisor to The Brattle Group, was awarded the Global Association of Risk Professionals’ 2008 Risk Manager of the Year Award. The award was presented during the association’s 10th Annual Risk Management Convention & Exhibition.

The Risk Manager of the Year Award was established in 1997 to recognize the outstanding contributions and positive impact made by individuals or organizations. He was honored in recognition of his many years of contributions to risk management through his extensive work in academia, as well as a lecturer, author, and consultant.

Dr. Stulz is the Everett D. Reese Chair of Banking and Monetary Economics and the Director of the Dice Center for Research in Financial Economics at Ohio State University.

Brattle’s Analysis of Self-dealing and Executive Compensation Helps Achieve Record-Setting $115 Million Settlement in Delaware Court on Behalf of AIG

Principal Benjamin Sacks assisted plaintiff Teachers’ Retirement System of Louisiana (TRSL) in reaching a record settlement of $115 million on behalf of American International Group (AIG). The settlement was reached on September 11, 2008, only four days before the trial was set to begin in the six-year long litigation, and recently became final. This settlement is the largest ever for a derivative lawsuit in the Delaware Court of Chancery, and more than doubles the previous record.

TRSL alleged that former AIG Chairman and CEO Maurice Greenberg and three other former AIG executives breached their fiduciary duties by directing insurance business worth hundreds of millions of dollars in commissions to a company they owned and controlled called C.V. Starr & Co. (Starr). These relationships were terminated shortly after Mr. Greenberg resigned from AIG in the wake of accounting investigations.

Mr. Sacks, the plaintiff’s damages expert, submitted two expert reports and testified at deposition on the damages sustained by AIG, under the entire fairness standard, due to the defendants’ self-dealing transactions. He also assisted TRSL’s counsel, Grant & Eisenhofer, with motions challenging the methodology and reliability of the defendant’s experts.

For more information, please visit www.brattle.com.
About the Authors

Dr. Atreya “Chuck” Chakraborty is an associate professor of finance at the University of Massachusetts, Boston. He is an expert in economics and finance, specializing in the economics of antitrust and intellectual property. He advises clients on antitrust issues regarding price fixing, collusion, and exclusionary practices. His scope of work includes formulation of the economic logic underlying litigation, the identification and coordination of expert witnesses, and assistance with discovery, depositions, and cross-examination.

He has been a consultant at CRA International and an assistant professor at the Graduate School of International Economics and Finance at Brandeis University. He has published in leading scholarly economic and finance journals on executive compensation, mergers and acquisition, risk management, and small business financing issues.

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He has broad-ranging research and teaching interests in finance and economics, with specialties in corporate finance, corporate governance, and private equity. He is an editor of The Review of Financial Studies, one of the leading academic journals in finance, and has been an associate editor of numerous other academic journals. He has over thirty publications on these and related topics, and is frequently cited in national and international media.

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Dr. Bin Zhou is a member of Brattle’s Finance Practice. He has over ten years consulting experience in financial institutions (banking and insurance), and in the utility, energy, and telecom industries. He specializes in the application of finance, accounting, and taxation in a variety of consulting and litigation settings.

He has served as a consulting expert in several high-profile securities and bankruptcy litigation matters and supported academic experts in various stages of litigation. His work has primarily focused on economic analysis of structured finance transactions, financial statement analysis, causation, and damages. His experience also includes evaluating failed hedge funds’ investment management and hedging strategies, and analyzing economic substance of leasing transactions.

Dr. Zhou holds a Ph.D. in International Economics and Finance from Brandeis University.

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The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world.

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