Advocate'sEDGE

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Fairness opinions: Don’t close a transaction without one

As the economy continues to make its slow and rocky recovery, more and more businesses are undertaking transactions that affect the value of their shareholders’ interests. That’s where fairness opinions come in. These reports can facilitate transactions, reduce the odds of disputes among the parties and provide legal protection in the event of litigation.

WHAT IT IS … AND ISN’T

In a fairness opinion, a qualified professional confirms that the terms of a proposed transaction are “fair” from a financial perspective. The professional bases his or her opinion on a comprehensive review of the transaction. This includes proposed pricing, relative consideration to be received by different shareholders, other financial terms, available alternatives and the treatment of minority interests.

The expert prepares a two-part report: 1) a formal opinion letter that describes the relevant data and methods used, and 2) the statement of fairness. This statement reflects the financial fairness of the offer as of a certain date under the specified set of circumstances and assumptions. However, the fairness statement doesn’t assert that the offer is the best price possible, doesn’t recommend any specific action and shouldn’t be viewed as investment advice or an evaluation of the legal fairness of a transaction.

Obtaining a fairness opinion from an independent financial expert can eliminate conflicts of interest.

WHEN THEY’RE ADVISABLE

Fairness opinions are especially important in light of the business judgment rule. This rule protects boards of directors and general partners from liability for transactions if they exercise due care by making an informed judgment, in good faith and without fraud or any conflicts of interest. Should directors or partners find themselves facing a shareholder lawsuit, a fairness opinion can support their argument that they exercised due care.

Fairness opinions are advisable for both buyers and sellers in a variety of transactions, including:

- Mergers and acquisitions,
- Spin-offs and divestitures,
- Employee stock ownership plan (ESOP) transactions,
- Minority interest or leveraged buyouts,
- Transactions involving closely held businesses, related parties or insiders, and
- Liquidations, recapitalizations or reorganizations.

Specific circumstances also may call for a fairness opinion, such as when shareholders disagree about an offer's adequacy, competing bids have been received or shares in the company are held in trust.

Although fairness opinions traditionally have been obtained by large publicly held companies, smaller private companies can also derive benefits from them. Private companies often lack an outside board of directors with the requisite expertise and independence to fairly assess a proposed transaction. A fairness opinion can validate a transaction for a smaller company with different classes of ownership and complex capital structures, as well as grease the wheels for family businesses vulnerable to disputes.

WHO SHOULD ISSUE IT

In the past, fairness opinions were almost always issued by the investment bank advising on a transaction. This was based on the theory that the investment bank is already thoroughly informed about the company, its industry and any transaction nuances. However, there are potential pitfalls related to relying on investment banks for fairness opinions. Investment banks could be viewed as being swayed, for example, by the success fees at stake or the desire for future business.

Obtaining a fairness opinion from an independent financial expert whose compensation isn't tied to a particular opinion can eliminate conflicts of interest and produce an opinion that's perceived to be more reliable. An opinion from an independent, credentialed expert also is more likely to withstand scrutiny if disputes or litigation should arise.

THE ROLE OF VALUATION METHODOLOGIES

Financial professionals who issue fairness opinions perform several analyses that are similar to these common valuation methods:

Guideline public company. The professional compares the effective price per share of the subject company with the publicly traded stock prices of comparable (or "guideline") companies to evaluate a transaction's fairness. Guideline stocks can be selected based on industry, growth and financial performance.

Merger and acquisition. The expert looks at transactions involving controlling interests in similar public or private businesses, using the same types of selection criteria as in the previous method.

Discounted cash flow. This technique discounts the subject company's projected future cash flows to present value. The discount rate is determined by the investment's perceived risk in the marketplace.

QUALIFICATIONS MATTER

While retaining an independent expert usually is the best route, not just any "expert" will do. It's essential that the financial professional be well versed in the relevant industry and on top of trends that can affect the company's value. This professional should also be familiar with the litigation process and have experience testifying in court in support of his or her opinions.

When fraud distorts value

Appraisers adjust statements and assist attorneys

Among the many negative consequences of occupational fraud — financial losses, public embarrassment and diminished employee morale — one is rarely mentioned: how fraud affects a company's value. Illegal schemes involving asset misappropriation, corruption and financial misstatements can distort value. Even shady but legal bookkeeping practices, such as delaying revenue recognition to temporarily reduce the value of an owner's business interest, can make accurate appraisals difficult.

To ensure they come to realistic value conclusions, professional appraisers must adjust financial statements when the existence of fraud is known.

TEAM OF TWO

Valuators rely on financial statements to estimate value. Unless it's specifically set forth in their engagement letters, valuators customarily don't audit financial information or investigate for fraud. So if financial statements contain fraudulent numbers, an appraisal may be inaccurate, unless properly adjusted.

What if management or the valuation professional suspects or knows about specific incidents of fraud? Some valuators are cross-trained in both valuation and forensic accounting. More likely, however, the valuator will bring in a forensic accounting colleague to help make the requisite adjustments to accurately value the business — and build a fraud case. Note that, if the scope of an appraisal assignment is expanded to include fraud work, the forensic expert usually requires the client to sign a revised engagement letter or an addendum to the existing contract.

INVENTORY OF INTERNAL CONTROLS

When assessing a subject company's risk of fraud, valuators and forensic experts consider several factors, such as a company's size. According to the Association of Certified Fraud Examiners, businesses with fewer than 100 employees — which often lack comprehensive fraud prevention policies — suffer the highest median financial losses.

A company's internal controls — policies and procedures for protecting assets, improving operating efficiency and ensuring reliable financial statements — can tell a valuator a lot about its fraud risk. Such controls as a fraud training program and whistleblower hotline can be a company's first line of defense.

Other examples of internal controls that minimize fraud and protect a company's value include:

- Restricted access to physical assets, including locks, passwords and security systems,
- Formal job descriptions, codes of conduct and employee manuals,
- Mandatory vacation policies,
- Duplicate signatures on checks above a preset dollar amount,
- Monthly bank reconciliations and physical inventory counts,
- Background checks on prospective job candidates, and
- Annual or surprise audits.

Unfortunately, internal controls can be circumvented by managers who override the system or become lax in supervising subordinates. It's easy for fraud schemes — including falsifying financial statements — to thrive in such environments.

If financial statements contain fraudulent numbers, an appraisal may be inaccurate, unless properly adjusted.

MAKING ADJUSTMENTS

In general, high fraud risk equates with lower values. Note, however, that valuators typically incorporate risk into their appraisals of smaller businesses — even when there's no specific evidence of fraud.

When the existence of fraud or shady accounting practices *is* known or suspected, valuators take steps to account for additional risk. For example, an unscrupulous CFO may prematurely post unearned or fictitious sales at year end to boost his annual bonus. His actions overstate the company's value because earnings or assets are exaggerated.

Using the income valuation method, a valuator might increase the company's risk premiums (a component of the cost of equity) to account for the CFO's actions. And when using the market valuation method, the appraiser might apply different criteria to pick guideline companies, or adjust median (or average) pricing multiples for differences between the subject company and the comparables.

Often, a subject company with significant fraud risk appears less attractive to potential buyers, especially minority investors. Accordingly, valuators might factor fraud risk into their valuation discounts. But regardless of how they choose to account for these risk factors, valuators must take care not to double-count the effect of fraud risk on value. Otherwise, they risk *under*valuing business interests.

APPRAISING A COMPANY, BUILDING A CASE

Because valuators typically don't look for fraud, be sure to discuss any concerns about the accuracy of financial statements when you engage an expert — particularly if a fraud investigation is already underway. Such information will enable the valuator to make appropriate adjustments and, if necessary, help your litigation team gather evidence and assess possible damages.

Price erosion theory supports patent infringement award

Calculating patent infringement damages for lost profits or reasonable royalties is almost always complicated, especially when it involves the theory of price erosion. Although price erosion can be difficult to establish, it can lead to significant damages awards — as the defendants learned the hard way in *SynQor, Inc. v. Artesyn Technologies, Inc.*

A $95 MILLION AWARD

The case involved high-efficiency power converter systems used in large computer systems and telecommunication and data communication equipment. SynQor held five related patents and sued nine power converter manufacturers for infringement.

In 2010, a jury found infringement and awarded lost profits and reasonable royalty damages of more than $95 million, based on the prices SynQor asserted it would have been able to charge but for the price erosion caused by the defendants' infringement. The "but-for" prices were roughly two to three times the prices the defendants actually charged. On appeal, the defendants argued that the evidence didn't support SynQor's price erosion theory.

COURT FINDS SUFFICIENT EVIDENCE

The U.S. Court of Appeals for the Federal Circuit explained that, to establish price erosion damages, SynQor needed to prove that, but for infringement, it would have sold its product at higher prices. A credible but-for analysis, it said, must account for the effect of a higher price on product demand and the impact of any available noninfringing alternatives on the market.

As the court noted, evidence showed that SynQor sold its converters for prices as high as $110 per unit when it first entered the market and made sales for $84 per unit in 2002. SynQor sold about 18,500 converters to Cisco in 2010 for only $70 and $81 per unit during a market shortage.

As to the question of whether the industry would have moved to noninfringing converters rather than pay SynQor's higher prices, SynQor's expert testified that the noninfringing converters were inferior to the patented technology. In late 2010, such converters were only just beginning to compete in performance with the earliest patented converters.

Moreover, Cisco's representative, testifying for the defendants, admitted that his company would have had to incur significant costs to redesign its end products to use any noninfringing converter that wasn't a "drop-in replacement," and that drop-in replacements didn't exist as of August 2010. Another defense witness testified that he wasn't aware of any customers that had actually switched to a noninfringing alternative.

The appellate court concluded that there was sufficient evidence for the jury to have accepted the but-for pricing. As a result, both the lost profits and reasonable royalty damages were supported by substantial evidence.

END-PRODUCT SALES EVIDENCE

The defendants also argued that a new trial on damages was warranted because SynQor's revelation of $20 billion in customer end-product sales skewed the damages horizon for the jury. Under the entire market value rule, a patentee may assess damages based on the entire market value of the infringing product only if the patented feature creates the basis for customer demand or substantially creates the value of the component parts.

But SynQor didn't try to justify its damages figure based on the price of the customer end products. Its damages calculations were based on the but-for sales price of the intermediate patented converters. SynQor only used the end-product value to argue that the price elasticity of demand for the converters would be high. The evidence, therefore, wasn't unfair or prejudicial.

MORE THAN NUMBERS

Remember that damages experts need to present more than just the numbers. They also have to show that they've conducted credible analysis that accounted for the relevant legal standards.

Goodwill Registry provides key comparables in divorce case

Should valuations of professional practices such as law firms and medical practices include an amount for goodwill? This question continues to pop up in divorce cases. One such Ohio case, *Gentile v. Gentile*, highlighted a tool that is often used to assist in valuing medical practice goodwill.

DUELING VALUATIONS

The Gentiles married in 1986. The husband was a board certified plastic surgeon with a master's degree in business administration, and was the sole shareholder and practitioner in an otolaryngology practice with three offices in Ohio. After the wife filed for divorce in 2010, the trial court valued the husband's practice at $227,277. He appealed that finding, among others.

At trial, the husband's expert valued the practice at $16,300 with no value for goodwill. The wife's expert testified that he'd reviewed the husband's expert's valuation report and also performed his own valuation using the net asset approach.

The wife's expert's valuation included $171,000 for the practice's goodwill. The expert obtained this figure from the Goodwill Registry, a nationwide database of health care practice transactions and goodwill values paid, with about 4,000 reports from transactions going back 10 years. Each report includes a limited amount of information about the transaction, such as state, reason for the valuation, valuation method, practice gross revenue, overhead percent, practice price, goodwill value and goodwill value expressed as a percentage of practice gross revenue.

After combining the total assets of the husband's practice and deducting for liabilities, the wife's expert put the fair market value of the practice at $679,000, including unreported cash revenues. The expert also provided an alternative valuation of approximately $486,000, excluding unreported cash revenues.

The trial court accepted the wife's expert's goodwill value of $171,000 in calculating its own value. The husband argued on appeal that the trial court shouldn't have included goodwill as a divisible asset. The Ohio Court of Appeals disagreed. Ultimately, it upheld the value from the Goodwill Registry.

SANITY CHECK AND MORE

The Goodwill Registry states that its information is intended to be used as benchmark data. And, in fact, many valuators use the registry as a "sanity check" — or secondary source of information — for goodwill numbers calculated using other methods.

Experts who rely on Goodwill Registry data generally make adjustments according to the particular valuation circumstances, such as those related to the practice's size, location, profitability and location. They also consider when a transaction occurred relative to the valuation date and any economic changes since that date.

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