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Pointing fingers lead to fairness opinions

An increasingly popular transactional safeguard

In a difficult economy, many parties want to point fingers when projected results fall short, acquisition synergies fail to materialize or insolvency ensues. For this reason, among others, fairness opinions are becoming increasingly popular.

What's fair?

Simply put, a fairness opinion addresses whether a transaction appears "fair" from a financial point of view. To create one, appraisers usually begin by estimating a range of values regarding a proposed transaction.

The ceiling of this range represents the highest price a prudent buyer would be willing to pay; the floor is the lowest price a prudent seller would accept. The analysis typically presumes that neither party has been forced to buy or sell, and that both parties have reasonable access to relevant financial data.

Another proxy for the lower end of a fairness range is the amount that dissenting shareholders could reasonably expect to obtain in a statutory appraisal action. Legal counsel can help the fairness opinion provider define the appropriate standard of value.

Estimating fairness is especially challenging if a transaction involves noncash terms, including earnouts and stock-for-stock transactions. Evaluating these deals may require looking at future expectations as well as the buyer's current and prospective financial position.

Timing is another important consideration. A fairness opinion is only valid on a particular date. A transaction may be fair one day but unfair the next because of changing market conditions or product obsolescence, for example. Generally, fairness opinions are performed as close to the transaction or proxy date as possible. Opinions dated too early or not updated for changing conditions may not withstand scrutiny — especially in volatile markets.

When is one handy?

Most people associate fairness opinions with public companies undergoing high-profile management buyouts, hostile takeovers or going-private transactions. But fairness opinions have become increasingly popular among private businesses with vocal minority shareholders, complex deal structures and related-party transactions.

Fairness opinions aren't legally mandated, but they can help facilitate major transactions, such as mergers and acquisitions (M&As), spin-offs, stock repurchases, and divestitures. Businesses that reorganize out of court or under Chapter 11 of the U.S. Bankruptcy Code may choose to obtain fairness opinions on behalf of creditors and other stakeholders.

In addition, buyers and sellers use fairness opinions to support their strategic decisions and to defend against lawsuits. Owners of private companies with limited M&A experience may find fairness opinions particularly insightful. And some loan covenants require fairness opinions to protect the bank's financial interests against fraudulent conveyances.

NASD rule guards against conflicts of interest

There's a misconception that fairness opinions (see main article) are merely "rubber stamps" from investment bankers. Courts may not perceive deal insiders, such as the investment banker or top executives, as objective third parties, because they'll make money only if a deal closes. And the higher the transaction price, the more insiders usually earn. For example, they may benefit from commissions based on a percentage of the selling price, golden parachute bonuses or postdeal financing arrangements.

The financial interests of managers and investment bankers may conflict with the best interests of minority shareholders and other stakeholders, such as lenders and employee-owners. Under National Association of Securities Dealers (NASD) Rule 2290, fairness opinion providers must disclose potential conflicts of interest, including:

- Compensation contingent on the selling price, as well as fees for providing the fairness opinion and/or acting as an advisor to the transaction,
- Relationships with the buyer or seller over the last two years or any contemplated future financial interests in the buyer or seller,
- Whether the expert relied on financial data prepared by the buyer or seller and, if so, whether that information was independently verified, and
- Whether the opinion addresses the fairness of officer, director and employee compensation related to the transaction.

Although Rule 2290 primarily applies to public company transactions, it's good form for all fairness opinion providers to be up front about potential conflicts of interest. Potential conflicts can dilute the value of fairness opinions. Often, the best bet is to select a disinterested third party, such as a business appraiser, with no ties to the deal.

What to expect?

Fairness opinions are typically more abbreviated than traditional appraisal reports but require similar analyses. For example, they rely on the same valuation approaches — cost, market and income — to value ownership interests or assets.

Moreover, they also address issues unique to fairness opinions, such as financial structure, tax and accounting consequences, and executive compensation from change-in-control and other bonus provisions. Most fairness opinion letters include these components:

- A description of the transaction,
- A summary of procedures and analyses,
- A list of sources used,
- Conflict-of-interest disclosures,
- A statement of assumptions and limiting conditions, and
- A conclusion.

If an expert concludes a deal is unfair from a financial perspective, it typically falls through — or management renegotiates the terms.

A fairness opinion is only valid on a particular date.

Bear in mind, however, that fairness opinions don't address legal or structural fairness, nor do they constitute an endorsement or a guarantee for a particular transaction. Directors and owners shouldn't substitute fairness opinions for internal due diligence procedures or external legal advice.

Is it verified?

Ultimately, a fairness opinion is only as valid as its underlying assumptions and analyses. Therefore, a court may perceive a fairness opinion backed by independent research and verification as more reliable than one in which the provider relied exclusively on management's representations. ✦

Oh, what might have been

How appraisers calculate lost profits

When a business suffers what it believes to be wrongful conduct leading to lost profits, an appraiser is often asked to estimate "what might have been." That is, for the resulting litigation, he or she must typically calculate, not just lost sales, but also the difference between lost sales and avoided costs. Let's take a closer look at this important calculation.

Breaking down the costs

Figuring out what costs were avoided may appear a fairly easy task. You'd just take the company's total costs and divide them by the total number of units produced to arrive at the cost per unit, right?

Not so fast. This oversimplified approach understates the plaintiff's lost profits because it fails to take into account the different types of costs. In reality, costs generally must be broken down into two categories:

1. Direct costs. Examples include raw materials and direct labor, which are directly related to the production of a specific product and almost always vary proportionately with the volume of production.

2. Indirect costs. These include items such as overhead and indirect labor, which may be fixed or variable. Fixed costs, such as rent, are the same regardless of the level of production (at least within a certain range). Variable costs, such as shipping expenses, depend on production levels.

In most cases, to help ensure accuracy, the appraiser takes lost sales and subtracts the incremental cost of producing those sales. The incremental cost generally includes direct costs plus indirect costs that vary with the volume of production, both of which are avoided when sales are lost. But because the plaintiff continues to incur fixed costs despite the lost sales, subtracting those costs distorts the plaintiff's lost profits.

Using direct costs, ratios

Once the costs involved are established, the appraiser can start applying various methodologies. For example, in disputes over the costs of a specific product, he or she may use direct cost assignment. This method analyzes costs directly related to a product, such as materials and direct labor. The analysis may require adjustments if material prices have changed or if the company

uses inventory accounting methods, such as last-in first-out (LIFO), that cause reported costs to differ from actual incremental costs.

In other cases, the appraiser may apply ratio analysis. This method explores relationships between specified costs and some measure of production, such as units sold, sales receipts (in dollars) or direct labor hours. Total overhead costs might be divided by total direct labor hours, for example, to arrive at overhead costs per direct labor hour. But this approach may not be appropriate under all circumstances, such as when marginal or incremental costs are at issue.

Considering other analyses

There are other methodologies as well. For instance, in an account analysis, the appraiser reviews various expense categories in the general ledger to determine which costs are fixed and which are variable. Variable costs are usually added together and divided by total revenues (or some other factor, such as direct labor costs) to obtain the variable cost per unit.

One drawback to this approach is that it doesn't distinguish semivariable costs — the appraiser must use his or her professional judgment to classify such costs. Because this introduces an element of subjectivity, the results should be confirmed using another approach.

Because a plaintiff continues to incur fixed costs despite lost sales, subtracting those costs would distort the plaintiff's lost profits.

There's also a regression analysis. Here the appraiser examines historic cost relationships and reduces them to an algebraic line formula. After plotting the observed costs, the appraiser mathematically determines a line that represents estimated costs at various levels of production.

By examining this information, the appraiser can estimate the avoided overhead costs associated with lost sales. Although this method is complex, the appraiser can often show the cost relationships on a graph that judges and juries can easily grasp.

Comparing the results

To maximize confidence in any cost estimate, an appraiser is free to use multiple methodologies and compare the results to historical data, independent estimates or industry statistics. As you can see, a lost profits calculation is a complex endeavor — but it's often absolutely necessary in certain forms of litigation. ✦

5 common vendor fraud schemes to watch out for

These are busy times for fraud investigators, with businesses more concerned than ever about protecting their bottom lines. One way a company's profits could take a major hit is if it's struck by vendor fraud. But by recognizing the signs of this crime and initiating a timely investigation, businesses can minimize the resulting losses.

If vendor fraud or another fraudulent scheme is suspected, a fraud expert's involvement is critical. A forensic accountant can confirm suspicions and help build a case to recover the perpetrator's ill-gotten gains. Here are five common schemes to watch out for:

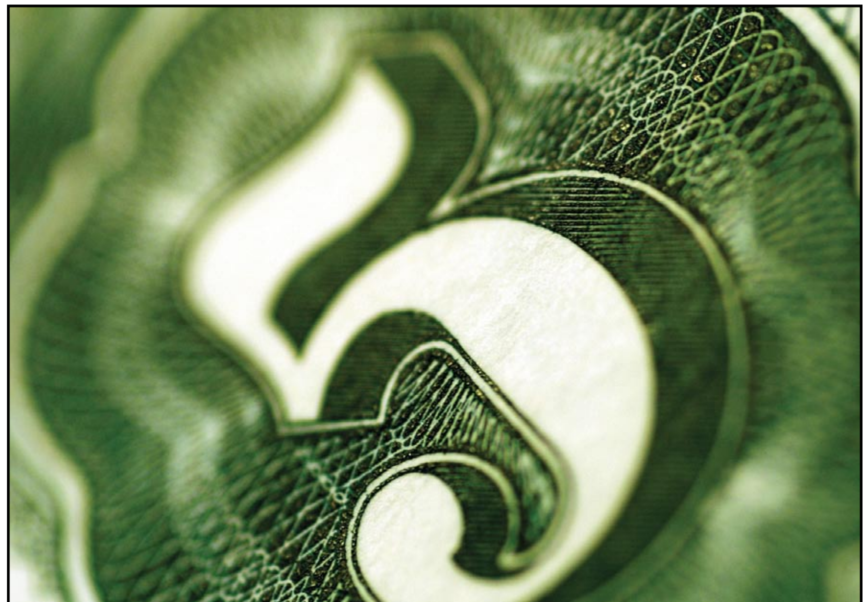
1. Bid rigging. Two or more vendors can conspire to steer a company's purchase of goods or services through different types of bid-rigging schemes. A *bid-rotation* scheme calls for all participating vendors to submit bids while taking turns as the low bidder.

Under a *bid-suppression* scheme, two or more vendors illegally agree that at least one of the participants will withdraw a previously submitted bid or not bid at all; the intent is to ensure acceptance of one particular bid. *Complementary bidding* is marked by competing vendors submitting token bids with a high price or special terms that will make them unacceptable to the company.

2. Price fixing. Contrary to popular belief, price fixing is not only an agreement among competitors to set the same price for goods or services. It also refers to competitors jointly establishing a price range or minimum price. Such agreements violate the Sherman Antitrust Act, regardless of whether the prices are unreasonable.

3. Market division. Market division occurs when competitors agree not to compete in a specific segment of a market — whether based on geography or customer type. If bids are solicited by a customer in that segment of the market, the competitors either won't bid or will submit complementary bids. The lack of truly competitive bidding drives up the price for the soliciting company.

4. Kickbacks. Vendors pay kickbacks to an employee who facilitates his or her employer's payment of a fraudulent invoice. The vendor typically incorporates the kickback amount in the price charged, thereby compounding the amount the company is overbilled.



5. Overbilling. Kickbacks aren't the only vehicle for overbilling a company. Vendors can submit invoices for their goods and services that are inflated in several subtle ways. For example, the price charged may exceed the prices agreed upon in the related contract. In other cases, the invoice might reflect charges for more goods than the customer actually received. Or a vendor could alter the date on a genuine invoice and submit for duplicate payment. ✦

COURT UPHOLDS FLP DESPITE POSTDEATH FUNDING

In the recent case of *Keller v. U.S.*, a federal court upheld a family limited partnership (FLP) in an estate tax refund case — even though the FLP wasn't funded before the decedent died. How did the family involved pull this off? Read on.

The Keller FLP

The FLP was established by a rich widow dedicated to safeguarding her family's fortune for her heirs. She particularly worried about losing control of family assets through divorces.

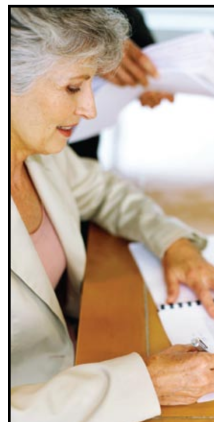
Before her unexpected death, the widow signed a partnership agreement for the FLP and clearly expressed her intent to fund it with $250 million in corporate bonds. The general partner would be a newly created limited liability company, also funded by the widow. The funding would leave her with more than $110 million in assets.

After her death, her financial advisors ceased all activity with respect to the FLP, and her estate paid estimated federal estate taxes of $148 million. About a year after her death, though, the advisors learned of an FLP case, *Church v. U.S.*, in which the court upheld an FLP that hadn't been formally funded at the decedent's death. The advisors resumed their efforts to formally establish the FLP and, subsequently, sought a tax refund.

Intent matters

The court observed that Texas law provides that an owner's *intent* to make an asset partnership property *causes* that asset to become the partnership's property — regardless of whether legal title has transferred. The widow clearly intended the bonds to become FLP assets. Thus, the FLP was fully formed at the time of death, and the bonds were FLP property.

The court noted that Internal Revenue Code Sections 2036(a) and 2038(a) prevent parties from avoiding estate tax by using vehicles that allow a transferor to retain lifetime enjoyment of transferred assets or to change the power to control the transferred interest. Neither code section applied to this FLP, according to the court, because the transfer was a "bona fide sale for an adequate and full consideration." Indeed, it pointed out that the FLP was created for a legitimate business purpose (protecting family assets from ex-spouses); the widow retained significant assets; and the percentages of partners' interests were proportionate to their respective contributions.



Further, the court found that, in calculating the discount for the widow's interests in the bonds, the government's expert had violated several of the tenets of the hypothetical-buyer-and-seller standard. Under the standard, fair market value is determined, not by the price that would be paid by the heirs or any specific remaining owners of the business entity, but by the price a hypothetical buyer would pay for the actual property transferred.

The court disregarded the government's expert's testimony because, among other things, he'd considered the true identities of the buyer and seller. Ultimately, it accepted the plaintiff's expert's testimony that a 47.5% discount was appropriate.

Support of intent

The lesson of *Keller* is clear: Detailed planning can produce significant tax savings for FLP owners. Lawful actions, careful correspondence and detailed documentation are needed to support intent. ✦

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It's a gift…..or, maybe not!?

Ok, so you are contemplating gifting the perfect gift to your spouse. Assuming you *really* intend to make a lasting gift, you need to know what it is you can gift and how, so the gift will outlast any litigation that may come your way.

First, the rules of gifting to live by. Under California Family Code Section 852(a), a transmutation of community property to separate property generally requires a writing which expressly states the intent to gift and "is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected." Hence, be clear in your writing that you intend to gift and SIGN the document!

Does this rule apply to all gifts? No! Generously, FC Section 852 subdivision (c) provides for an exception to the writing requirement if gifts are of "tangible articles of a personal nature" that are "not substantial in value, taking into account the circumstances of the marriage". What does this mean?

In the recent case of In re Marriage of Buie & Neighbors (2009), Cal. App. 4th {No. D053925. Fourth Dist., Div. One. Dec. 1, 2009}, the Court looked at the essence of what FC Section 852 subdivision (c) means and concluded that both prongs of 852 (c) must be met in order for the exception to the writing requirement to apply.

First, the facts. Husband purchased a $60,000 Porsche with a check drawn on Wife's separate property bank account. Husband claimed that because this purchase occurred shortly before his birthday, it was a gift from his Wife.

At the Trial Court level, the court ruled that it was a gift because the gift was "not substantial in value taking into account the circumstances of the marriage." However, the trial court did not address whether the Porsche was a "tangible article of a personal nature". And this was why the Court of Appeals said not so fast Husband.

Looking into the legislative intent of the words in the statute, the Court concluded that the gift of an automobile does not fall within the exception in section 852. The Court relied on legislative history which revealed that the gifts this was intended to encompass were "clothing, wearing apparel, jewelry, and other tangible articles of a personal nature, used solely or principally by the person." Hence, the exception did not apply to the gift of an automobile because an automobile is not an article of a personal nature.

So, to summarize, if you are going to gift the house or the car, sign a document which clearly states your intent to do so. If you are going to gift away clothing, wearing apparel or jewelry, make sure it is not substantial in value taking into account the circumstances of the marriage, otherwise, sign a document which evidences your intent to gift.

If, on the off chance you want to hedge your bets, consider not signing a written waiver for the gift of the house or car (purchased with your separate property) as this may cause your gift to be deemed a community asset entitling you to reimbursement under FC 2640. But, before doing anything, or deciding to do nothing, you should consult with an attorney who specializes in family law matters.

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Did You Know …
Bill Graham, a California rock promoter shared the same name as a famous evangelist

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