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Summer 2006

CBIZ Litigation & Valuation Services

Greetings everyone,

We have included four articles covering two topics in this issue of our newsletter. The first two articles relate to fairness opinions. The next two articles relate to marital dissolution litigation.

While many of you are familiar with fairness opinions, please let me give a quick summary for those that are less familiar with the concept. Fairness opinions are reports that indicate whether a transaction is fair, from a financial point of view. Fairness opinions are used to provide decision-makers (usually the Board of Directors) with information that may impact the decision to conduct the transaction. They also serve as evidence that the decision-makers used reasonable judgment and fulfilled their fiduciary duties in approving a transaction.

Fairness opinions are often used in the following situations:

- By independent directors in a transaction between the company and related parties;
- By the seller in the sale of a company or the sale or spin-off of material assets/divisions/subsidiaries;
- By the purchaser in the acquisition of a company or the purchase of material assets/division/subsidiaries;
- By the purchaser in the buybacks of outstanding securities;
- By limited partners regarding contributions to, or sale of assets by, a partnership; and,
- By trustees in the acquisition or divestiture of securities or businesses by nonprofit organizations and charities.

Of the two marital dissolution articles, I found the first slightly humorous and I hope you enjoy the article, too. The second article simply addresses the need to pay attention to the details when considering compensation adjustments and expectations for future business performance.

I hope all of you are doing well and getting some time to enjoy our wonderfully hot Colorado summer. As

always, please give us a ring if you would like to get to know us. We'll buy lunch.

If you'd like to sign up for additional copies of our newsletter or opt-out of receiving it, please email LVS-news@cbiz.com.

Kind regards,

Eric Six, CPA/ABV

The Problem with Fairness Opinions—and the Business Appraisal Solution

Fairness opinions have come under recent attack in the pressrooms and the courtrooms for being marred by conflicts of interest and failing to provide meaningful information. The current controversy is part of the larger universe of corporate difficulties—and it is prompting more and more corporate fiduciaries to seek unbiased, independent advice on proposed transactions.

Even before a company receives a formal M&A offer, for example, many independent directors are contacting business appraisers and/or fairness opinion providers for advice. Fairness opinions utilize common valuation methodologies, and tap into skills and resources that professional business appraisers already have.

New regulatory efforts are also prompting the search for accuracy and independence: The National Association of Securities Dealers (NASD), the private sector regulator of the U.S. securities industry, recently proposed Rule 2290. The Rule would require greater disclosure to shareholders about the company's actual or potential conflicts of interest with any valuation agent rendering a fairness opinion; NASD would also require valuers to identify any such conflicts of interest.

Disillusionment has reached the courts, too

As most business people and analysts know, a fair-

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ness opinion is a qualified, independent review by a financial advisor assessing whether the price of a prospective corporate transaction is “fair” (from a financial perspective) to one of the parties. Either the buyer or the seller may obtain a fairness opinion, although it’s become standard for a corporate Board of Directors to obtain the opinion on behalf of its shareholders. A fairness opinion focuses on the price of the proposed transaction without assessing any other terms of the deal, including its legal aspects. It should be a simple “yes” or “no” proposition.

And yet: “Conflicts between the board and financial experts who issue fairness opinions have become the norm,” observed Judge Charles Ramos, in reviewing the negotiated settlement between parties to the proposed merger of the New York Stock Exchange (NYSE) and Archipelago Holdings, Inc., which took place earlier this year. “Fairness opinions have become watered down and toothless.”

“The important purpose of fairness opinions appears to have been lost,” the Judge continued. When he asked the roomful of top-tier attorneys and financial advisors who’d assembled for the merger hearing whether they were aware of any negative fairness opinions, “the response was a resounding ‘NEVER’” (emphasis in the original opinion).

Independent appraisal allows for “eyes wide open”

A unique aspect to the NYSE/Archipelago merger was the analysis of the fairness opinions by an independent business valuator. According to Judge Ramos, the valuator’s assessment ensured “transparency and complete disclosure in stark contrast to the usual perfunctory fairness opinion.” The independent analysis was “unique,” the Judge explained:

...Unlike relying on a typical fairness opinion, these competing presentations provide a fair and balanced view of the proposed merger and present the NYSE Seatholders with an opportunity to exercise their own business judgment with eyes wide open. Calling on business appraisers to provide fairness opinions won’t solve every woe of the corporate world—but it certainly could help reduce the current controversy, with all its attendant costs to public confidence, and corporate profits.

Another Reason to Hire BV Analysts to Provide Fairness Opinions

Ha-Lo Industries, Inc. v. Credit Suisse Boston, 2005 U.S. Dist. LEXIS 23505 (October 12, 2005). Judge Gittleman.

Fairness opinions are rife with potential conflicts of interest, none so obvious as when an investment firm’s

fee is tied directly to the completion of a deal, which in turn depends upon that same firm issuing an opinion that the deal is financially “fair.”

That’s what happened here, when plaintiff Halo-Industries, a promotional products company, wanted to acquire a technology platform for internet expansion, and hired defendant investment banking firm as financial advisor. Defendant’s fee was specifically tied to the purchase price; if the deal fell through, defendant would end up with no more than its retainer and a modest “break-up” fee.

As defendant had no specific expertise in technology systems, it advised plaintiff to hire Ernst and Young to assess this aspect of the deal. E&Y’s report came back negative, indicating that the target’s systems were incomplete, requiring significant investments. Plaintiff’s CEO allegedly presented a positive picture to the Board, however, and the company proceeded with the acquisition; defendant, who disputed receiving E&Y’s report, issued its fairness opinion and earned its \$2.5 million fee.

Despite investing millions post-merger, plaintiff later filed Chapter 11 bankruptcy—and filed suit against defendant bank for “gross negligence” in rendering its fairness opinion.

Among its claims: 1) the investment bank had valued the target using a methodology that would overstate its value; 2) it had disregarded relevant information about value and public information about the target’s management practices; and 3) it had permitted self-interest in a lucrative fee and future business to override reasonable judgment.

‘Simple mistakes’ in valuation lead to Fifth Amendment plea

Before the facts went to a jury, defendant filed a motion for summary judgment, arguing that the claims lacked legal merit. In denying the motion, the U.S. District Court (N. Dist. Illinois) touched on several undisputed facts, primary among them defendant’s admission that any errors in its valuation of the target resulted from “simple mistakes.”

Given that the investment analyst who’d gathered the data had asserted his Fifth Amendment right to avoid self-incrimination rather than testify how the “simple mistakes” occurred, the court could not, as a matter of law, absolve the defendant from bad faith.

For now, the case is moving forward—while fairness opinions are headed for further scrutiny. If more “independent” opinions are called for, then business appraisers may be among the more experienced professionals to answer the call.

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Divorcing Wife Learns: Be Careful What Value You Ask—You Just May Get It

Edenfield v. Edenfield, 2005 Tenn. App. LEXIS 689 (October 31, 2005). Judge Cottrell.

A spouse who owns and operates a business will likely want to keep it after a divorce. The non-owner spouse may very well agree with this allocation—but will argue for a higher valuation, so that the offsetting award on his/her behalf will be equally as high.

What the non-owner spouse probably *doesn't* want is what happened in *Edenfield*, where the husband co-owned and operated a business that furnished various sales and warranty services to local auto dealerships. His expert testified that as the business held no assets of its own and employed only the husband and a second principal, it had no or a nominal value.

The wife's expert used the capitalization method to reach a value of \$344,780 for the husband's share of the business. At the end of the expert's testimony, however, the trial court surprised him with these questions:

Court: Mr. Hulen, just one thing...If the Court awarded Mrs. Edenfield Mr. Edenfield's shares in this corporation, would she then be receiving an asset worth \$344,700?

Witness: If she got all of it.

Court: All right. Thank you. You may step down.

Court gives wife exactly the value she asked for—and then some

Not only did the trial court grant the wife's higher value—it gave her the business, the value of which precluded her from a share of the husband's pension and reimbursement for attorneys' fees, all because she'd acquired an asset "valued in excess of \$340,000."

One can only guess at the judge's reasoning—although a good hint lies in the first line of the appellate court's opinion, which describes the case as "bitterly fought." The conflict left no "in between ground" between the two competing values of zero and \$345k. The contention might have also left the lower court disinclined to favor either party: When the wife had requested a review of the decision, the trial judge had all but said "you asked for it." ("Now, as it turns out, it looks like in retrospect, [the husband's] accountant may have been...correct.")

As the husband had started a new job by then, he no longer wanted the business or the debt that went along with it—and the wife appealed, forced into the unusual position of arguing that her own valuation report had failed to give appropriate weight to the nature of the business. The Court of Appeals agreed, holding that

the business "had little or no value in and of itself and certainly had no value in the hands of the [wife]." An asset or fair market approach might have been more relevant, according to the court—but there's a sense that it really would have preferred less argument from these parties, and more effort toward using their valuations to reach a fair settlement.

Productivity Adjustment Key For Private Practice Valuations

Schiro v. Schiro, 2005 Mich. App. LEXIS 2085 (August 25, 2005). *Per Curiam*.

The *Schiro* case illustrates the real-life productivity adjustments that the valuation of a dental/medical practice often requires. The parties agreed that the husband's 50% share of the tangible assets in an oral surgery practice amounted to \$120,000, per the only valuation analysis in the case, submitted by husband's expert. Not surprisingly, the disagreement was over the expert's calculation of the intangibles—specifically, the estimated annual hours variable, which reflected the number of procedures the husband performed rather than the time he spent in the office.

To value the intangibles, the expert took the husband's projected work hours (based on procedures) and multiplied them by an estimated rate of collections, giving her a total projected annual collection. Subtracting payroll taxes and other expenses, she arrived at a value of \$585,000 for the intangibles, for a total practice value of \$705,000.

On cross-examination, the expert admitted that the practitioner had worked an estimated 2,750 annual hours in 2001. In 2002, he reduced his hours to 2,100 per year, to take care of his son. Pursuant to the surgeon's new work schedule, and in projecting his 2003 hours, his expert used a base of 1,320 per year, even though the industry standard was 1,600. The expert also admitted that her prior practice valuations had ranged as high as \$1.5 million, based on the husband's 2002 income of approximately \$950,000.

The trial court discredited the husband's claim that he would only work 1,320 hours per year. The industry average wasn't entirely persuasive either, as this going-concern business could reasonably expect 1,800 annual hours from its chief practitioner. Plus, the husband had just hired a new partner and bought a new house for \$775,000; it was clear to the court that historically, he was a harder-than-average worker "who likely would continue to work hard." His practice was worth \$1 million, according to the lower court—and the appeals court agreed, stating that the value fell within the range of the evidence *and* realistic experience.

The CBIZ Litigation and Valuation Services group has been practicing in the Denver area since 1988. Our specialized expertise includes:

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- Wrongful Termination
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- Personal Injury

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