

New SEC 2290 Raises the Bar on Fairness Opinions

The SEC recently approved amendments to Rule 2290, which addresses the disclosures and procedures related to the issuance of "independent" fairness opinions. Originally proposed by NASD (the National Association of Securities Dealers, which has since reincorporated as FINRA, the Financial Industry Regulatory Authority), the stated objective of the new rule is to provide greater clarity to investors and simplify compliance. Factors such as Sarbanes-Oxley, shareholder lawsuits, and state investigations helped encourage SEC approval, and the new rule has put fairness opinions under heightened scrutiny.

Boards of directors and corporate executives often seek fairness opinions during sales and/or acquisitions to provide a legal "safe harbor" for the financial aspects of the transactions. The opinion provides a public statement that the consideration in the proposed transaction is fair from the shareholders' perspective. Too often, however, critics and the courts have complained that fairness opinions are nothing but rubber-stamped endorsements of corporate deals rendered by the investment bankers, who could have a conflict of interest. With the advent of Rule 2290, those days may be ending.

Notably, the new Rule recognizes that the real issue with fairness opinions was not their flawed analysis so much as their procedural limitations. For instance, a provider may have had too little time to make the proper analysis or received wrong information. Because fairness opinions are subject to public disclosure, third parties can sometimes use them in unintended ways or to draw incorrect conclusions. A fairness opinion is some evidence of fair dealing and fiduciary compliance but it is never an attestation of the "best price" or a substitute for good business judgment.

The new disclosure requirements in Rule 2290 should help shareholders as well as boards of directors to make better informed decisions. In addition to disclosing the parties' additional roles in the transaction, opinions must now disclose any material relationships during the two years prior and any contingent compensation. Management supplied information must receive independent verification, and a fairness committee must approve the overall opinion.

New procedural requirements relate largely to the

selection and qualification of the fairness committee members and the process by which they will conduct a balanced, independent review. This includes the selection of appropriate valuation methods, because while a fairness opinion is not a formal valuation, it should include at its core a credible valuation. Opinion providers should start documenting their analysis right from the start of the engagement and be prepared for disclosure in every deal.

Jelke Overruled: 11th Cir. Approves 100% Discount for Imbedded Capital Gains

Estate of Jelke v. Comm'r, 2007 U.S. App. LEXIS 26477 (November 15, 2007)

The 2005 Jelke v. Commissioner decision has been described as "poor" for the taxpayer and frustrating for the appraiser. In that case, the Tax Court declined to adopt a dollar-for-dollar discount for a holding company's built-in capital gains tax liability. On appeal two years later, the Eleventh Circuit reversed the Jelke decision.

The decedent in Jelke owned a minority (6.44%) interest in a closely held investment company that owned marketable securities. Citing IRS Revenue Ruling 59-60, the Eleventh Circuit found that the net asset value method was the most appropriate for valuing a stock

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Statistical Study of Options Backdating Supports Opening the Company Books

holding company, which in turn relies on the “venerable willing buyer-willing seller test.”

The Tax Reform Act of 1986 required the recognition of corporate-level gains on distributions of appreciated property. Because an individual shareholder/taxpayer would no longer receive a step-up in basis to fair market value on the valuation date (for estate tax purposes, on the date of a decedent’s death), “it now became more important than ever for a taxpayer to be able to quantify his or her loss in value of the stock due to inherent capital gains tax liability in the corporation.”

Reform took place more slowly in the courts. In the estates of Davis (1998), Eisenberg (2nd Cir. 1998), Welch (6th Cir. 2000) and Jameson (5th Cir. 2001), the courts allowed some discount to reflect the imbedded capital gains.

The Fifth Circuit went a step further in Estate of Dunn (2002) when it stated a hypothetical buyer and seller must always be assumed to liquidate the corporation immediately upon the valuation date, triggering a tax on the built-in gains. The “likelihood is 100%,” the court said, and the appropriate amount for the discount was equal to 100% of the capital gains liability, dollar for dollar.

In Jelke, the IRS urged the Eleventh Circuit to ratify the Tax Court’s acceptance of a present value of the \$51 million capital gains liability, indexed over a sixteen-year period (the likely time when the assets would be sold), which came to \$21 million. The estate claimed this approach was both inconsistent and incomplete, given the likelihood that the value of underlying securities would change over time. It urged the application of Dunn and the certainty of a dollar-for-dollar discount and the Court agreed.

“We are dealing with hypothetical, not strategic, willing buyers and sellers,” the court said. Thus it made a threshold, “arbitrary” assumption that a liquidation takes place on the date of death, freezing all assets and liabilities at that time. Whether a majority or minority interest is present “is of no moment.” Moreover, the Tax Court’s present value approach was “fluidly ethereal,” requiring courts to “gaze into a crystal ball, flip a coin, or at the very least, split the difference” between the respective approaches of the taxpayer and the IRS.

“We think the approach set forth by the Fifth Circuit in [Dunn] is the better,” the court held, in a two-to-one decision. By calculating the estate tax based on a “snapshot of valuation” on the date of death, the simple, logical Dunn rationale provides “practical certainty to taxpayers, appraisers and financial planners alike.” It is a “welcome road map for those in the judiciary,” the court added, “not formally trained in the art of valuation.” The dollar-for-dollar approach also relieves courts from spending time and resources having to “wade through a myriad of divergent expert witness testimony, based on subjective conjecture and divergent opinions.”

Louisiana Municipal Police Employees’ Retirement System v. Countrywide Financial Corp., 2007 Del. Ch. LEXIS 138 (October 2, 2007)

In the summer of 2006, the Los Angeles Times ran an article on the fortuitous timing of executive stock option grants at a number of companies, including Countrywide Financial. One of Countrywide’s larger shareholders, a defined benefit pension fund for Louisiana police officers (LAMPERS), retained an expert to review the company’s option grants from 1997 to 2002. Based on the expert’s statistical study, LAMPERS sent several letters demanding inspection of Countrywide’s internal accounts which were promptly rejected. Having exhausted all means outside of litigation, it sued for access in the Delaware Chancery Court.

To support its efforts, LAMPERS’ offered expert analysis that used a unique statistical methodology to test the likelihood of a company manipulating stock option grants, also known as the “Goldberg Test.” The only restriction LAMPERS imposed on the expert’s analysis was that he review Countrywide’s options grants between 1997 and 2002 (the latter being the date of Sarbanes-Oxley, which reduced the risk of option backdating). The expert further limited his dataset to executive compensation option grants, because Countrywide’s option plans afforded wide latitude to both the timing and quantity of these grants while fixing those to outside directors by dates and formula. That left him a set of eleven grants during the relevant time period.

The expert’s statistical analysis found that on average, the eleven executive stock option grants returned more than ten times the average returns for the entire six year period. By applying the Goldberg Test, he concluded that there was only a 0.1% chance that such a consistent pattern of high returns was due to random chance.

The expert also compared the average fifteen-day returns for the eleven option grants to the average returns of the S&P 500 on the same dates. If the observed positive returns for the option grants correlated to positive movements in the broader market, then “springloading” probably did not occur. The expert did not find such a correlation, however. In his opinion, springloading as well as option backdating served as two “plausible explanations” for the short-term performance of Countrywide’s stock price on the observed option grant dates.

Countrywide criticized the expert for “cherry-picking” his dataset, arguing that he should have expanded the time period and examined the company’s nineteen option

grants between 1997 and 2005. According to its expert, six of these option grants exhibited negative returns. Countrywide argued that their exclusion rendered the entire analysis by LAMPERS' expert unreliable.

Further, Countrywide criticized the expert's use of a fifteen-day window for measuring the gains for all option grants. Once the Countrywide expert corrected the LAMPERS data to account for the publicly disclosed grants, he was unable to find a statistical correlation that supported backdating. He also rebutted LAMPERS' claim of springloading as an explanation for the option grants' high returns.

In reviewing the "battle of the experts," the Delaware Chancery Court was reminded of the famous saying (attributed to Mark Twain), that "there are three kinds of lies: lies, damned lies, and statistics." In this case, the court "toiled" in the statistical realm to uncover the "outer limits of the minimal quantum evidence a shareholder must adduce" under Section 220 to support opening the corporate books. This standard sets the "lowest possible burden of proof," the court observed. In addition, public policy encourages Rule 220 actions before shareholders resort to derivative suits.

Accordingly...a shareholder in a Section 220 action need only demonstrate, by a preponderance of the evidence that there is possible corporate malfeasance that warrants further investigation.

The statistical evidence by LAMPERS' expert, coupled with his credible testimony, offered "some evidence" of corporate wrongdoing at Countrywide. His protocols were "appropriate and sufficient."

Countrywide's "vigorous challenge" may yet prove successful on the ultimate question of liability, however. "LAMPERS is far from conclusively establishing that wrongdoing has in fact occurred at Countrywide." But allegations of cherry-picking and using improper statistical protocols did not amount to a "fatal flaw" in LAMPERS' expert analysis. His plausible conclusion was all that Section 220 required to warrant further, limited inquiry into the company's books and records.

Lost Profits Evidence Turns on Key Expert Assumptions

Mood v. Kronos Products, Inc., 2007 Tex. App. LEXIS 9243 (November 28, 2007)

After eleven years in business together, both parties in this case breached material portions of their exclusive distribution agreement. Defendant Kronos terminated the agreement without adhering to the sixty-day notice provision, and sued to recover a past due amount on the plaintiff's (Mood's) account in excess of \$188,000. The plaintiff counterclaimed for lost profits resulting

from the defendant's unauthorized sale to one of its customers and for damages arising from breach of the notice requirement.

At trial, plaintiff presented no direct expert testimony on the first of his claims. Rather, he presented: 1) invoices from the defendant over a period of nearly two years; 2) plaintiff's average gross annual sales to the customer that the defendant began to deal with directly; 3) a general assertion that plaintiff's "usual" profit margin was 20%; and 4) an expert witness's assertion that about 80% of plaintiff's sales were from defendant's brand of products.

The plaintiff did present an expert to calculate damages for breach of the notice provision. His expert attempted to predict lost profits over the course of ten years, 2004-2014, using a "discrete revenue forecast" based on recent years' net income and applying a 17% discount rate. His calculations showed total lost profits of \$1.1 million.

The jury awarded the plaintiff damages totaling approximately \$580,000, \$30,000 of which was for lost profits. On reconsideration, however, the trial court vacated the jury's awards and entered a "take nothing" verdict, and the plaintiff appealed.

On review, the appellate court ratified the trial court's decision. In particular, evidence of the defendant's gross sales to the one customer provided insufficient evidence of lost profits, as they did not clearly indicate that the defendant was selling the same product at the same volume or pricing scale as the plaintiff. The reliance on gross sales was equally misplaced, as that figure came up during a hypothetical statement by counsel at trial, and was "no evidence" of actual sales. Likewise, general statements that the company operated on a 20% gross profit margin and that 80% of its overall sales came from one product lacked sufficient factual basis.

Further, in calculating damages for breach of the notice provision, plaintiff's expert based his analysis on historical financial data and sales figures during the distributorship period. However: "It did not differentiate between profits lost as [defendant's] sole distributor in the exclusive territory during the sixty-day notice period (direct damages) and those lost from other contracts or damaged business relationships (consequential damages)."

Instead, the expert simply assumed that business would continue for the next ten years; he didn't limit his calculations to lost profits resulting from the inadequate notice. Based on these errors and omissions, the appellate court found the damages evidence speculative and insufficient to support the jury's award, and it confirmed the trial court's "take nothing" verdict.

VMI HIGHLIGHTS

- VMI welcomes Eric Fiorentino, CPA to its staff. As a financial analyst, Eric's area of concentration will be fair value measurement for financial reporting purposes. His prior work experience includes over 9 years in financial accounting. Welcome Eric!
- Ed Wilusz, ASA, CFA, VMI President, was recently named Vice Chairman of Pearl S. Buck International (PSBI). PSBI is a private, non-profit organization with the mission of improving the quality of life and expanding opportunities for children, promoting and understanding the values and attributes of other cultures, the injustice of prejudice, and the need for humanitarianism throughout the world.
- On February 7, Ed Wilusz spoke at a Pennsylvania Bar Institute Death & Taxes seminar in Philadelphia, PA. The topic was "Business Valuations for Estate and Gift Tax Purposes." Ed also presented on January 15 to the Bucks County Estate Planning Council. The topic was "Business Valuations and Buy/Sell Agreements."
- VMI was a sponsor at the Pennsylvania Bar Association's Family Law Section conference on January 18-20.
- On March 20, Andrew Wilusz spoke to the Chester County Estate Planning Council. The topic was "Ethical Issues in Estate Planning."

If you are interested in having one of our analysts speak to your firm or give a presentation at a conference, please contact Susan Wilusz at smw@valuemanagementinc.com or (215) 598-9310.

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