

### Arm's-Length Merger Price Less Synergies Equals Fair Value

*Union Illinois v. Union Financial Group*, 2003 Del. Ch. LEXIS 136 (December 19, 2003). Judge Strine

The issue in this case was the fair value of the shares of a bank holding company for purposes of appraisal rights following a merger. The court concluded that the price of the shares determined by the merger most closely approximated fair value and set the appraisal right recovery amount at \$8.74 per share, the merger price less synergies.

#### Facts

Union Financial Group (UFG) was a bank holding company with two subsidiaries, Union Bank of Illinois and the State Bank of Jerseyville. Because of failed ventures and mismanagement, the board of directors ousted CEO Denis O'Brien. UFG was then labeled a "troubled financial institution" by the Federal Reserve, because it was undercapitalized and heavily leveraged.

Litigation began when O'Brien, the ousted CEO, filed a suit challenging change of control severance agreements among other things. The O'Brien family, owning 38% of UFG's stock, was unhappy with the ousting of Denis O'Brien. Their suits, in combination with the classification by the Federal Reserve and the heavy debt, made the company a high capital risk. The company was unable to secure other financing and was forced to seek a purchaser.

After a competitive auction, a merger agreement was reached with First Banks at \$9.40 per share with two additional payments of 80 cents per share to be paid if certain contingencies were met over the next two years.

#### Valuation Evidence

The O'Brien family's expert testified that the fair value of the UFG shares was more than \$16.00 per share. To support this conclusion the expert relied upon the discounted cash flow (DCF) method.

UFG's expert testified that he believed the merger price was the best indication of the fair value price. He gave a synergy discount of 13% and arrived at a net present value of \$8.74

per share. This expert relied upon management's projections believing there was no basis for the assumption that the company would perform any differently in the future.

#### Chancery Court Findings and Ruling

The court was extremely critical of the O'Brien family expert's DCF analysis and optimistic assumptions, which the court found were not supported by the evidence. The court conducted its own DCF analyses substituting more realistic assumptions for Mayer's assumptions.

“...the court stated that the exclusion of synergies was in accordance with Delaware law that the appraised company be valued as a going concern.”

Ultimately, the court rejected use of the DCF model in this case altogether, stating that:

“More generally, our case law recognizes that when there is an open opportunity to buy a company, the resulting market price is reliable evidence of fair

value.” Or, as then-Vice Chancellor, now Justice Jacobs, aptly

*continued on next page...*

### IN THIS ISSUE

Court Case Updates	Page
Arm's-Length Merger Price Less Synergies Equals Fair Value	1
After-Death Event Used as Basis of Value Over Experts' Protest	2
Collateral Appraisal and Disposition Upheld Without Sale	2
Valuation Models are 'Opinion' not 'Fact'; Appraiser Need Not Disclose Others' Valuations	2
<b>Other Updates</b>	
Fairness Opinions not Always "Fair" (Lack of Independence Leads to Bias)	3
Valuing a Decedent's LP and GP Interests	3

# Court Case Updates

put it: “The fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subject thought process of a valuation expert) is viewed as strong evidence that the price is fair.”

The court concluded that the fair value of the shares was the merger prices minus synergies, which was \$8.74 per share. In its holding the court stated that the exclusion of synergies was in accordance with Delaware law that the appraised company be valued as a going concern.

---

## After-Death Event Used as Basis of Value Over Experts’ Protest

*Estate of Noble v. Commissioner, 2005 Tax Ct. Memo LEXIS 3 (January 6, 2005). Judge Laro.*

The issue in this estate tax case focuses on the value of a decedent’s interest in a bank. At the date of death, September 2, 1996, decedent owned an 11.6% interest in Glenwood State Bank. On decedent’s estate tax return, the estate valued the interest, as of the date of death, at \$903,988. The IRS sent a notice of deficiency asserting the interest was worth \$1.1 million.

### Valuation evidence

The estate valued the shares based on their book value less a discount. Decedent owned 116 shares out of 1000 shares outstanding. The book value of these shares, minus a 45% minority interest discount, equaled \$903,988. The rest of the shares were owned by the Glenwood Bancorporation, which was controlled by the Dean family. The Dean family did not share any family relationship with the decedent. Prior to the valuation date, Glenwood Bancorporation had bought two blocks of stock paying \$1,000 per share for ten shares and \$1,500 per share for seven shares. The court opinion did not elaborate as to the circumstances surrounding these two sales. On December 31, 1996, which was after the death of the decedent and after the valuation date, a member of the Dean family offered to buy the shares for \$878,004. The estate declined the offer. On October 24, 1997, the estate sold the shares to Glenwood Bancorporation for \$1.1 million.

### Holding and Rationale

Judge Laro, after an extensive review of the law and different methods of valuation, valued the interest at its post-death sale price, minus inflation. The court noted that there had not been any material change in circumstances between the sale date and the date of death. The court reasoned that, “An event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to

establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date... Unforeseeable subsequent events which fall within this latter category include evidence, such as we have here.”

---

## Collateral Appraisal and Disposition Upheld Without Sale

*Burns v. Anderson, 2004 U.S. App. LEXIS 26026 (December 15, 2004). Per Curiam.*

Burns loaned Anderson \$14.3 million dollars and Anderson offered, as collateral, shares of Covista stock. Anderson defaulted on the note and Burns prepared to sell the stock pursuant to the pledge agreement.

Prior to the sale, Burns sought a professional appraisal of the stock from Russell Bregman. Bregman valued the stock at \$7.9 million as of April 2002. Burns contacted Anderson to notify him of the sale and Anderson suggested that the stock would be worth more if Burns would wait a couple of quarters to see the results of a recent merger. Based on Anderson’s advice Burns delayed the sale.

In August 2002, Burns asked Bregman to update the previous valuation. The updated valuation yielded a value of \$5.6 million. Burns transferred the shares into his name and deducted that value from the amount due under the loan.

Anderson filed suit. During the trial, Anderson did not present any expert testimony; rather he tried only to discredit Bregman’s valuation. The trial court found the expert testimony sufficient and entered a judgment against Anderson for \$11.6 million plus fees and costs.

### Holding and Rationale

The court of appeals upheld the trial court’s order, noting that the trial court properly admitted the testimony of Bregman, and that the amount of the judgment was not clearly erroneous.

---

## Valuation Models are ‘Opinion’ not ‘Fact’; Appraiser Need Not Disclose Others’ Valuations

*In re Salomon Analyst Level 3 Litigation, 2005 U.S. Dist. LEXIS 317 (January 11, 2005). Judge Lynch.*

In this securities fraud action, the issue was whether research analyst reports disseminated by Jack Grubman and Salomon Smith Barney (SSB) were materially false and misleading. On a motion for reconsideration, the plaintiffs argued that the

# Court Case & Other Updates

court failed to address their allegation that: Grubman's reports on Williams Communication Group (Williams) were false and misleading because his valuation models valued Williams at approximately \$30 billion while other valuation models at SSB valued the company at approximately \$9.3 billion. The plaintiffs thus alleged the defendants omitted a material fact, which they had a duty to disclose, and therefore defendants' "truly held belief with respect to this omission" was irrelevant.

## Holding and Rationale

The court rejected the characterization of valuation models as "fact" rather than "opinion." The court said that, "Facts" about a company include data like amount of sales in a past quarter or the firm's market capitalization on a given date (closing price of the stock multiplied by number of shares outstanding), or events like an executive's promotion to CEO or the acquisition of a competitor. In contrast to these objective statements, financial valuation models depend so heavily on the discretionary choices of the modeler—including choice of method (e.g., discounted cash flow vs. market-based methods), choice of assumptions (such as the proper discount

rate or cost of capital for a particular firm or industry), and choice of "comparables"—that the resulting models and their predictions can only fairly be characterized as subjective opinions.

The court determined that an analyst who sets out his own opinion of a stock's value based on the valuation model he finds most persuasive for that company does not omit a material fact by failing to note that others may have different opinions or analytic approaches.

---

---

## Fairness Opinions not Always "Fair" (Lack of Independence Leads to Bias)

*Opinions Labeling Deals "Fair" Can be Far from Independent*, Ann Davis and Monica Langley. The Wall Street Journal, December 29, 2004.

When J.P. Morgan Chase & Co. merged with Bank One Corp., J.P. Morgan claimed to its shareholders that they had paid a

*continued on next page...*

## Valuing a Decedent's Limited Partnership Interest and General Partnership Interest

**QUESTION:** Sometimes a decedent owns the/a general partnership interest and a limited partnership interest in the same entity. After considering issues including "amount of control" and "ability to liquidate" enjoyed by the general partnership interest, it seems to me that the limited partnership interests owned by this person's estate should be valued using the same discounts as those applied to the general partnership interest. Do you agree?

**ANSWER:** While it may certainly be the case that the logical application of valuation principles and analysis in a specific case may result in the same set of discounts being applicable to both the general and limited partnership interests, this may not hold true in other cases under other sets of facts and circumstances. There could easily be rights and restrictions that apply to one interest but not the other, or that are applied to a different degree to one than to the other interest.

It is instructive to read two Tax Court cases on this issue. The first, *Ahmanson Foundation v. United States* (81-2 U.S.T.C. 13,438 (9th Cir. 1981)), centered on the valuation of two blocks of stock of a company, one a control voting class block and the other a block of nonvoting class stock, for estate tax and charitable deduction purposes. The court held that, for estate tax purposes, the two blocks should be valued as a single holding and therefore no discounts were allowed for the nonvoting stock. The court went on to rule that, when considering the value of the block of nonvoting stock as a separate transfer for a charitable deduction, discounts were applicable because the control voting stock was not included in the charitable transfer.

The second case is more recent. In *Estate of Albert Strangi v. Commissioner IRS* (115 T.C. 35 (2000)), the judge considered the value of a 99% limited partnership interest in the estate and a 47% block of the stock of a corporation owning the general partnership also in the estate. The court held that the relationship between these should be considered in valuing both interests. However, the judge determined that an 8% lack of control and a 25% lack of marketability discount applied to the limited partnership interest, while a 5% lack of control and a 15% lack of marketability was applicable to the 47% stock interest (based mostly on the IRS' expert's report). The fact that a hypothetical seller might be able to market the two interests as a unit was a factor the court felt should be considered. The differences between the terms of the limited partnership agreement and the shareholders agreement were also apparently a factor for consideration.

fair price because they had obtained an opinion from one of “the top five financial advisors in the world.” This renowned “advisor” was none other than the in-house bankers at J.P. Morgan.

Interestingly, Bank One Chief Jamie Dimon purportedly was ready to sell for billions of dollars less if he would become chief of the merged firm. This suggestion was denied, and has sparked a lawsuit brought by J.P. Morgan shareholders who believe the in-house evaluators endorsed a higher price to keep CEO William Harrison in power.

J.P. Morgan has denied these allegations, but cases such as this have caused the NASD to launch an enforcement inquiry over “fairness opinions.” Boards of directors get fairness opinions to show that they have independently checked out the price of the deal, giving them some legal protection.

Unfortunately, fairness opinions are not often arms-length. Investment bankers frequently write fairness opinions for

clients whom they have had business relationships with and with whom they hope to have relationships in the future. Often, the opinion is written by the bank that suggested the merger in the first place and that now is acting as an adviser on that deal. Additionally, the banks typically receive the majority of their advisory fee only if the deal goes through.

“...cases such as this have caused the NASD to launch an enforcement inquiry over fairness opinions.”

This creates financial incentives to see that the deal goes through, as a fee is collected for both the “fairness opinion” as well as for the successful completion of the merger or acquisition (known as the “success fee”). Some have commented that “fairness opinions are one of the highest profit margin businesses on Wall Street.” In addition to these conflicts of interest, when there is a merger between financial institutions, the fairness opinion often comes from insiders instead of an independent, uninterested party.

---

**ABOUT VALUE MANAGEMENT INC.** VMI is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 3,500 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI's** clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.

---

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

---

©2005 Business Valuation Resources, LLC. No part of this newsletter may be reproduced or redistributed without the express written permission of the copyright holder.

---

**Value  
Management  
Inc.** The Business Valuation Specialist

---

---

758 Durham Road • Newtown, PA • 18940-9676

FIRST CLASS  
U.S. POSTAGE  
PAID  
NEWTOWN, PA  
PERMIT NO.43

Address Service Requested