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Fairness Opinions for Transactions

Shareholders have questions when a deal is on the table: Is it time to sell? Is this the best price? Is the deal structured to benefit all shareholders, or a select few? Is the deal fair? For mergers or acquisitions, a fairness opinion states from an objective viewpoint whether a proposed transaction is fair, from a financial point of view, to the shareholders (or a specific group of shareholders) of a company. A fairness opinion, which is usually provided in a letter format, is typically addressed to a company's board of directors or to a special committee of the board (such as the trustees of an Employee Stock Ownership Plan).

The purpose of a fairness opinion is to assist directors in making decisions concerning the transaction. It also serves to protect decision makers against claims that they violated the business judgment rule which requires that: the board exercises due care in the process of reaching its decision; the board acts independently and objectively in reaching its decision; the decision was made in good faith; and, there was no abuse of discretion in making the decision.

There are no hard and fast rules concerning when a fairness opinion is required. However, frequently in transactions, a fairness opinion is considered a necessary step in the due diligence process of the seller. While the facts and circumstances of the transaction will dictate the areas that are explored in the fairness opinion, some issues are routinely involved.

For most transactions, a number of alternatives may exist to the proposed transaction, and certain groups of shareholders may believe that one or more of those alternatives is preferable to the deal at hand. Deals that might be in the best interest of all could be delayed or killed by dissenting shareholders. A fairness opinion can help avoid some of the misunderstandings that might cause poor shareholder relations at a critical time. It can also help to prevent disagreements in situations where there is a perception that corporate insiders could enrich themselves at the expense of the minority shareholders due to the structure of a transaction.

Fairness opinions are also commonly obtained in a sale or merger where a number of competing offers representing different exchange rates, different ratios of cash to stock, or where different credit quality (in terms of debt) is received. The fairness opinion letter will typically interpret and compare the competing bids and explain why one alternative is preferable to the others. If a company has recently experienced poor financial performance, a fairness opinion will typically explore the idea of waiting to sell the company at a later date (after a turnaround) rather than selling at what might be perceived as a low valuation.

Unsolicited and/or hostile offers often give rise to fairness concerns, as surprised minority shareholders may perceive that their concerns were not addressed in the process. If the board of directors lacks unanimity in such a situation, it is almost certain that some stockholders will be dissatisfied with the transaction. When the consideration offered is other than cash, and particularly when the consideration offered is an interest in a closely held company, the financial advisor must investigate not only the interest being sold, but also the interest received in return.

In addition to concerns surrounding the total consideration paid in a transaction, issues of fairness can arise concerning the distribution of the consideration. For example, if different classes of stock exist, certain shareholders may disagree as to the relative value of those classes of stock. Shareholders may also take issue with the noncompete or employment agreements received by managers, or with any other perceived differential treatment of insiders. Regardless of the reason for the fairness opinion for a sale or merger, the opinion serves as evidence of the effort expended by the board in reaching its decision regarding the adequacy of the consideration received in the transaction and the fairness of the transaction to the company's stockholders.

Even when an outright sale or merger is not being considered, fairness opinions are often sought on other significant corporate transactions. These include the sale of subsidiary businesses or lines of business,

recapitalizations, Employee Stock Ownership Plans, stock repurchase programs, squeeze-out transactions, spin-offs, and other material corporate events. Particularly when insiders or other affiliated parties are involved in the transaction, a fairness opinion can help avoid disagreements among shareholders and between shareholders and the board.

Carrying Amount Conundrum

SFAS 142 Update

Intercompany Debt Allocations. In performing valuation analyses for step one impairment testing under SFAS 142, the determination of the appropriate carrying amount of the reporting unit can often be less straightforward than anticipated. Under SFAS 142, the fair value of the reporting unit is compared to the carrying amount to determine if there is goodwill impairment. (For readers unfamiliar with the provisions of SFAS 142, see the Winter 2001-02 issue of VALUE ADDED™).

The carrying amount of a reporting unit is presumably the net of the carrying values of the assets (including goodwill) and liabilities assigned to the reporting unit. Paragraph 32 of SFAS 142 addresses the assignment of assets acquired and liabilities assumed to reporting units.

"For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

1. The asset will be employed in or the liability relates to the operations of a reporting unit.
2. The asset or liability will be considered in determining the fair value of the reporting unit.

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the above criteria are met. Examples of corporate items that may meet these criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets."

Extending this advice to allocating existing assets and liabilities to reporting units, two primary conclusions can be drawn:

1. Tangible (and recognized identifiable intangible) operating assets and liabilities should be allocated to the reporting units where the assets are utilized and where the liabilities are incurred.
2. Financial assets and liabilities should be allocated in a manner consistent with the valuation assumptions made regarding the reporting unit.

Application of the first point is straightforward. Implementation of the second conclusion often becomes complicated with large multi-unit companies that have complex systems of intercompany receivables and payables. If the intercompany items allocate the actual financing structure of the consolidated entity to the reporting units, it would appear appropriate to rely on the intercompany receivables and payables in determining both fair value and the carrying amount comparison. However, if the intercompany items are not reflective of the actual consolidated capital structure (thereby creating a large net "corporate" receivable from, or payable to, the reporting units), it is appropriate to eliminate the "excess" intercompany balances from the carrying amount determination of the reporting units.

The following principles are consistent with the FASB's guidance in SFAS 142:

1. Analyze the earning power of the reporting units on an operating basis (EBIT), ignoring financing concerns.
2. Allocate 100% (no more or less) of the actual debt outstanding to the reporting units on some logical basis (the relative amount of intercompany debt assigned to the unit may be such a basis). Subtract the implied interest expense from the ongoing EBIT estimate to derive ongoing pretax and net income. Alternatively, value may be estimated on the basis of some relevant total capital multiple, from which the

allocated amount of actual debt outstanding would be subtracted to determine fair value.

3. Determine the carrying amount of the reporting unit on the same basis as actual debt outstanding was allocated to estimate the fair value of the reporting units.

4. Confirm that the combined net earning power of the reporting units equals that of the consolidated entity, and that the combined carrying values of the reporting units equals consolidated book value. In general, the net "corporate" carrying amount should be minimal.

In the end, the determination of the carrying amount is an accounting, rather than a valuation, concern. However, the valuation expert should have an understanding of all the assets and liabilities assigned to the reporting unit.

Recent Tax Court Cases

Hackl v. Commissioner, 118 T.C. No. 14 (U.S. Tax Ct. March 17, 2002) The court ruled that gifts of limited liability company interests were gifts of future interests and did not qualify for the annual gift tax exclusion.

The taxpayers, Christine and Albert Hackl, made gifts of units of a limited liability company formed to acquire real estate and operate a tree farm. The goal for this LLC was long-term appreciation and no short-term profits or cash flows were expected. In order to qualify for the annual gift tax exclusion, a gift must be of a present interest. The taxpayers argued that the gifts were present interest gifts for several reasons, including the assertion that the recipients had the same rights in the gifted LLC units as Mr. and Mrs. Hackl had in the LLC units they retained.

The court determined that under the LLC operating agreement, the ability to realize economic benefits was contingent upon a future event – the approval of the manager. A member could not receive distributions, withdraw their capital accounts or sell their membership units without the prior consent of the manager. This prevented the gifted property from being characterized as a present interest. Hence, it did not qualify for the annual gift tax exclusion.

In light of this decision, if the restrictions on owners are too onerous, gifts may not qualify for the annual exclusion. Some professionals have suggested that utilizing a provision giving the donee a 60-day put at fair market value may help avoid an IRS argument. The full text court case can be found at: www.ustaxcourt.gov/InOpHistoric/Hackl.TC.WPD.pdf

Estate of Fontana v. Commissioner, 118 T.C. No.16 (U.S. Tax Ct. March 28, 2002) The Court held that decedent's two blocks of stock should be aggregated for valuation purposes.

The issue in this case was whether two blocks of stock owned by the estate should be valued separately or aggregated. Decedent owned a 50% interest outright and a 44.049% interest in a trust that he held pursuant to a testamentary General Power of Appointment ("GPA").

The estate argued that the two blocks should be valued separately based on *Mellinger v. Commissioner*. In *Mellinger*, the Court found that the stock the decedent held pursuant to a QTIP trust should not be aggregated with the stock held outright. In *Fontana*, the court held the stock had to be aggregated for valuation purposes because "pursuant to the GPA, [decedent], at the moment of death (i.e., the critical moment for estate tax valuation purposes), had control and power of disposition over the property." In *Mellinger*, the decedent did not retain control over the ultimate disposition of the stock held in the QTIP trust. The full text court case can be found at: www.ustaxcourt.gov/InOpHistoric/fontana.TC.WPD.pdf
S Corporations and the Tax Court

At least three recent Tax Court cases (*Gross v. Commissioner*, *Estate of Heck v. Commissioner* and *Estate of Adams v. Commissioner*) have concluded that S corporations are worth more than otherwise identical C corporations. The Tax Court determined that pre-tax earnings rather than after tax earnings should be used in establishing the value of an S corporation. Applying similar valuation multiples, the S corporation can have a value of \$10 million while the identical C corporation paying a 40 percent corporate tax rate may have a value of \$6 million.

In the first of these cases, *Gross v. Commissioner*, the IRS had a great fact pattern. The company being valued consistently distributed all of its net income to the shareholders. Restrictive agreements made it difficult to break the S election and there was no indication from ownership that the S election would be broken. Also, a minority interest was being valued. Under these circumstances, a buyer would be willing to pay more for stock in an S corporation than an otherwise identical C corporation.

The above fact pattern is rare. Problems arise when this case law is applied to situations that do not have the same facts. Unfortunately, with the *Gross*, *Heck* and *Adams* cases, there is momentum in the Tax Court to use pre-tax earnings in valuing S corporations.

In the business appraisal community, there is general agreement that S corporations are worth the same as otherwise identical C corporations at the enterprise (majority interest) level of value. On a minority interest basis, there is a general consensus that S corporations may be worth more or less than otherwise identical interests in C corporations. Each valuation must address the facts present in the situation.

Not long ago, the Tax Court maintained that consideration of embedded capital gains in C corporations was improper unless liquidation of the subject corporation's assets was imminent. However, this was eventually reversed. Hopefully, the current Tax Court trend with S corporations will also eventually be reversed.

VMI HIGHLIGHTS

Andrew Wilusz, Director of Mergers & Acquisitions at VMI, was recently awarded the designation of Accredited Senior Appraiser ("ASA") from the American Society of Appraisers (The American Society of Appraisers, which originated in 1936, is the oldest and only major appraisal organization representing all of the disciplines of appraisal specialists.). To qualify for the ASA designation, an individual must prove a minimum of five years full-time equivalent appraisal experience, pass a series of intensive written examinations, including a test on the Uniform Standards of Professional Appraisal Practice ("USPAP"), and undergo peer review of actual appraisal reports. Congratulations Andrew!

Andrew Wilusz, ASA, will be speaking at the Philadelphia Estate Planning Council's ("PEPC") Foundation Series on August 8th, 2002 along with Angela Hudson of Sotheby's. The Valuation of Tangibles and Intangibles is the general topic of this 2-hour program.

Ed Wilusz, ASA, CFA, President of VMI, will be speaking on the topic of "Valuing Closely-Held Companies, Family Limited Partnerships and Limited Liability Companies" at a one day seminar titled "Estate Planning In Pennsylvania". This seminar will be held on August 21, 2002 in Fort Washington, PA.

Ed recently spoke on the topic of "Valuing Stock for Employee Stock Ownership Plans". This was presented at a June 19th half-day seminar on ESOPs in King of Prussia.

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