Business Valuations

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Appraiser not required to verify facts, but client should be notified

The issue that this column addresses is the appraiser's duty to independently verify information provided by management.

Issue arises in recent case

The subject arose as a result of a case which we reported in our last issue, Olympic Coast Investment, Inc. (OCI) v. Gadini. OCI had hired Paul Iverson to appraise a gasoline station and convenience store, Toppenish Texaco Food Mart (TTFM), for the purpose of making a loan in connection with the sale of the business.

Iverson valued the business in 1998 at $800,000 based on sales and gallonage records provided to him by Louis Gadini, one of the sellers. OCI made the loan based on Iverson's appraisal. The buyer defaulted on the loan, and the investigation revealed that Gadini had presented highly inflated sales and gallonage records, which Iverson relied on in his appraisal.

Perpetrator of fraud claims appraiser negligent

OCI sued Gadini for misrepresentation. Although Gadini acknowledged the misrepresentation, he used as his defense the theory that the appraiser was the proximate cause of the damages because he was negligent in not verifying the records presented. Therefore, OCI should be suing the appraiser instead of Gadini.

In support of his theory, Gadini presented an affidavit by J. L. Haney, a certified general real estate appraiser in the State of Washington. Haney's affidavit alleged that Iverson's failure to independently verify the records presented to him by the seller's management constituted negligence under USPAP Standards Rules 1-4(b), 2-2(b)(vi) and 1-1 (b) and (c).

Content of USPAP relied on

Rule 1-4(b) deals with collecting, verifying, analyzing, and reconciling data. Rule 1-1(b) (1998 version) states that:

> In performing appraisal services an appraiser must be certain that the gathering of factual information is conducted in a manner that is sufficiently diligent to ensure that the data that would have a material or significant impact on the resulting opinions or conclusions are considered.

Rule 1-1(c) says that the appraiser must "not render appraisal services in a careless or negligent manner..."

Rule 2-2(b)(vi) (1998 version) requires that the report:

> state the extent of the process of collecting, confirming and reporting data. This requirement is designed to inform the client and intended user whose expected reliance on an appraisal report may be affected by the extent of the appraiser's investigation.

Few would interpret USPAP to require independent verification of facts presented

Few, if any, of us would interpret the foregoing language in USPAP (or its more current counterpart) to imply that the appraiser had a duty to independently verify information presented to him by management as facts. In fact, I spoke with Mr. Iverson, and he told me that he included in his statement of limiting conditions that "information is assumed to be accurate but not guaranteed."

However, on the basis of Haney's affidavit, the trial court dismissed the suit by OCI against Gadini. Fortunately, OCI did not act on the trial court's implication that they should sue Iverson rather than Gadini, but instead appealed.

Appellate court reverses

The appellate court reversed the trial court. The appellate court quoted a prior case:

> A party to whom a positive distinct and definite representation has been made is entitled to rely on that representation and need not make further inquiry concerning the particular facts involved...When applying this rule, it is immaterial that the means of knowledge are open to the complaining party, or easily available to him, and that he may ascertain the truth by proper inquiry or investigation.

In the ASA BV E-Letter, my Associate Editor, Noah Gordon (not an appraiser) wrote, "to avoid such malpractice, appraisers should make sure they do not fail to independently verify reports and representations made to them by interested parties to a transaction." We (justifiably) received a lot of flack about this comment.

To protect appraiser have disclaimer in engagement letter

In the BVU case summary, we said:

> Although the appraiser was not the defendant in this case, the court intimated that OCI could have a case against him for negligence/malpractice. This is contrary to appraisal practice because appraisers commonly rely on managements' representations and include language in their reports that an investigation into the veracity of such representations is beyond the scope of normal business valuation work.

My suggestion to protect the appraiser is to have a disclaimer to the effect of accepting management's representation without further verification not only in the report but also as an attachment to the engagement letter.

Fairness opinions not always "fair"

***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 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 billons 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.

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.

Quality financial information crucial in a business transaction

***The importance of financial information for M&A transactions*, Holger Erchinger and Thomas A. Rowels**, *Valuation Strategies*, September/October 2004, pp. 32-35.

It is critical in every M&A transaction that the financial information of the subject company be reliable, relevant, transparent, and consistent. It is a significant part of the M&A process to perform financial due diligence, which is strongly tied to the business valuation process, especially in predicting cash flows. Financial due diligence has a profound impact on the completion of the valuation, on the price willing to be offered for the subject, and on the completion of the transaction.

The determination of the quality of financial information has in large measure been shaped by the FASB, which requires that all past, present, and future financial information be relevant and reliable to make accounting, financial information, and financial planning useful for decision making.

Financial information is reliable so long as it is verifiable, is a faithful representation, and is reasonably free of error and bias. Noncompliance with expectations regarding the quality of financial statements can create uncertainty, which can lead to discounts by investors. In an M&A transaction, the lack of financial transparency will provoke the investor to increase the risk profile attached to the investment, causing a reduction in value of the investment.

Because it is so critical that the potential investors have strong financial information for the valuation, the seller should aim to assure the investors that all presented information is of the highest quality, as well as being completely candid in the communication of financial information.

One key to communicating qualitative financial information successfully is by establishing internal processes, which generate financial information independently of existing or anticipated M&A transactions. The seller should also provide the buyer with timely updates regarding financial information.

If the seller can provide interrelated and reconcilable financial information consisting of the past, current, and future financial data, he will then be able to maximize the selling price by reducing the risk perceived by the potential buyer.

With proper planning, ESOPs don't have to be a grim affair

***ESOP's Fables: Increased Scrutiny for ESOP Fiduciaries*, Timothy R. Lee.** *Mercer Capital Value Added*, No. 4, Vol. 16, 2004, pp. 1-3.

Recently, there has been increased scrutiny of processes and the propriety of conduct relating to ESOP's and their fiduciaries. As a result, ESOP trustees and boards of directors have sought highly skilled and experienced service providers to enhance their knowledge of the valuation process and to improve the credibility of their valuations.

Preparation is important when it comes to ESOPs. Has the ESOP pool been examined for diversification and retirement needs? Furthermore, if the company has experienced volatile or declining performance, has the valuation report changed to reflect the impact? The valuation report should neither seek consistency with past reports nor ignore the seriousness of real threats.

Aesop's fables hold many relevant morals concerning the planning and structuring of ESOPs. Some relevant themes are, "An ounce of preventions is worth a pound of cure," and "They who act without sufficient thought, will often fall into unsuspected danger."

Imputed income approach only has to be reasonable to be upheld

***In re the Marriage of Covell*, 2005 Cal. App. Unpub. LEXIS 1321 (February 16, 2005)**. *Judge Garcia.*

The issue in this marital dissolution case was whether husband's real estate and business investments provided him with positive or negative income.

Husband was not a typical income earner but rather engaged in sophisticated and complex real estate transactions to generate wealth. Therefore, the trial court determined that the appropriate method of income calculation was to calculate imputed income by valuing non-income-producing investment assets, and then applying a rate of return to those assets.

The court appointed **Karen Kaseno**, a forensic accountant, to value husband's investments. In addition to applying a rate of return to the value of non-income-producing investment assets, she also compared the difference in net worth over a period of time, but the court chose to use the first method. Husband retained **Alvin Golden** to review Kaseno's report.

Valuation evidence

Kaseno and Golden disagreed on the value of some of husband's properties, as well as the correct way to calculate husband's imputed income. As to asset valuation, the court adopted the valuations used by Golden for all of husband's assets, except one, and as to calculating income, the court adopted Golden's calculations, except it declined to use certain debt service reductions recommended by Golden. Essentially, Kaseno concluded that husband was involved in lucrative activities, whereas Golden concluded that husband had a negative income and was living off loans secured by his real estate.

After calculating a total asset value for all of husband's interests, and subtracting various mortgages and other liabilities, Kaseno calculated that the current net value of husband's assets was $4,994,325. Based on this net value, and using an annual rate of return between two and six percent, Kaseno calculated that his imputed income was $99,800 to $299,640 per year. Golden used a similar approach, but accounted for recent lender appraisals and information that one of the properties operated at a loss. Accordingly, he determined that the net value of Ralph's assets was $2,311,825. Using a 4.44 percent treasury bill rate of return, Golden calculated husband's imputed annual income from the net value of his assets was $102,645.

However, Golden recommended the annual imputed income be further reduced to account for husband's residence on one of the properties. To accomplish this, he suggested that $95,840—apparently representing husband's annual debt service costs (i.e., interest payments) for one of the properties—be deducted from the $102,645 imputed income. Accordingly, Golden reduced Ralph's annual imputed income under to $6,805.

Trial court holding

The trial court adopted Golden's approach, but found that husband's net equity in the assets was $1 million more than that calculated by Golden.

Holding and rationale on appeal

The court of appeals affirmed and found that the record supported the trial court's conclusions. The appellate court rejected husband's arguments that the trial court had to rely on lender appraisals, rather than an actual purchase price. However, the court did note that an independent appraisal would have been preferable. Finally, the court emphasized that there is no single methodology appropriate to all cases—rather, the reasonableness of an imputed income calculation depends heavily on the particular facts of the case.

Chancery court charts own course in appraisal action

***Gholl v. eMachines, Inc.*, 2004 Del Ch. LEXIS 171 (November 24, 2004).** *Judge Parsons.*

The issue in this appraisal action was the value of the shares of **eMachines Inc.**, a company that provided low-cost computer goods to consumers. Charles and Michelle Gholl, owners of 339,000 shares, brought this appraisal action. Other shareholders, who combined owned 1,005,600 shares, also exercised their appraisal rights for the fair value of their shares.

Like many technology-based companies, eMachines went public in March of 2000 in a successful IPO, with the stock set at $9 a share. eMachines' business model was modified to gain revenue from initiating Internet-based consumer relationships. As a result of this change, the company sold its computer hardware for cost or less than cost. This Internet-based revenue model was later labeled a "financial disaster" by eMachines. By late 2000, eMachine stock was trading below $.50 a share.

As a result of this downturn in business, eMachines recruited new management that implemented a turnaround strategy. Despite the changes that were being made, eMachines was delisted from the NASDAQ and began being traded on the Over-the-Counter (OTC) Bulletin Board market.

The new business plan proved successful in turning the fortunes of the company around. Wayne Inouye, the new CEO, declared in an October 2004 conference call that he didn't "understand why the stock is not at least a $2 stock."

In April 2001, the board of directors considered the possibility of a sale of the company. To this end, they retained the services of **Credit Suisse First Boston** (CSFB). CSFB contacted 55 potential buyers and received some indications of interest ranging from $.71 a share to $.83 a share. The company rejected the offers as inadequate and never disclosed the offers publicly.

In October 2001, John Hui, a member of eMachines' board of directors, tendered an offer at $.71 a share. This began a bidding war, which concluded with Hui's offer of $1.06 per share, which was the high bid submitted to the board just prior to the November 18, 2001 deadline.

CSFB prepared a fairness opinion concerning the offer and determined it was fair. The board unanimously approved the merger

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Chancery court charts own course in appraisal action

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and recommend it to the shareholders. Hui commenced the tender offer on November 27, and by December 27 controlled 87 percent of the shares. Hui then exercised a "top-up" option that allowed him to purchase additional shares from the company giving him the 90 percent he needed in order to complete a short-form merger, which was completed on December 31, 2001.

CSFB's fairness opinion

CSFB stated in its written report to the board that it thought the final offer was financially fair. In its valuation of the company, CSFB used several valuation methods including two discounted cash flow models. The first DCF was based on management projections, submitted in November of 2001 for 2002, and resulted in a value range of $1.41 to $2.22 per share. This method was termed "Management Case" by the court. The second DCF analysis was termed "Sensitivity Case" and was based on "much gloomier predictions" resulting in a value range of $.91 to $1.20. Although CSFB never stated which method it relied on in its opinion, the court assumed that it was based on the Sensitivity Case projections.

Shareholder's expert's valuation

Daniel Larson, ASA, testified as the expert for the Gholls. Larson used both a DCF analysis and a market analysis. Based on the 2002 budget Larson weighted the methods 75%/ 25%, respectively. His valuation resulted in a value of $2.48 per share.

Company's expert's valuation

Gregg Jarrell, a professor of economics and finance, testified as the expert for the company. In his valuation, Jarrell first used a DCF analysis using the Management Case projections and arrived at a value range of $.93 to $1.03 per share. Then Jarrell used the 2002 budget, just as the shareholder's expert did, and arrived at a range of $1.00 to $1.22 per share. Jarrell conducted two market-based analyses, but because he did not rely on them for his report, the court considered them only as a "reality check."

Court's valuation

The court, after deciding that neither party had met their burden of persuasion, conducted its own valuation of the company as of the merger date. The court agreed with both experts on methodology and used the DCF method. The court then applied a weighted average cost of capital (WACC) rate of 18.5 percent. The court used a growth rate of 5 percent and calculated the company had $162.5 million in excess cash. These figures resulted in a valuation of $1.62 per share.

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