

You May Not Need a Business Valuation

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Business transactions have become increasingly more complex over time. Individuals responsible for making the decision whether to accept a complex business transaction will sometimes request that a business valuation be performed. Alternatively, the decision maker may seek the advice of a valuation analyst who will act as the independent financial adviser to that decision maker. The independent financial adviser may conduct an analysis that is consistent with generally accepted business valuation standards and practices. However, such an analysis will focus on the specific information needs of the decision maker.

INTRODUCTION

Individuals are often asked to decide, for themselves or on behalf of others, whether to enter into a transaction as either the buyer or the seller. On many occasions, these decision makers will ask for a business valuation to be performed to help them make their decision. Especially when their decision is going to affect others, they want to be comfortable that they are making the appropriate decision.

While a valuation analyst can provide important services to help support such a decision, it may not be a business valuation that the decision maker needs. It may be a different assignment that the decision maker needs: advice from an independent financial adviser. Valuation analysts are often the appropriate providers of that independent financial advice.

THE ECONOMIC CONFLICT

The buyers want to minimize the consideration they pay in the purchase transaction. The sellers want to maximize the proceeds they receive from the sale transaction. Hence, there is an inherent economic conflict between the buyers and sellers of in purchase transactions.

The final purchase transaction price is typically the result of informed (and intense) negotiations between sophisticated (or, at least, well-advised) parties. During these informed purchase/sale negoti-

ations, both parties seek to achieve their maximum economic self-interests.

When an individual is making a decision on behalf of others, that individual may have a fiduciary duty to those people. A fiduciary has a duty of loyalty to the beneficiary of his or her decisions, and the fiduciary should not put personal interests before that duty.

A fiduciary functions as an agent of the beneficiary. The fiduciary can be, for instance, an individual, a trust, or a board of directors. It seems as though the interpretation of fiduciary duties is ever-changing. Fiduciary duties are based on the continued guidance of law, courts, regulations, and regulators.

The fiduciary's duties typically do not pass through to the advisers that are engaged by the fiduciary. The financial adviser's client is the fiduciary (and not the beneficiary of the fiduciary's duty). The financial adviser takes instructions from and works for the benefit of the fiduciary. Normally, the financial adviser does not have a fiduciary duty to the parties to whom the fiduciary has a duty.

In the purchase/sale transaction, the independent financial adviser typically performs several functions, among them are the following:

1. Conducting the financial analysis of the property that is the target of the proposed transaction
2. Assisting the decision maker in the negotiation of the purchase/sale transaction price

3. Assisting the decision maker and his or her legal counsel, if any, in the structuring of the purchase/sale transaction
4. Advising and counseling the decision maker on the purchase/sale transaction details
5. Rendering a transaction opinion to the decision maker that the price of the transaction is fair from a financial point of view

A financial adviser's opinion report is typically a short letter issued by the independent financial adviser to the fiduciary stating that a proposed transaction is fair or adequate from a financial point of view to a specific constituent, such as a particular group of shareholders.

These opinions can be relevant in a variety of transactions involving both public and private companies. Such transactions may involve negotiated mergers, friendly or hostile tender offers, management buyouts, transactions involving employee stock ownership plans, going-private transactions, recapitalization or restructuring transactions, leveraged buyouts, and transactions involving a conflict of interest.

The members of the board of directors may obtain independent financial advice primarily to satisfy their obligation to assure that either selling shareholders receive a fair price for selling their stock or, if for the buyer, the acquiring company isn't paying too much. Particularly when the proposed transaction involves a change of control, the target company's directors may obtain a fairness opinion to demonstrate that they have not breached their duty of care.

There are no federal or state laws that mandate that an independent fairness opinion be considered when decision makers decide whether or not to accept a proposed transaction. Courts have indicated that they give weight, when analyzing whether decision makers have fulfilled their obligation, to the advice that was provided by independent financial advisers.

While the advice of the independent financial adviser helps the decision maker scrutinize a potential transaction, it also serves to provide other parties involved in the transaction with assurance regarding the financial soundness of a deal.

The other parties involved in the transaction may not be privy to the detailed efforts being put forth by the financial adviser to the decision maker. However, merely knowing that the decision maker is getting advice from an independent financial adviser may provide comfort to the other parties involved in the transaction.

If there is a risk that the decision maker may be sued for allegedly accepting the wrong price when entering into a transaction, then the decision maker will want to make sure he or she has directors/officers insurance. The insurance carrier will expect the decision maker to have followed customary procedures. One such customary procedure is to obtain independent financial advice.

If a board of directors' rationale is that the advice of an independent financial adviser provides comfort to the directors in change of control transactions, that kind of advice should provide comfort in other situations as well.

There are many situations when the advice of an independent financial adviser would assist the decision maker even when the risk of being sued is minimal. These situations include, for example, when a proposed transaction:

- involves different classes of capital that have different attributes—what's fair to one class may not be fair to another class;
- changes the way the company does business;
- exchanges debt for equity;
- redeems only certain shares;
- is an acquisition of a business or of significant assets, even a relatively small acquisition, that may cause dilution to shareholders of the acquirer;
- is one in which one shareholder is deliberately given special treatment (e.g., greenmail) or special consideration (e.g., bonus, premium employment agreement, agreement to not compete, earn-out or royalty based on future performance);
- is one in which one party to the transaction (e.g., the retirement plan) has special access to confidential information that, if it were available to other parties, may lead to a different decision to buy, hold or sell;
- involves a controlling shareholder who proposes an action:
 - that may affect the capital structure of the business,
 - that may be considered to be an "insider" transaction,
 - to acquire an entire tranche of preferred stock not offered to any other stakeholder, or
 - that requires special consideration to be paid to the controlling shareholder in order to accept a transaction that is presented as if it provides a benefit to other shareholders.



Different classes of capital may have privileges for which holders of those classes expect to receive a premium. The buyer of the entire entity for one overall price is not so much concerned with how that one overall price is to be allocated to the sellers. In many situations, the allocation of the purchase price to the various claims on that purchase price is controversial.

The decision maker needs to understand the substance of the advice from the independent financial adviser so that reliance is not misplaced. In some circumstances, a second opinion may be prudent.

The advice provided by the independent financial adviser describes the intended audience for the advice, the scope of the analysis, the work that was completed and the assumptions that underlie the analysis. The independent financial adviser should be clear that the advice about financial fairness:

1. is not a recommendation regarding whether to enter into a transaction and
2. is not an affirmation that the proposed consideration is the best achievable.

The decision maker should be on the alert if non-standard assumptions are identified in the text of the opinion report rendered by the financial adviser. Nonstandard assumptions may signal the limitations of the opinion and may limit its usefulness to the decision maker.

BUSINESS JUDGMENT

The business judgment rule was developed by the courts to avoid unnecessarily scrutinizing director actions, as long as directors act in good faith on an informed basis, without fraud or self-dealing, and in a manner that the directors believe to be in the best interest of shareholders.

The business judgment rule is meant to preclude a court from imposing its own judgment on the business and affairs of a company. The “rule” is a legal presumption that provides that the decisions made are not subject to challenge as long as the decision maker:

1. is disinterested,
2. has acted on an informed basis, and
3. has acted with an honest belief that the action taken was in the best interests of the beneficiaries, as a whole.

Decision makers are not considered to be disinterested if (1) they stand on both sides of a transaction or (2) they expect to derive a personal financial benefit from the transaction.

In other words, if the decision maker is engaged in self-dealing, then he or she cannot claim the benefit of the business judgment rule as a defense to claims of breach of duty. However, self-interest alone is not sufficient to base a claim against a decision maker. A claim against a decision maker may be based on either of the following:

1. Disloyalty to the beneficiary
2. The receipt of (or the potential to have received) a material or significant benefit

The mere fact that, in hindsight, a decision maker made a bad decision or a mistake is not sufficient to challenge that decision or allege breach of duty or other mismanagement claims. While it may be apparent in hindsight that the decision was wrong, the decision can withstand an attack if it was made in good faith on an informed basis by disinterested persons.

The board of directors may consider whether the transaction is fair to the company from points of view other than only from a financial point of view.

In some circumstances, the stakeholders in a business are considered to be the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and/or risk bearers. The argument is that debt holders, employees, and suppliers also make contributions and take risks in creating a successful firm.

By attempting to consider the needs and wants of many different people ranging from the local population and customers to their own employees and owners, the board can prevent damage to the image of the business and its brand, prevent losing large amounts of sales and irritating customers, and prevent costly legal expenses.

When the board of directors is deliberating about whether to execute a particular transaction, in addition to the fairness from a financial point of view, these other points of view may also be considered by the board of directors.

To analyze the fairness of the proposed transaction from a financial point of view, the financial adviser may analyze information such as projections prepared by management, the financial performance of publicly traded guideline companies, pricing evidence derived from transactions involving mergers and acquisitions of guideline companies, pricing evidence derived from prior transactions involving the subject company, and break up/liquidation scenarios.

In addition to these analyses, the independent financial adviser may conduct an analysis of the sensitivity of the value to various assumptions. These analyses are consistent with generally accepted business valuation procedures. However, the work product of these analyses may be a brief opinion letter rather than a narrative valuation opinion report.

In addition to a relatively brief fairness opinion letter, the fiduciary will normally receive a more detailed presentation from the financial adviser that summarizes the entire process undertaken by the financial adviser.

The financial adviser's presentation helps the fiduciary to become familiar with important factors from a financial point of view that affect the fiduciary's decision regarding the proposed transaction. The presentation assists in making the decision and provides support for the fiduciary's business judgment rule defense that his or her decision was "informed."

SELECTION OF THE INDEPENDENT FINANCIAL ADVISER

The criteria that decision makers typically consider during the independent financial adviser selection process include the following:

1. The professional qualifications of the financial advisory firm
2. The professional qualifications of the firm's financial adviser principal analyst(s)
3. Any independence issues regarding the financial advisory firm

The advice provided to the decision maker by the independent financial adviser involves more than generally accepted business valuation techniques. The financial advice ultimately relates to whether a proposed transaction is fair to a particular party to the transaction.

Being proficient in the application of generally accepted business valuation approaches and methods is one skill set that the independent financial adviser should be able to demonstrate. Valuation analysts are often the appropriate providers of independent financial advice.

Some of the common professional accreditations related to the business valuation profession that may be considered during the process of selecting the independent financial adviser include the following:

1. The accredited senior appraiser (ASA) designation of the American Society of Appraisers
2. The certified business appraiser (CBA) designation of the Institute of Business Appraisers (IBA)
3. The accredited in business valuation (ABV) designation of the American Institute of Certified Public Accountants (AICPA)
4. The certified valuation analyst (CVA) credential of the National Association of Certified Valuators and Analysts

Conflicts of interest, or the appearance of conflicts of interest, can damage the purpose of the advice and leave the advice meaningless. Many parties to a transaction have adverse interests so, obviously, if the financial adviser is acting or has acted on behalf of any party with any interest whatsoever in the transaction, then the financial adviser's independence will appear to be missing.

In some situations, an "independent" financial adviser may not be viewed as serving the interests of the decision maker. Regardless of the interests of the decision maker, some financial advisers have an incentive to render advice in order to:

- protect an investment in, or perpetuate a relationship with, management of the company or advisers in the transaction;
- promote a high level of merger and acquisition activity in a particular industry; and
- reciprocate to other financial advisers in the transaction for access to fees in other situations.

The financial adviser may not be perceived to be independent if, for example, the financial adviser:

- in an existing or prior assignment, has given advice on strategy, or has attended discussions whereby the strategy and merits of the contemplated transaction have been developed;

- has accepted data and analysis from the commissioning party or other interested parties without critical review;
- has entered into a fee agreement where the fee or the fee amount is dependent upon the outcome of the transaction;
- has discussed future business relationships with the commissioning party or any other interested party before issuing the final opinion;
- has changed its opinion following a factual review of a draft of the opinion by the commissioning party for a reason other than a change in the facts on which it was based;
- has changed its opinion at the suggestion of the commissioning party or any other interested party without due inquiry and analysis by the opinion provider.

The financial adviser should be trusted to explain to the decision maker, for example, the following:

- Both the seller's and the buyer's perspectives of the transaction
- Alternatives to entering into the transaction
- The financial aspects of the transaction to the beneficiaries of the decision
- An analysis of the assumptions upon which the decision is most sensitive

FAIR TO WHOM?

A transaction may be fair in the aggregate (i.e., the total price is fair to the company) but still be unfair to certain owners (e.g., preferred stockholders, ESOP participants, nonvoting LLC members).

If certain parties to the transaction will receive special consideration in the transaction (e.g., an ownership interest in the surviving company, payment for an agreement not to compete with the company, or a lucrative employment contract), then the relative fairness of the transaction may be of concern to the decision maker who is not being offered that consideration. The terms of the transaction being offered to the decision maker may not properly account for these differences. Disclosing these differences is not the same as accounting for these differences.

Especially in transactions that have multiple classes of capital, financial advice should be carefully scrutinized. A transaction that is fair to one constituent may not be fair to another.

The following section presents some examples of financial advice that, upon close scrutiny, should not be relied upon by all parties to these transactions.

The advice may not be pertinent to many decision makers who represent other beneficiaries. This financial advice does not support a decision for all parties to the transaction as to whether to enter into the subject transaction.

You have asked for our opinion as to whether the consideration to be received by the holders of the Company common shares pursuant to the Merger Agreement is fair from a financial point of view to such holders.

We were engaged by the Trustees of the trust holding stock of the Company under the 401(k) Plan to act as an independent financial adviser to the Trustees (solely in their capacity as such) to provide an opinion as to whether the consideration to be received by the Plan in the Offer and Merger is not less than adequate consideration, as defined by Section 3(18) of the Employee Retirement Income Security Act of 1974, as amended, and is fair to the Plan from a financial point of view.

We have not been asked to pass upon, and we express no opinion with respect to, any matter other than the fairness to the holders of the Company common stock, from a financial point of view, of the Cash Consideration as of the date hereof. We do not express any view on, and our opinion does not address, the fairness of the proposed Transaction or any other matter with respect to, or any consideration received in connection therewith by, the holders of any other securities, creditors or other constituencies of the Company, nor as to the fairness of the amount or nature of any compensation to be paid or payable to any of the officers, directors or employees of the Company, or any class of such persons, whether relative to the Cash Consideration or otherwise.

Unless the assignment conducted by the financial adviser specifically states otherwise, a fairness opinion is not:

- an opinion or any form of assurance that the highest and best possible price is being obtained or received for a given transaction;
- an assessment or evaluation of the sale or negotiation process leading to the pending transaction or consideration to be paid/received therein;
- an affirmation of the strategic merit of the contemplated transaction;

- a recommendation to security holders on how to vote;
- an analysis of, or opinion on, other aspects of a given transaction such as lockups, termination fees, severance agreements, and so on; or
- a confirmation of, or any form of opinion or assurance (audit, review, or compilation) on, historic or prospective financial or any other information provided by or on behalf of the client or obtained publicly.

The independent financial adviser typically does not participate in the preparation of the data that is to be considered by the decision maker for the ownership interest that is the subject of the transaction.

The independent financial adviser should perform a sufficient amount of due diligence and quantitative/qualitative analysis with regard to the significant components of the transaction, especially with respect to the expected financial performance of the subject ownership interest.

Even in the rare situation when the price that is offered to the seller is higher than all indications of value for that ownership interest, it may not be prudent for the seller to enter into the transaction.

When the transaction price seems too good to be true, it probably is. In this situation, the financial adviser may be asked by the seller to consider whether the buyer has the capacity to enter into the transaction. If it is likely that the transaction would render the buyer insolvent, then the seller may be accused of fraudulently conveying the property to the buyer. The decision maker may ask the financial adviser to conduct a solvency analysis.

THE "AS OF" DATE

It is important that the decision maker provide enough time for the financial adviser to conduct reasonable and responsible due diligence. The amount of time required to conduct the due diligence varies from one transaction to the next due to the following reasons:

1. The complexity of the transaction
2. The consequences that are potentially associated with making the wrong decision

The decision maker should allow the financial adviser to begin the analysis as early as possible.

The financial adviser will provide the decision maker with a description of the information being

considered in the analysis and the steps undertaken toward understanding the financial aspects of the proposed transaction.

The work product provided by the financial adviser typically includes a presentation to the decision maker regarding the history and the financial merits of the proposed transaction. This presentation should take place early enough prior to the date the final decision is required so that the decision maker can ask questions and fully contemplate the advice being provided.

Often, transactions are delayed through no fault of the decision maker or the financial adviser. In most of these situations, the decision maker should ask the financial adviser to update the presentation and the financial advice so that the financial advice is relevant as of the date on which the irrevocable decision is to be made.

SUMMARY

When a person is asked to decide for him or herself or on behalf of others whether to enter into a transaction, that person should seek independent financial advice. There are many transactions for which decision makers should seek independent financial advice.

The independent financial advice that decision makers should seek is different from, and in many situations broader than, a business valuation.

Many decision makers engage independent financial advisers for objective advice even before they receive an offer.

It is more important than ever for people involved in potentially controversial transactions to obtain timely, independent financial advice. This discussion presented only some of the types of potentially controversial transactions with which a decision maker may be confronted.

It is prudent for a decision maker, especially one who is acting for the benefit of others, to obtain his or her own independent financial advice, including (and maybe especially when) transactions in which other parties have engaged another financial adviser.

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