

J.L. PIERSON & Co. LLC

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ROUTE TO:

J.L. PIERSON & Co. LLC
BUSINESS VALUATION
June, 1999

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Information Requirements for a Business Appraisal

This article focuses on the key documents any appraiser is likely to request at the outset of an appraisal assignment. These fundamental documents provide the platform from which a sound appraisal is constructed. Ideally, reliable information at the outset will prompt well-reasoned follow-up questions by the appraiser at the management interview, making the process more efficient and accurate.

While the list of documents that will likely be requested might appear voluminous, they are vital to the appraisal. A good appraiser will help in this process by explaining which documents are needed and why. The successful organization of the information gathering process is critical to the overall accomplishment of a timely and well-reasoned appraisal.

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- **Financial Statements.** All businesses have financial statements, and it is those numbers in the balance sheet, income statement and cash flow statement that help provide some quantification to the company's efforts. Financial statements can be audits, compilations/reviews, tax returns or internal financials, but remember, it is important for the appraiser to have the best financial information available to accurately analyze the company. Accounting statements with full detail and footnotes will be the most helpful. Historical financial statements are analogous to management's report card on its financial performance. Past performance is only a guide to the future and management will be key in making that future happen. So, it is important to thoroughly understand the past in context with management's vision for the future, and several years of historical financial statements will highlight those problems and opportunities facing the company, that will be discussed in the management interview.
- **Other Financial Documents.** Annual financial statements can be broad brush documents, yet the analysis takes place in the details of operating expenses, other income, receivables and payables aging, next year's budget, five year plan and details of grouped items such as "other" assets and liabilities. Footnotes may provide this information and it is important in understanding the business.
- **Corporate Documents and Records.** These documents help the appraiser understand who owns the business and the nature of the security interest being valued. Docu-

(Continued on Page 2, Column 1)

The Importance of Fairness Opinions in Transactions Involving ESOPs

If a company with an Employee Stock Ownership Plan (ESOP) is contemplating a proposed merger/sale transaction, it is important to obtain the services of an independent financial advisor to evaluate the deal. This formal review is known as a fairness opinion. A fairness opinion is provided by an independent financial advisor to the ESOP trustees of selling (and sometimes acquiring) companies in many transactions today, especially those in which the ESOP is a significant shareholder.

A fairness opinion for an ESOP involves a total review of a transaction from the financial point of view of the ESOP participants. The financial advisor must look at pricing, terms and

(Continued on Page 2, Column 3)

IN THIS ISSUE

Information Requirements for a Business Appraisal	1
The Importance of Fairness Opinions in Transactions Involving ESOPs	1
Federal Rules of Evidence and Expert Testimony	3

ments to review include summary shareholder list showing names and numbers of shares owned; any restrictive agreements applicable to the company's stock; and any corporate policy regarding dividends. For those appraisals that relate to an Employee Stock Ownership Plan ("ESOP"), ESOP-specific information, such as the Plan Document and other special financial information, is important.

- **Operating Facilities and Other Assets.** The company's operating (production) assets sometimes contain hidden value, obscured by accounting conventions. A listing of operating assets showing the cost basis, accumulated depreciation and net book value helps the appraiser focus on asset items such as land, which may be worth more than stated book value. Non-operating assets need to be highlighted to consider these items separately from the operating enterprise.
- **Products and Markets.** To assist the appraiser in understanding what business the client is in, important documents include a mission statement, company brochures, marketing materials, and the sales/manufacturing/distribution of the client's product or service. Additional detail about unit volume, branch sales, top ten customers, major accounts gained or lost, and competitive strengths and weaknesses helps the appraiser to properly position the company in the marketplace vis-a-vis other market players with different resources at stake.
- **Operations and Production.** A chart showing how the major operating entities fit together, the top suppliers, and which production inputs have only one source are important. If the company has patents, trademarks or licenses, the client should help the appraiser understand how the value of those items translate into financial performance. For those businesses such as franchisees, distributors, construction companies or other homogeneous enterprises, clients should tell their appraiser how they compare to others in their peer group. Often, the pertinent trade association(s) or

buying cooperative(s) will have comparative data for similar operators in other markets.

- **Management Personnel and Board of Directors.** Family-owned businesses have an incentive to minimize the pre-tax profit line by certain expenses. For this reason, a detailed compensation review of, at least, the company's top officers is helpful. In addition, names, ages and experience of senior management, the number of employees and their skill levels, and the Board of Directors and their compensation are often requested.
- **Background and History.** A company's background provides perspective on its potential for future performance. A copy of the corporate charter, name changes over the years, dates of acquisitions, changes in control groups and a written history (such as an article in a trade magazine or local business journal) should be considered. The history and perspective on current management operations will help round out the text of a written report, and serve to tie together disparate elements in the analysis.
- **A Summary of Recent Stock Transactions.** Privately held companies do not often have trades in their corporate stock, but the basis upon which any transactions were made should be considered for at least the last three years. This listing should reflect the transaction date, price per share, a characterization of the buyer or seller and any explanatory comments.
- **Details on Corporate Facilities.** The appraiser needs a complete picture of the means of production for the business. A listing by major fixed assets showing location, date acquired, square footage (acreage), book value, estimated or appraised value should be provided. For heavy equipment, similar information regarding asset items showing age, date purchased, current cost basis and appraised or estimated value will help.

For more information or to discuss a valuation in confidence, please feel free to call us. ♦

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Fairness Opinions in Transactions Involving ESOPs

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consideration received in the context of the market for similar companies. The advisor then opines that the transaction is fair, from a financial point of view and from the perspective of the ESOP shareholders.

Although ESOP trustees are not required to retain a financial advisor when contemplating a significant transaction, a fairness opinion provides a potential safe harbor from the charge that the trustees violated their fiduciary duty to the ESOP participants.

The facts of any particular transaction can lead reasonable people to conclude that a number of perhaps preferable alternatives are present. A fairness opinion from a qualified financial advisor can minimize the risks of disagreement among shareholders and misunderstandings about a deal, as well as litigation than can kill transactions and/or litigation against the trustees after the transaction is consummated.

Although the following is not a complete list, consideration should be given to obtaining a fairness opinion if one or more of these situations are present:

- Competing bids have been received that are different in price or structure, thereby leading to an interpretation as to the exact terms being offered, and which offer is "best."
- Insiders or other affiliated parties are involved in the transaction. This is especially the case when the controlling shareholder is also the trustee of the ESOP.
- The company has experienced a recent history of poor financial performance.
- The offer is hostile or unsolicited.
- There is lack of agreement as to the adequacy of the offer.
- There is concern that the shareholders fully understand that con-

siderable efforts were expended to assure fairness to all parties.

- The board desires additional information about the investment characteristics of the acquiring company.
- Varying offers are made to different classes of shareholders.
- There is only one bid for the company, and competing bids have not been solicited.
- There is a significant transaction between a significant insider (perhaps even an ESOP trustee) and the company.

Directors have a fiduciary responsibility to the shareholders known as the “business judgment rule.” In general, directors and management are given broad discretion in directing the affairs of a business. Directors are expected to act in good faith based on the care that an ordinary person would take in supervising the affairs of the business. Inherent in this rule is the requirement that the board of directors be informed about the basis for major decisions prior to reaching a conclusion. In essence, there is an expectation that reasonable decisions will be made in a proper way.

The fairness opinion is a short document, typically a letter. The supporting work behind the fairness opinion letter is substantial, however. A well-developed fairness opinion will be based on at least the following five considerations:

1. Financial performance and factors impacting earnings.
2. Dividend-paying history and capacity.
3. Pricing of similar transactions.
4. A review of the investment characteristics of the consideration to be received.
5. A review of the merger agreement and its terms.

Due diligence work is crucial to the development of the fairness opinion. The financial advisor must take steps to develop an opinion of the value of the selling company and the invest-

(Continued on Page 4, Column 3)

Federal Rules of Evidence and Expert Testimony

Litigation often boils down to a “battle of the experts.” We have reviewed a number of cases where the court has been presented with opposing expert opinions and has chosen to follow one expert’s opinion, or has chosen to use the experts’ opinions for guidance and reached its own conclusion. Due to the significance of expert testimony in the litigation process, potential expert witnesses and those employing expert testimony should be cognizant of recent judicial trends regarding its admissibility.

Admissibility of expert testimony is governed by Federal Rule of Evidence 702. This statute states that “If scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.”

In its 1993 decision in *Daubert* (*Daubert v. Merrell-Dow*, 509 U.S. 579 (1993)), the Supreme Court indicated that scientific expert testimony was admissible only if it is relevant and reliable. The Court stated that the Federal Rules of Evidence mandate that the trial judge should ensure the expert’s testimony is reliable and relevant. The Court suggested four factors which the trial court may use to determine the admissibility of an expert’s testimony. These factors include:

1. Whether the theory or technique has been/can be tested.
2. Whether the theory or technique has been subject to peer review.
3. Known or potential error rates.
4. Acceptance within the relevant scientific community.

Daubert was a product liability case where the link between birth defects and medication was in question. The

facts of the case suggested that the above factors applied to “scientific” testimony. The Court’s decision did not specifically include skill or experience-based testimony; therefore, it could be argued that expert testimony related to valuation issues would be excluded from the *Daubert* test. However, it has been widely held that despite *Daubert*’s focus on “scientific” expert testimony, anyone in the professional community should be aware of the heightened review of potential expert testimony because *Daubert*’s requirements could be expanded to “non-scientific” testimony.

The Supreme Court recently issued an opinion specifically expanding the *Daubert* “gatekeeping” obligation from “scientific” expert testimony to all expert testimony. In *Kumho Tire*

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(*Kumho Tire Company Ltd, et al. v. Patrick Carmichael et al.*, 119 S.Ct 1167 (1999)), the Court addressed whether plaintiff’s expert’s testimony in a products liability case was admissible. The trial court had excluded the expert’s testimony regarding the cause of tire failure as not reliable. Plaintiff’s expert’s opinion was based on a visual and tactile inspection of the tire. He was to testify based on the theory that the tire blow out at issue was caused by a manufacturing defect. He concluded the blow out was caused by a manufacturing defect because his inspection indicated there was an absence of at least two of four physical symptoms indicating tire abuse.

At the trial court level, *Kumho Tire* argued that plaintiff’s expert testimony was unreliable and should be inadmissible based on a gatekeeper theory as

(Continued on Page 4, Column 1)

defined in *Daubert*. The trial court agreed, stating that even though plaintiff's expert testimony was "technical" rather than "scientific," the expert's methodology did not satisfy the reliability factors indicated above. The Eleventh Circuit reversed the trial court's decision, stating that *Daubert* only applies where the expert was relying on "the application of scientific principles" rather than "on skill or experienced-based observation."

The Supreme Court agreed with the trial court and reversed the Eleventh Circuit. The Court stated that the gatekeeping function mandated by Federal Rules of Evidence and *Daubert* applied to all expert testimony. The Court noted that a rule differentiating scientific from technical or other specialized knowledge would be difficult to apply. In addition, the Court noted that such a distinction was unnecessary because "experts of all kinds tie observations to conclusions through the use of...general truths derived from specialized experience."

The Court reiterates that "*Daubert's* general principles apply to the expert matters described in Rule 702. The Rule establishes a standard of evidentiary reliability. It requires a valid con-

nection to the pertinent inquiry as a precondition to admissibility. Where such testimony's factual basis, data, principles, methods, or their application are called sufficiently into question, the trial judge must determine whether the testimony has a reliable basis in the knowledge and experience of the relevant discipline."

The Court also stated that the *Daubert* factors must be applied flexibly. These factors are not a definitive test or checklist. The Supreme Court indicated that the trial judge must have considerable leeway in determining how to assess the reliability of an expert's testimony in a particular case. The factors listed in *Daubert* are to be considered only when they are reasonable measures of reliability.

When reviewing a lower court's determination of reliability, the reviewing court must grant broad latitude regarding how the lower court determined reliability as well as the ultimate reliability determination. In assessing the record, the Supreme Court determined that the trial court did not abuse its discretion, and its exclusion of plaintiff's expert was reasonable.

Appraiser's expert testimony clearly falls within the "technical or other spe-

cialized knowledge" described by the Court. Those considering utilizing expert testimony must be aware of potential heightened scrutiny of such evidence. In addition, experts must be prepared to explain their valuation methods and convince the trial judge that their analysis is relevant and reliable. ♦

Fairness Opinions

(Continued from Page 3)

ment prospects of the buyer (when selling for stock). It is prudent to visit the selling company, conduct extensive reviews of documentation, and interview management.

A similar process should be performed with respect to the buying company, especially if the consideration is its stock. If the purchaser is a public company, it is imperative that all recent public financial disclosure documents be reviewed. It is also helpful to talk with financial analysts who routinely follow the purchasing company in the public markets.

For more information or to discuss the need for a fairness opinion in confidence, please feel free to contact us. ♦

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