MARKS PANETH

ACCOUNTANTS & ADVISORS

VALUATION AND LITIGATION BRIEFING, JANUARY 2016

CALCULATING DAMAGES IN POST-ACQUISITION DISPUTES

Merger and acquisition (M&A) transactions rarely turn out precisely as the parties anticipated when they negotiated the deal and signed the documents. So it's not unusual for disputes to arise over contractual purchase price adjustments, representations and warranties, and earn-out provisions. Determining liability and computing damages in these disputes involves a combination of business valuation, forensic accounting and economic analysis techniques.

Did the buyer get what they bargained for?

Some of the most challenging disputes involve "benefit of the bargain" claims. Essentially, the buyer argues that the value of the business is less than what the seller represented it to be. Suppose, for example, that Company A acquires Company B for five times earnings before interest, taxes, depreciation and amortization (EBITDA). Company B's EBITDA for the 12-month period ending on the closing date is $20 million, so the purchase price is $100 million (5 × $20 million).

After closing, Company A alleges that Company B's financial statements contained material misrepresentations under US Generally Accepted Accounting Principles (GAAP). Company A alleges that Company B overstated its EBITDA by $3 million. As a result, it bargained for a business worth $100 million but received a business worth only $85 million (5 × $17 million).

Can it get complicated?

In the previous example, assuming Company A's allegations are true, it seems clear that the buyer was damaged to the tune of $15 million by Company B's inaccurate financial statements. But many post-acquisition disputes are less clear-cut. Suppose, for example, that Company B's financial statements are accurate, but it loses a customer that contributes $3 million to the company's annual EBITDA just before

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

closing and fails to disclose this development to Company A. Company A might argue that the customer loss reduces the company's EBITDA to $17 million and, therefore, reduces its value to $85 million.

On the other hand, Company B might argue that this type of customer turnover is an ordinary part of its business and, as of the closing date, management was in negotiations with prospective new customers intended to replace those lost revenues. Company B's damages expert might present forecasts and other evidence showing that normal customer attrition isn't expected to hurt the company's future financial performance or market value.

Often, the company's actual performance is relevant. If Company B can show that the company's post-closing performance was in line with Company A's expectations, it's arguable that Company A received the benefit of its bargain, despite the loss of a major customer.

Another important issue is causation. Even if Company B is shown to have made misrepresentations or breached the purchase agreement, it may be able to rebut Company A's causation arguments with evidence that the diminution in the company's value was caused by adverse economic conditions or other external factors. In fact, if Company B can convince the court that Company A failed to meet its burden of proving causation, Company A may not have a case for damages at all. Such evidence may require analysis and testimony by an industry expert or economist, in addition to the work of a valuation specialist.

Be prepared

In litigation involving post-acquisition disputes, it's critical to enlist economic, valuation and forensic accounting experts to analyze issues of liability, causation and damages. Whether you represent the buyer or the seller, these experts can provide objective, market-based estimates of post-acquisition economic damages.

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

HOW TO MEASURE GOODWILL IMPAIRMENT

Under US Generally Accepted Accounting Principles (GAAP), public companies that report goodwill on their financial statements must test it at least annually for impairment. Impairment is essentially measured by comparing the fair value of goodwill to its book value. So it's a good idea to involve a professional valuator in the process. This is true even for companies that opt to avoid rigorous quantitative testing by conducting "qualitative" impairment assessments.

Accounting for goodwill

Typically, goodwill arises when one company acquires another. After the purchase price has been allocated among tangible assets and identifiable intangible assets (such as intellectual property and covenants not to compete), any remaining value is attributed to goodwill. At one time, GAAP required companies to capitalize goodwill and amortize its cost over its estimated life (up to 40 years). In 2001, however, the Financial Accounting Standards Board (FASB), recognizing that goodwill doesn't necessarily lose value, adopted new rules now found in Accounting Standards Codification (ASC) 350-20-35.

The ASC requires public companies to evaluate goodwill annually and write it down only if it is impaired — that is, if the goodwill's fair value has dropped below its book value, or "carrying amount." Under certain circumstances, public companies must conduct impairment testing in between annual tests. Interim testing may be required, for example, if certain "triggering events," such as unanticipated competition or loss of a major customer or key employee, signal a potential loss of value.

Testing goodwill for impairment is a two-step process, applied separately to each of a company's reporting units:

1. Determine a reporting unit's fair value and compare it to the unit's book value. If the fair value is higher, no further testing is required. If fair value has dropped below book value, proceed to step two.

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

2. Calculate the "implied fair value" of goodwill — that is, the fair value of the reporting unit as a whole minus the fair value of its identifiable net assets. If the implied value of goodwill is less than its carrying amount, goodwill has been impaired.

Impairment testing can be somewhat complex and costly, so in 2011 FASB offered a simpler, "qualitative" option that allows some companies to avoid quantitative impairment testing. This option allows management to evaluate certain qualitative factors and then determine whether it's more likely than not that a reporting unit's fair value has sunk below its carrying amount. If management determines that the chances of impairment are 50% or less, no further testing is required.

Valuator's role

A valuator — particularly one with accounting experience — is instrumental to the goodwill impairment testing process. Clearly, companies that opt to conduct quantitative testing need valuation assistance in determining the appropriate reporting units, the fair value of those reporting units and, if fair value is less than book value, the fair value of their tangible and identifiable intangible assets.

For companies that test for impairment but hope to avoid quantitative testing, a valuator can assist in applying the qualitative option. A valuator can also help management design appropriate policies, procedures, controls and documentation for making the assessment and determining whether the process will satisfy the company's auditors. This is key because, without a reliable process for conducting a qualitative assessment, an auditor may conclude that evaluating goodwill impairment without quantitative testing is too risky and, therefore, doesn't comply with GAAP.

Given the potential risk, the qualitative option may not be appropriate for larger, more complex companies, especially public companies that file their financial statements with the Securities and Exchange Commission. One possible exception, however, is a company that has conducted quantitative testing in the recent past. If a previous impairment test indicated that a reporting unit's fair value was substantially higher than its book value — and no significant value-related events have occurred since then — the qualitative option may be appropriate.

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

Don't play games with goodwill

To ensure their financial statements are GAAP-compliant, public companies with goodwill must evaluate it at least once a year to be sure they are reporting it accurately. Because goodwill impairment is closely tied to the value of a company and its assets, a valuation expert is critical to this process.

A SIMPLER ALTERNATIVE FOR PRIVATE COMPANIES

Under GAAP, private companies can now elect to amortize goodwill and certain intangible assets acquired in business combinations over a period of up to 10 years instead of testing them for impairment. They can also forgo the recognition of non-compete agreements and customer-related intangibles unless these agreements or intangibles can be sold or licensed independently.

The majority of private companies are expected to take advantage of these simplified accounting rules. Private company stakeholders are primarily interested in tangible assets, cash flows, and earnings before interest, taxes, depreciation and amortization (EBITDA). Such metrics are unrelated to how companies report intangible assets in business combinations. But a few private companies — especially those that are large enough to consider going public someday — may continue to test for impairment, similar to public entities.

IT ALL ADDS UP - PARTNER PROFILE

Eric J. Barr, CPA/ABV, CFF, CVA, CFE

Eric J. Barr is the partner-in-charge of valuation services within the firm's Financial Advisory Services group. To his role, he brings more than 40 years' experience specializing in litigation support, consulting and traditional accounting and auditing services. He is based in Marks Paneth's New Jersey office.

Eric is a nationally sought after thought leader, lecturer and webinar presenter on accounting, forensic and valuation matters affecting businesses. He is the author of numerous articles and publications, including *Valuing Pass-Through Entities*, published in 2014 by John Wiley & Sons, Inc.

In addition to his professional activities, Eric enjoys collecting sports memorabilia and has been a member of SABR (the Society for American Baseball Research).

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

EVALUATING THE DEAL - A FAIRNESS OPINION CAN PROVIDE NEEDED OBJECTIVITY

Shareholders may become suspicious of deals that seem to benefit “insiders” at their expense, especially if the deal’s projected results fall short, acquisition synergies fail to materialize or insolvency becomes likely. They often challenge such transactions under the assumption that decision makers aren’t fulfilling their fiduciary duty to act in the best interests of the company and its shareholders. This can lead to costly litigation. A fairness opinion from an experienced, independent valuation advisor can help avoid this situation.

Finding a range of values

Simply put, a fairness opinion addresses whether a transaction appears “fair” from a financial point of view. To create one, a valuator usually begins by estimating a range of values regarding a proposed transaction.

Theoretically, the ceiling of this range represents the highest price a prudent buyer would be willing to pay; the floor is the lowest price a prudent seller would accept. The analysis typically presumes that neither party has been forced to buy or sell, and that both parties have reasonable access to relevant financial data.

Another proxy for the lower end of a fairness range is the amount that dissenting shareholders could reasonably expect to obtain in a statutory appraisal action. Legal counsel can help the fairness opinion provider define the appropriate standard of value.

Addressing the details

Estimating fairness is especially challenging if a transaction involves non-cash terms, including earn-outs and stock-for-stock transactions. Evaluating these deals may require looking at future expectations as well as the buyer’s current and prospective financial position.

Timing is another important consideration. A fairness opinion is only valid on a particular date. A transaction may be fair one day but unfair the next because of changing market conditions or product

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

obsolescence, for example. Generally, fairness opinions are performed as close to the transaction or proxy date as possible. Opinions dated too early, or not updated commensurately with changing conditions, may not withstand scrutiny — especially in volatile markets.

Facilitating a deal

Most people associate fairness opinions with public companies undergoing high-profile management buyouts, hostile takeovers or going-private transactions. But fairness opinions have become increasingly popular among private businesses with vocal minority shareholders, complex deal structures and related-party transactions.

Fairness opinions aren't legally mandated, but they can help facilitate major transactions, such as mergers and acquisitions (M&As), spin-offs, stock repurchases, and divestitures. Businesses that reorganize out of court or under Chapter 11 of the US Bankruptcy Code may choose to obtain fairness opinions on behalf of creditors and other stakeholders.

In addition, buyers and sellers use fairness opinions to support their strategic decisions and defend against lawsuits. And some loan covenants require fairness opinions to protect the bank's financial interests against fraudulent conveyances.

Fairness opinions are typically more abbreviated than traditional appraisal reports but require similar analyses. For example, they rely on the same valuation approaches — cost, market and income — to value ownership interests or assets.

Generating the opinion

Moreover, they also may address issues unique to fairness opinions, such as financial structure, tax and accounting consequences, and executive compensation from change-in-control and other bonus provisions. Most fairness opinion letters include these components: 1) description of the transaction, 2) summary of procedures and analyses, 3) list of sources used, 4) conflict-of-interest disclosures and 5) statement of assumptions and limiting conditions.

Of course, every fairness opinion arrives at a conclusion. If an expert concludes a deal is unfair from a

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

financial perspective, it typically falls through — or management renegotiates the terms. Bear in mind, however, that fairness opinions don't address legal or structural fairness, nor do they constitute an endorsement or a guarantee for a particular transaction.

Backing it up

A fairness opinion tells whether a proposed transaction is fair, from a financial perspective, to the company's shareholders. An opinion that's backed by an independent valuation expert's research and verification can help protect directors and officers from personal liability and minimize the risk of shareholder litigation.

LEVERAGE OUR EXPERTISE

Marks Paneth's Financial Advisory Services group has a reputation for providing litigation, corporate financial advisory, valuation and dispute analysis, labor and employment, intellectual property, trade remediation, compliance, and fraud and forensic accounting services of the highest quality. The group serves a wide range of clients, including law firms, private and public companies, insurance carriers and governmental entities at the federal, state, local and international levels.

Since 2010, readers of *New York Law Journal*, have ranked Marks Paneth among the top three fraud and forensic accounting providers. For the past two years, the firm was ranked #2.

For more information

If you would like to learn more about our services, please click here or contact us directly.

Fraud, Securities, Litigation, Board Investigations:
Steven L. Henning, Ph.D., CPA
Partner-in-Charge, Financial Advisory Services
212.201.3179
shenning@markspaneth.com

Valuation Services:
Eric J. Barr, CPA, ABV, CFF, CVA, CFE
Partner-in-Charge of Valuation Services
973.630.5031
ebarr@markspaneth.com

Valuation and Litigation Briefing – January, 2016
All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP

Fraud, Forensic, Commercial Damages:
Eric A. Kreuter, Ph.D., CPA, CFE
Partner
212.201.3118
ekreuter@markspaneth.com

Economic Consulting, Commercial and Personal Damages, Labor Economics, Executive Compensation:
Josefina V. Tranfa-Abboud, Ph.D., CFE, MAFF
Principal
212.201.3143
jtabboud@markspaneth.com

Healthcare Valuation:
Monica Kaden, MBA, ASA
Director
973.630.5035
mkaden@markspaneth.com

Business Valuation, Intangible Assets, Transfer Pricing:
Angela Sadang, MBA, CFA, ASA
Director
212.201.3012
asadang@markspaneth.com

© Marks Paneth LLP 2015 | markspaneth.com

NEW YORK CITY | WASHINGTON, DC | NEW JERSEY | LONG ISLAND | WESTCHESTER

Privacy Policy & Legal Disclaimer

All Rights of Use and Reproduction Reserved
Copyright © 2015 Marks Paneth LLP