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Litigation & Valuation

REPORT

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It ain't over 'til it's over

Postclosing disputes in M&A transactions

Mergers and acquisitions (M&As) are complicated transactions, even when small businesses are involved. So getting from letter of intent to closing takes time — at least several months and likely longer.

During that time, things may (and usually do) change. And if those changes affect the purchase price or the target company's financial position, disputes may (and often do) follow. In many cases, these disputes revolve around the application and interpretation of accounting and valuation principles.

Points of agreement

M&A agreements generally contain a variety of representations, warranties and covenants, as well as an indemnification provision in the event of a breach. The seller, for example, may represent that the target company's financial statements were prepared in accordance with generally accepted accounting principles (GAAP) or some other agreed-upon standard. It's also common to warrant that no liabilities exist other than those already disclosed to the buyer.

Covenants may:

- ◆ Require the parties to take specific actions necessary to consummate the transaction,
- ◆ Come into play when the party in control of the business has the ability to harm the other party,
- ◆ Help ensure the company is operated in the ordinary course of business before the closing,
- ◆ Require the seller to maintain a set level of working capital,
- ◆ Prevent the seller from making any significant new capital investments or other major changes without the buyer's consent, and
- ◆ Help prevent abuse of earnout provisions.

In many deals, whether the target company will live up to its earnings potential is uncertain. To account for this



uncertainty, the initial purchase price is based on the assumption that the company won't achieve its potential, with additional consideration to be paid if the company meets certain financial targets (generally referred to as an earnout arrangement).

The agreement may contain covenants designed to prevent the party in control of the business from manipulating revenues, income or cash flow (depending on how earnings targets are defined) to increase or decrease earnout payments. Suppose, for example, that the seller's management team continues to operate the business after closing. Absent an appropriate covenant, an income-based earnout provision may provide an

incentive to cut research and development, marketing, or other expenses to boost earnout payments.

Postclosing adjustments

One of the most highly litigated contract provisions involves postclosing adjustments to the purchase price. In arriving at a purchase price, a buyer typically applies a combination of income-, market- and asset-based valuation methods, relying on information in the target's most recent financial statements.

To account for changes in this information during the preclosing period, the purchase price is adjusted based on the target's closing-date financial statements. Typically, the seller prepares these financial statements within a specified period (60 days, for example) after the closing. Postclosing adjustment provisions vary from agreement to agreement, but it's common to adjust the purchase price dollar-for-dollar for changes in net working capital, net asset value or some other financial metric.

Ripe for dispute

Business and accounting decisions involve a great deal of subjective, professional judgment, so it's no surprise that M&A transactions are ripe for dispute and that buyers often challenge postclosing adjustments and the closing financial statements on which they're based. The most common disputes involve:

- ◆ Alleged misrepresentations by the seller,
- ◆ Alleged breaches of covenants or warranties,
- ◆ Disagreement over postclosing purchase price adjustments, and
- ◆ Disagreement over earnout payments.

A buyer may claim, for example, that the seller misrepresented the company's financial condition by recognizing revenue prematurely or understating expenses or liabilities, thus inflating the buyer's valuation of the company.

But proving detrimental reliance on the financial statements can be a challenge, because the purchase price is influenced by many factors in addition to the target's financial condition and earnings trends. Examples include economies of scale and other

synergies expected by the buyer and competing bids from other potential acquirers.

In addition, a buyer may challenge the closing-date financial statements. Most agreements require the seller to prepare financial statements in accordance with GAAP, consistently applied. The buyer may claim that the seller used different accounting methods in the closing-date financial statements to boost the purchase price.

Resolving subjective matters

Often, disputes arise because the language in the agreement is ambiguous or vague. There's a common misconception, for example, that GAAP dictates a precise number, when in fact it permits the use of different methods and leaves ample room for subjective judgment. Here again, proof can be a challenge: It may be difficult to distinguish between selecting the most appropriate accounting method for a particular situation and choosing a method that produces a postclosing adjustment in the seller's favor.

Consider the allowance for uncollectible receivables. Evaluating the collectibility of receivables is, to a great extent, a judgment call. By reducing this allowance on the closing-date financial statements, the seller can boost net asset values and increase the purchase price. To successfully challenge such an adjustment, however, the buyer would have to show that the change was inconsistent with the seller's past accounting practices rather than an exercise of managerial judgment with respect to a new set of facts.

In many deals, whether the target company will live up to its earnings potential is uncertain.

Similar issues can arise in the context of earnout provisions. Are management's postclosing business and accounting practices commercially reasonable and consistent with applicable standards? Or are they designed to manipulate earnings benchmarks to increase or decrease earnout payments?

The financial expert's role

Financial experts and M&A advisors play a key role in business sale disputes. Most agreements provide for disputes to be resolved through arbitration or some other form of alternative dispute resolution. Accountants are well suited to the arbitrator's role.

They may serve as consulting or testifying experts by interpreting applicable accounting standards, analyzing the target company's accounting practices, identifying potential discrepancies in the closing-date financial statements and weighing in on challenges to postclosing adjustments.

If the agreement contains an earnout provision, this expert can help determine whether earnings targets have been met. And he or she can provide an opinion as to whether postclosing actions are commercially

reasonable — or simply a pretext for manipulating earnout provisions.

Financial experts are indispensable in helping attorneys draft discovery requests designed to uncover audit workpapers, internal memoranda, consultants' reports and other documents that shed light on the target's accounting policies and practices, the determination of the purchase price and other key issues.

An ounce of prevention

Although financial experts are essential in helping to resolve postclosing disputes, they're most effective when involved earlier in the transaction.

By consulting an accountant or other financial expert when drafting the agreement, you may be able to prevent many of the most common disagreements. And this helps ensure the deal is fair and equitable for both parties. ♦

VALUING IP ASSETS: A TEAM APPROACH

Intellectual property (IP) and other intangible assets often constitute a significant portion of an enterprise's value. And because IP's value is inextricably linked to the legal rights that define it, an accurate valuation requires lawyers and valuers to work as a team.

What is protected

IP rights — especially patents and copyrights — encourage innovation and creative pursuits by giving owners exclusive rights to exploit the economic benefits of their work for a specified period of time. Because much of IP value resides in this legally recognized monopoly, a key valuation issue is whether and to what extent these rights are protected under applicable law.

An attorney can guide a valuator in assessing the commercial advantage IP confers on its owner, which is affected by the patent's or copyright's validity as well as the ability of others to produce competitive products without infringing. For example, a patented technology is of limited value if there's an easy workaround that would enable competitors to achieve similar results.

Life in the real world

One of the most important aspects of valuing IP is determining an asset's remaining useful life. And this is an area where legal rights collide with real-world practicalities.

An IP asset's value lies in the owner's ability to generate economic benefits by creating products or through licensing arrangements. But these benefits don't last forever.

First, valuers must determine the IP's statutory term (20 years from the filing date for a patent, for example). But typically, IP's useful life is shorter than its legal life. Several economic, competitive and legal factors may curtail an asset's ability to continue generating returns for its owner. Market demand for a product may dry up or technological advances may render it obsolete. Litigation or regulatory developments may also shorten an asset's lifespan.

Valuation experts can estimate an asset's remaining useful life by studying the historical life cycles of comparable IP assets.

FLP and FLLC updates

Taxpayers enjoy some important victories

Family limited partnerships (FLPs) and family limited liability companies (FLLCs) have long been popular business and estate planning vehicles for transferring minority interests. The frequency of IRS challenges to these vehicles, however, might be enough to make one question their viability.

Yet virtually all successful challenges to FLPs and FLLCs have been “bad facts” cases: The subject entities were structured or operated carelessly or had no legitimate business purpose other than to avoid gift and estate taxes. In two recent cases, however, taxpayers have won important victories that show properly structured FLPs and FLLCs can withstand IRS scrutiny.

Estate of Mirowski

In recent years, the IRS’s most effective weapon against FLPs and FLLCs has been Section 2036(a) of the Internal Revenue Code. That section enables the IRS to render the valuation issue moot by bringing property transferred to an FLP or FLLC back into the decedent’s estate and taxing it at its full fair market value.

Sec. 2036(a) applies when a decedent retains possession or enjoyment of the property, or the right to income from the property, after the transfer. It also applies if the decedent has the right, either alone or with others, to designate the parties who will enjoy the property or its income. There’s an exception, however, when the transfer is a “bona fide sale for adequate and full consideration.”

According to the Tax Court’s 2005 decision in *Bongard v. Commissioner*, the bona fide sale exception applies when “the record establishes the existence of a legitimate and significant nontax reason for creating the FLP, and the transferors received partnership interests proportionate to the value of the property transferred.” Other factors, such as deathbed transfers or a transferor’s failure to retain sufficient liquid assets to meet his or her living expenses, also may indicate that a sale was not bona fide.

Estate of Mirowski involved an FLLC formed by the widow of the physician who invented the pacemaker. Although she’d transferred a substantial amount of property to the FLLC shortly before her death, the Tax Court found that the bona fide sale exception applied. The court didn’t consider it a deathbed transfer because her death was unexpected. In addition, she’d deliberated for about a year about whether to form the FLLC.



Key to the Tax Court’s decision, however, was the existence of three legitimate and significant nontax purposes for forming the FLLC:

1. For joint management of the family’s assets (by the decedent’s daughters, and eventually her grandchildren),
2. To maintain the bulk of the family’s assets in a single pool to allow for investment opportunities that otherwise would not be available, and
3. To provide on an equal basis for each of her daughters, and eventually each of her grandchildren.

There was no evidence of an implied understanding that the decedent would have access to the transferred assets if needed. Moreover, the operating agreement’s terms as well as her fiduciary duties to the entity and its other members limited her control over the FLLC as general manager.

Astleford v. Commissioner

Astleford v. Commissioner involved the valuation of gifted interests in an FLP that owned farmland and other

assets. The Tax Court addressed a number of valuation issues, including the availability of “tiered” discounts based on multiple levels of ownership.

One of the assets the FLP owned was a 50% interest in a real estate general partnership. The issue was whether the value of the general partnership interest should be discounted for lack of control and marketability along with similar discounts applied to interests in the FLP that held those general partnership interests.

The IRS’s valuation expert stated that only one tier of valuation discounts should be applied, but the Tax Court disagreed. The court noted that the general partnership interest was entitled to a combined 30% discount for lack of control and marketability in valuing the interest as an asset of the FLP. In addition, the transferred FLP interests were entitled to a combined discount of 35.6%. The cumulative effect of the two layers of discounts

effectively reduced the value of the general partnership interest by almost 55%.

The court cautioned that tiered discounts generally aren’t available when the lower-level interest constitutes a significant portion of the parent entity’s assets. But in this case, the general partnership interest constituted less than 16% of the FLP’s net asset value and was one of 15 real estate investments held by the FLP.

The court also discussed the use of data from real estate limited partnerships (RELPs) and real estate investment trusts (REITs) to support control and marketability discounts.

A few good facts

When the IRS challenges an FLP or FLLC, the outcome depends on the particular facts and circumstances. These cases provide valuable guidance on the types of facts that can help support a taxpayer’s position. ♦

Unemployment compensation

Calculating damages for lost earnings

Lost earnings can be a significant component of damages in many litigation contexts, including wrongful termination, employment discrimination and personal injury. At first glance, calculating lost earnings may seem simple, but in many cases it’s deceptively complex.

Projecting future earnings

Calculating lost past earnings — or earnings the plaintiff would have received from the time of the incident until trial — is relatively simple. Estimating future earnings, however, can be nearly as complex as estimating lost profits for a business.

Unless the plaintiff is unable to work at all, the expert must make two calculations: 1) the earnings the plaintiff would have enjoyed but for the defendant’s wrongful act, and 2) the plaintiff’s actual expected earnings. The plaintiff’s damages are generally equal to the present value of the difference between those two numbers.



Establishing a base

As with a business, the first step is to analyze the plaintiff's earnings history — including salary, benefits, bonuses and commissions — to establish a level of base earnings from which to extrapolate. If the plaintiff has worked for the same employer for several years with a consistent pattern of annual increases, determining base earnings is relatively straightforward. If his or her earnings history is erratic, however, the expert takes into account the reasons — such as health problems or lifestyle choices — in arriving at base earnings.

It also may be necessary to adjust base earnings for unusual, nonrecurring payments, such as a “signing bonus.” The expert further considers variable compensation, such as commissions, performance bonuses and overtime.

Of course, past earnings trends can be a good predictor of future earnings, but they may need to be adjusted. For example, a startup business with little or no earnings history may nevertheless recover substantial lost profits damages if it can establish future earnings with reasonable certainty. Similarly, an individual plaintiff may recover lost earnings well beyond what his or her earnings history might suggest if the plaintiff's education, skills and experience suggest a higher level of future earnings.

In analyzing historical earnings trends and projecting future earnings, an expert considers the impact of seasonal variations and economic trends that may distort past earnings patterns. The expert also analyzes the plaintiff's promotion history and evaluates the likelihood that promotions will continue at the same rate in the future.

If the case involves employment discrimination, the plaintiff's earnings history may not be a reliable indicator of his or her earnings potential. Under those circumstances, it may be necessary to rely on the earnings of other employees in comparable positions.

Valuing benefits

Placing a monetary value on benefits is another challenge. Benefits can cover a lot of ground, from health insurance and retirement plans to company cars and meals, and they can be a significant component of earnings. The plaintiff may not remember — or even

MITIGATING CIRCUMSTANCES

Lost earnings damages are generally equal to the present value of the difference between the earnings the plaintiff would have received but for the defendant's wrongdoing and his or her actual expected earnings. What if the plaintiff chooses not to work or accepts an unreasonably low-paying position?

In most states, a plaintiff has a duty to mitigate damages by finding alternative employment. If the plaintiff fails to do so, the defendant's expert might assert that actual post-injury earnings should be projected based on the highest-paying reasonable alternative derived from earnings data for similarly situated individuals.

In evaluating mitigation, however, experts consider the plaintiff's future opportunities. Perhaps the plaintiff accepted a low-paying job that offers opportunities for future advancement. Or maybe the plaintiff chose to start a business or go back to school to learn a new trade. Awarding the plaintiff the full amount of lost earnings during this “startup” period may be appropriate.

be aware of — all of the benefits he or she receives, so it's important to use the discovery process to make sure all benefits are accounted for.

In some cases, using statistical evidence, such as average employee benefits as a percentage of salary, may be appropriate. But if benefits are substantial, it may be worthwhile to determine the value of each benefit separately.

Finally, the expert needs to determine the loss period. The appropriate loss period can have a significant impact on the overall damages award. Typically, it extends from the date the plaintiff was discharged or otherwise prevented from working until he or she secures comparable employment. If the plaintiff can't work or is no longer able to achieve the previous level of earnings, the loss period may extend over his or her entire worklife expectancy.

Considering all the factors

These are just a few of the many factors experts consider in establishing or opposing lost earnings damages. Experience and expertise are key to ensuring all the bases are covered. ♦

We deliver objectives

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- ◆ Obtaining Financing
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Our Valuation Experts



Donald W. Nalley, Jr., CPA, CVA, AM, ABV, is a founder and a director of the CPA and consulting firm Beason & Nalley, Inc. He is a holder of the appellation of Certified Valuation Analyst (CVA), an accreditation that recognizes special training and experience in business valuations and adherence to the standard established by the NACVA and an Accredited Member (AM), awarded by the American Society of Appraisers. Mr. Nalley, a former tax manager with Price Waterhouse, has over twenty-five years of valuation, management consulting, litigation, tax and accounting experience, and is a member of the NACVA, the American Institute of Certified Public Accountants, the Alabama Society of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the American Society of Appraisers, a former member of the NACVA advisory board, and the former president of the Alabama Chapter for the NACVA. Mr. Nalley has also served as special master and an expert witness in litigation matters.



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