Valuation & Litigation BRIEFING

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Don't play games with goodwill

Nearly eight years ago, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, dramatically altering the accounting treatment of goodwill and other intangible assets acquired in a merger or other business combination.

In the current economy, it's critical for companies to monitor goodwill closely, and business valuation plays a vital role.

Changing the rules

Previous rules required companies to capitalize goodwill and amortize the cost over a period of up to 40 years. But in issuing SFAS 142, FASB recognized that goodwill isn't necessarily a "wasting asset" whose value deteriorates over time. The new rules require businesses to annually test goodwill for impairment and take a write-off only if the goodwill's fair value has dropped below its book value or "carrying amount."

SFAS 142 also requires a company to test goodwill for impairment *between* annual tests if certain "triggering events" indicate that its fair value has deteriorated. One triggering event that's particularly relevant now is "a significant adverse change in legal factors or in the business climate." But other events may also require unscheduled testing, including unanticipated competition and the loss of key personnel or a major customer.

Goodwill is what's left over after the value of a company's tangible assets and identifiable intangible assets have been determined.

If you have clients that have been hit hard by the economy or suffered other significant business setbacks, they should consult a valuation professional to determine whether their goodwill needs to be tested for impairment.

Keeping score

If a business experiences a triggering event, determining whether goodwill has been impaired and measuring the amount of the loss can be a challenge. That's because the value of goodwill can't be measured *directly*. Rather, goodwill is what's left over after the value of a company's tangible assets and identifiable intangible assets have been determined.

Testing for goodwill impairment is a two-step process:

1. Determining fair value. The valuator determines the fair value of the company as a whole (or of each reporting unit, if

applicable) and compares that value to its carrying amount. If the business's (or reporting unit's) fair value is less than its carrying amount, the valuator moves on to Step 2. Proceeding to Step 2 doesn't necessarily mean that goodwill is impaired; fair value may have declined because the value of assets *other than goodwill* has gone down.

2. Calculating implied fair value. The valuator's next task is to calculate the company's (or unit's) "implied fair value," which is the fair value of the company or unit as a whole less the fair value of its recognized net assets. If the result is a positive number, it represents the implied fair value of goodwill. And if that value is less than the carrying amount of goodwill, the difference is the impairment loss that should be recognized.

JUDGMENT CALLS

Statement of Financial Accounting Standards (SFAS) No. 157, which provides accounting rules for determining fair value, creates a three-tier valuation hierarchy that requires valuators to give the greatest weight to "observable inputs," such as quoted prices in active markets for assets that are *identical* to those being valued. The lowest weight is given to "unobservable inputs," such as a company's own discounted cash-flow analyses or other internally developed data.

In today's struggling economy, however, quoted prices have declined — particularly for financial assets, such as debt securities — leading to confusion over whether they should be relied on in determining fair value. To address these concerns, FASB has issued several FASB Staff Positions (FSPs) to provide guidance on measuring fair value in the current climate.

FSP 157-4 offers guidance on applying FAS 157 when the market is inactive or when available pricing data reflects distressed sales. The FSP makes it clear that judgment should be exercised in determining whether a market has become inactive and, if so, in relying on a company's internal data to determine fair value.

Playing fair

Testing goodwill for impairment requires a valuator to determine the "fair value" of a company or reporting unit as well as the fair values of its tangible and identifiable intangible assets. When working with valuation experts, it's important to discuss these issues and become familiar with recent FASB guidance on valuing financial assets in illiquid and inactive markets. (See "Judgment calls" at left.)

If one of your clients is planning a merger or acquisition, make sure it seeks valuation assistance in the planning stages. As noted above, SFAS 142 is applied at the reporting-unit level. Acquirers have some flexibility in allocating goodwill and other purchase-price components among various reporting units. A valuator can help put together an allocation strategy designed to minimize the impact of goodwill impairment on the client's financial statements.

Spreading the word

In today's tough economy, it's likely that many of your clients have experienced a triggering event that calls for goodwill impairment testing. You can provide them with a valuable service by steering them to a qualified valuation expert to guide them through the testing process. ◆

Vying for the rights to flat-screen TV technology

No damages for breach of patent license

Last summer, two companies engaged in a fierce battle over licensing rights to a patented flat-screen TV technology. In *Nano-Proprietary Inc. v. Canon Inc.,* the U.S. Court of Appeals for the Fifth Circuit held that a patent licensor couldn't terminate a "perpetual" license agreement, despite the licensee's material breach of the agreement. In addition, the licensor could not recover monetary damages, because it had failed to establish the amount of damages with reasonable certainty.

Background to the story

Canon, the defendant, paid Nano about $5.5 million to license Nano's patented flat-screen TV technology. The license agreement granted Canon a "fully paid-up, worldwide, royalty-free, irrevocable, perpetual, nonexclusive license (without the right to sublicense)" that "shall continue in full force and effect until the expiration of the last to expire" of the licensed patents.

Later, Canon entered into a joint venture with Toshiba to develop products using that licensed technology. Both companies invested around $83 million in the venture, but Canon received a slim majority of shares. Apparently, the idea was to qualify the venture as a Canon subsidiary so as not to violate the license agreement's restrictions on sublicensing. But despite Canon's slight ownership advantage, the joint-venture arrangement gave the parties equal control over many important decisions.

Nano claimed that Canon materially had breached the license agreement by sublicensing the technology to the joint venture. Nano terminated the license, kept the $5.5 million fee and sued Canon, seeking damages based on loss of its prospective license with Toshiba or the joint venture.

During the litigation, Canon restructured the joint venture as a 100% Canon subsidiary, buying back Toshiba's stock for $83 million.

The U.S. District Court for the Western District of Texas found that:

- The joint venture wasn't a Canon subsidiary,
- Canon had materially breached the license agreement, damaging Nano,
- Nano's termination of the agreement was effective, and
- Canon's restructuring of the joint venture didn't prevent the termination.

At trial, the jury found that Nano hadn't sustained any damages beyond what was covered by retaining the license fee and terminating the agreement.

Damages were too speculative

On appeal, the Fifth Circuit held that, even assuming Canon had breached the license agreement, Nano wasn't entitled to terminate the agreement, because the agreement unambiguously granted Canon an "irrevocable," "perpetual" license. Nano's sole remedy for a

breach was to sue Canon for damages, but in this case, damages were too speculative to justify an award.

In reaching this conclusion, the appellate court ruled that Nano's expert couldn't use Canon's and Toshiba's internal sales projections to establish the value of the purported lost license from Nano's perspective. "It cannot be the case," the court said, "that having 'reasonable knowledge of relevant facts' requires knowledge of all of the opposing party's secret documents."

Moreover, the appellate court excluded the expert testimony about a correlation between fluctuations in Nano's stock price and the value of the lost license as too speculative. The court also found that the $83 million Canon had paid to Toshiba was not evidence of the value of the lost license. Any correlation between that figure and the value of a license was also speculative.

Additionally, the appellate court found that the district court had properly dismissed Nano's claim for tortious interference with prospective business relations. There was no evidence that a business relationship between Nano and Toshiba or the joint venture was "reasonably probable."

Note that lost profits don't have to be calculated with absolute precision, but rather with reasonable certainty. Lost profits are an estimate, based on fact and reasonable assumptions rather than speculation or complete precision.

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Speculating on speculation

The appellate court found that Nano wasn't entitled to damages based on the value of a prospective license, because it had failed to prove such damages with reasonable certainty. The moral of the story? Retaining a qualified valuation expert can help eliminate speculation and improve your chances of success should your client find itself at the end of a lawsuit. ◆

Fairness opinions can help provide needed assurance

In the wake of recent corporate scandals, many shareholders have become suspicious of transactions that benefit corporate "insiders." Many have challenged such transactions, believing that the decision makers aren't fulfilling their fiduciary duty to act in the best interests of the corporation and its shareholders.

So how can your clients insulate their directors and officers from personal liability and avoid shareholder litigation? Among other things, they should obtain a fairness opinion from an independent financial advisor before entering into major transactions.

Assuring fair transactions

A fairness opinion is a written opinion from an independent financial expert that a proposed transaction is fair — from a financial perspective — to the corporation's shareholders or a particular group of shareholders. It can demonstrate that the directors and officers acted independently, objectively and in good faith in making major corporate decisions. While fairness opinions aren't required by law or by statutory authority, court decisions indicate that courts look favorably on boards that have obtained a fairness opinion in fulfilling their fiduciary duties.

Obtaining a fairness opinion is particularly important when:

- A proposed transaction involves insiders or related parties,
- Significant stakeholders (especially board members) disagree about a proposed transaction's merits,
- A company's ownership changes hands and competing offers are on the table with different prices and structures, or
- Only one bid has been solicited or the offer is unsolicited.

A fairness opinion is not, however, a substitute for due diligence. Nor is it a guarantee that a proposed transaction is a smart business move.

Satisfying the business judgment rule

In the event of shareholder litigation, a fairness opinion helps corporate leaders demonstrate that they satisfied the business judgment rule. Under that rule, a court won't second-guess the decisions of a corporation's directors and officers — even if they turn out to be unwise or unprofitable — as long as the decision makers exercised due care, were informed of all the relevant facts, acted in good faith and reasonably believed that their actions were in the corporation's best interests.

A fairness opinion also may help avoid litigation by providing minority shareholders with some comfort that the transaction is fair and that insiders aren't trying to enrich themselves at the minority's expense. This is particularly important when a company has several classes of ownership with competing interests.

Employing a valuation expert

Valuation experts can offer objectivity and are ideally suited to provide fairness opinions because determining whether a transaction's price and terms are fair involves the application of business valuation techniques. The valuator analyzes the business or interest being sold, scrutinizes every aspect of the proposed transaction, and evaluates its pricing and structure compared with deals among similar companies.

A valuator can review not only the overall transaction price, but also the way proceeds will be distributed among the selling company's shareholders and the relative values of different classes of stock. And if the consideration for the transaction includes stock as well as cash, the valuation expert will also take this into account in his or her final value determination.

A transaction's fairness goes beyond the purchase price. Business valuators also have experience in determining the value of employment contracts, noncompete agreements and other terms that may benefit management.

Fulfilling fiduciary duties

Fairness opinions produced by a qualified valuation expert may aid any transaction in which the value of shareholder interests is at stake, including mergers and acquisitions, recapitalizations, going-private transactions, employee stock ownership plan (ESOP) transactions, stock repurchase programs, sales of a subsidiary or line of business, spin-offs, and bankruptcy reorganizations. They also can be useful when the company's recent financial performance has been poor.

Working with a valuation expert can help your corporate clients ensure they're fulfilling their fiduciary duty to act in the best interests of the corporation and its shareholders. ◆

Avoiding settlement mistakes

Deciding whether to settle a case requires an evaluation of the likely outcome if you proceed to trial. But according to a study published in the September 2008 issue of the *Journal of Empirical Legal Studies*, parties make the wrong decision a lot more often than you might think. A "wrong decision" means rejecting a settlement offer and then achieving a less satisfactory result at trial.

Some key findings

The study, co-conducted by DecisionSet, a California-based "decision services" company, and faculty at the Wharton School of Business, examined thousands of civil cases litigated in California and found that plaintiffs had made the "wrong decision" in 61.2% of them. Defendants were wrong only 24.2% of the time, but their mistakes were much more costly, averaging $1,140,000 compared to $43,100 for plaintiffs. (Note that these results don't reflect attorneys' fees and other trial costs.)

The study also analyzed the results by category based on a variety of factors, including case type, the nature and amount of damages sought, whether a statutory offer in compromise was made (and by whom), whether insurance coverage was available, and whether the parties participated in an arbitration or mediation.

Lessons to be gleaned

Perhaps most important, the results indicate that parties are less prone to making the wrong decision when they conduct a careful evaluation of the likely cost of going to trial.

For example, the frequency and size of errors were significantly lower when a statutory offer in compromise was made. In California, as in many other states, a party who rejects such an offer and obtains a worse result at trial may be liable for the other party's court costs, expert witness fees and other expenses. The lower error rate suggests that the offer in compromise (and its potential consequences) provide an incentive to conduct a more careful evaluation of likely trial outcomes.

Similarly, the error rate went down when insurance coverage was available or the parties went through an alternative dispute resolution process. This suggests that input from experienced professionals, such as insurance adjusters, financial experts and valuators, had a positive impact on the parties' evaluation of settlement options.

A useful guide

The study provides a useful guide to the types of cases and situations where litigants are most prone to making the wrong decision. It also highlights the value of expert analysis, decision-tree analysis and other strategies that can help you take the guesswork out of the settle-or-litigate decision. ◆

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