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ADVOCATE'S EDGE

How valuation expertise strengthens buy-sell agreements

Update on patent damages under the *Panduit* test

Is collaborative divorce right for your client?

Fraud prevention
Audit committees are a critical defensive tool

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How valuation expertise strengthens buy-sell agreements

A solid buy-sell agreement can help closely held businesses avoid disruptions when a shareholder leaves the business. Arguably, the most critical provisions in a buy-sell agreement are those that address valuation-related issues. Incomplete or outdated valuation provisions can lead to costly, bitter disputes that hurt both individual shareholders and the company.

Here are some business valuation issues to consider when drafting a buy-sell.

What's the appropriate valuation method?

The valuation provision of a buy-sell agreement describes how a departing shareholder's business interest will be priced for purchase by the company or the remaining shareholders. Three common methods of valuing an interest include:

1. Prescribed formula. Some buy-sell agreements call for a simple formula to establish the amount of the buyout. For example, a buy-sell might specify that "shares will be purchased at four times earnings before interest and taxes (EBIT) for the previous 12 months." Usually, a valuation professional will suggest an initial buyout formula.

A drawback to valuation formulas is that they typically apply to historical financial results (not projected results) and may not reflect a business's current value in today's marketplace. Moreover, it's difficult to account in a formula for all factors that can affect earnings in any given year — including discretionary, unusual or one-off expenses.

Earnings-based formulas also may be subject to misinterpretation or manipulation. For instance, shareholders might over- or understate expenses in anticipation of a buyout. Or they may disagree about what's included in (or excluded from) "earnings."

2. Fixed price. An agreement also might specify a fixed price reached through negotiation by the shareholders, often with the input of a business valuation expert. This approach fosters collaboration and discussion among shareholders at a time when they aren't yet facing a triggering event.

Like a formula, the main appeal of a fixed price often is its perceived simplicity. But a fixed price may not reflect the business's value at the time of a triggering event. And both formulas and fixed prices might require periodic adjustments due to external factors (such as the recent Tax Cuts and Jobs Act) that can affect a company's value and capital structure in ways not contemplated when the agreement was drafted.

3. Outside opinion from a business valuation professional. Alternatively, a buy-sell agreement could call for an agreed-upon process, usually a formal business valuation, to guide the buyout when a triggering event happens. Objective, timely business valuations are likely to take into consideration current circumstances, thereby producing more meaningful results.

The agreement might provide for the retention of a joint valuation expert or require that both sides hire their own experts. In the latter situation, a third expert might be needed if the experts' opinions don't fall within a certain range of each other. The buy-sell agreement should specify who's required to pay the valuation fees (the buyer, the seller or the company).

What are the valuation parameters?

Other relevant parameters to consider in the valuation provision of a buy-sell agreement include the appropriate level and standard of value, as well as the valuation date.

There are basically three "levels" of value: 1) minority, marketable, 2) minority, nonmarketable, and 3) controlling. In turn, these levels can affect the methods, assumptions and adjustments the expert uses — and, therefore, the final value.

For example, if an expert uses publicly traded (minority, marketable) stock prices to value a private business interest on a minority, nonmarketable level, it may be appropriate to apply a discount to reflect the time and effort required to sell private stock vs. an actively traded stock. Conversely, if valuing a controlling interest, the expert might apply a control premium or make adjustments that only a controlling owner could do to optimize the company's earnings.

Likewise, the buy-sell agreement should specifically define the "standard" of value to prevent disputes during the buyout process. A business valuation expert can provide definitions for a variety of relevant standards, including fair market value, fair value, book value and investment value. Different triggering events or departing shareholders may require different levels or standards of value.

Don't forget the funding mechanism!

Many companies purchase life insurance to fund a buyout when a shareholder dies. The funding mechanism can directly affect a company's value if it's treated as a nonoperating asset that's includable in the value of the business.

To avoid disputes, the buy-sell agreement should specify whether life insurance proceeds are an asset of the business or merely a funding mechanism for the buy-sell agreement. In some cases, it might be advantageous for the company to set up a separate trust to facilitate the funding mechanism.

It's also critical to specify the valuation date in advance. After all, a business's value can change overnight. Using the date of the triggering event could prompt shareholders to time their departures to maximize their buyouts. It could also create financial reporting headaches if the buyout happens in the middle of the reporting period. So, many owners opt to value the interest "as of" the last day of the most recent fiscal year.

Choose wisely

When creating or reviewing a buy-sell agreement, there are no one-size-fits-all valuation provisions. The right choice depends on the shareholders' objectives — and what's right today might not be the right choice tomorrow. ■

Update on patent damages under the *Panduit* test

The *Panduit* factors for determining lost profits damages in patent infringement cases were established about 40 years ago. The courts still rely on this test when plaintiffs seek more damages than just reasonable royalties. Over the years, these factors have been challenged on various grounds — and could soon come under U.S. Supreme Court scrutiny.

4 factors

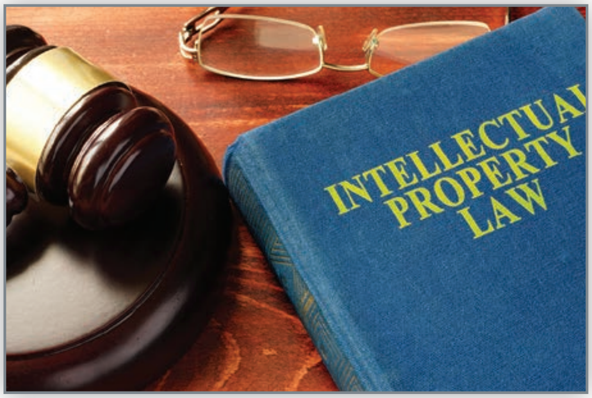
Damages represent the sales the patent owner would have earned but for the infringement, less variable costs (such as raw materials and labor) the owner would have incurred to earn those sales. Under the *Panduit* test, a patentee may recover lost profits damages by establishing:

1. Demand for the patented product as a whole,

2. The absence of acceptable noninfringing alternatives (that is, demand for particular features of the claimed invention),

3. Manufacturing and marketing capabilities to exploit the demand, and

4. The amount of profit it would have made but for the infringement.



Some of the factors have evolved over time. For example, the Federal Circuit Court of Appeals, which hears all patent appeals cases, has allowed patentees to recover damages based on market share when acceptable noninfringing substitutes were available.

Apportionment debate

In 2017, a three-judge panel of the Federal Circuit issued a significant ruling involving the *Panduit* factors. In this case, Mentor Graphics sued its competitor Synopsys, claiming it produced a simulation-emulation technology that included features patented by Mentor Graphics.

> Lost profits damages represent the sales the patent owner would have earned but for the infringement, less variable costs the owner would have incurred to earn those sales.

The parties were the only suppliers in the market, and both supplied Intel. The jury awarded Mentor Graphics about $36 million in lost profits, and the defendant appealed.

Synopsys didn't dispute that, for each infringing sale to Intel, Mentor Graphics lost a potential sale — or that the plaintiff satisfied all the *Panduit* factors for the Intel sales. Instead, the defendant argued that complex multifeature devices require a change in patent damages law. Synopsys proposed a two-step process, where the patentee must: 1) calculate the amount of profits lost from the infringement using the *Panduit* factors, and 2) apportion its lost profits to cover only the patentee's inventive contribution.

The court rejected this approach, finding that the *Panduit* factors already incorporate apportionment into the lost profits analysis. Specifically, the court ruled that requiring patentees to establish demand for both the product as a whole and for the absence of noninfringing alternatives ties the damages to specific claim limitations and ensures that they're commensurate with the value of the patented features. Thus, satisfaction of the *Panduit* factors satisfies principles of apportionment, and, therefore, Mentor Graphics' damages were tied to the worth of its patented features. Notably, the court didn't consider whether a different theory of "but for" damages would adequately incorporate apportionment principles. That question was left "for another day."

The majority of the Ninth Circuit denied Synopsys' subsequent request for an en banc review, but not without dissent. The dissenters contended that the panel opinion "simply does not apportion — even though it purportedly recognizes apportionment's

importance" — because the *Panduit* factors make no apportionment.

Stay tuned

As of this writing, Synopsys is seeking review of the Federal Circuit's decision by the U.S. Supreme Court. If the high court decides to hear the case, the apportionment debate may be settled once and for all. ■

Is collaborative divorce right for your client?

Since the concept of "collaborative divorce" was introduced in the 1990s, it's been gaining momentum as a creative, cost-effective alternative to the traditionally adversarial divorce process. Here's an overview of how it works — and for whom.

The basics

In general, collaborating spouses sign a contract agreeing to amicably settle their divorce out of court. They promise to openly and honestly exchange all relevant financial information and to negotiate in good faith. In lieu of traditional litigation, the parties conduct a series of "four-way conferences" between husband, wife and their respective attorneys. Between conferences, the parties gather information, calm emotions and evaluate settlement proposals.

Although both sides retain separate attorneys, neither party may seek (or threaten) court action. If they do, the collaborative process stops.

Role of financial experts

Financial experts often participate in the collaborative process to help keep the parties focused on financial — rather than emotional — issues. For example, they can help evaluate alimony and child support options, discuss marital asset allocations and value private business interests.

Instead of advocating one-sided victories, financial experts in collaborative divorce encourage value-based discussions and settlements that "expand the pie" before divvying it up. They also facilitate settlement with creative financial solutions to complex personal and financial issues that incorporate both parties' needs and priorities.

Several advantages

Compared to traditional divorce proceedings, collaborative divorces generally settle faster and at a fraction of the cost. In collaborative divorce all legal fees and financial expert expenses are paid from the couple's community property.

Collaborating spouses also save costs by sharing one neutral financial advisor or valuation professional, rather than hiring separate experts to battle on the stand. The use of a joint expert is desirable when the marital estate includes a private business interest, because it minimizes the time spent educating experts about business operations and prevents adversarial experts from asking employees inappropriate questions that may precipitate unwanted rumors.

In addition, four-way negotiations promote ongoing communication after the divorce. Such rapport is especially important when the parties co-parent or retain a financial connection related to support payments, college tuition or asset distributions paid on an installment basis.

Furthermore, collaborative divorce minimizes many risks inherent in traditional litigation and mediation. For instance, courts and mediators sometimes mandate one-sided settlements, whereas collaborating spouses mutually decide their final outcomes. In turn, the parties are more likely to comply with self-imposed settlement agreements.

Potential pitfalls

Collaborative divorce isn't perfect, however. If a stalemate occurs or either party seeks legal injunction, the process starts over and both attorneys are disqualified from the case. Not only must the spouses find, educate and pay for new counsel, but also they must hire additional financial experts and fund court costs separately.

If the parties end up in court, information shared during collaborative negotiations can come back to haunt them. Typically, collaborating spouses stipulate that all financial documents, correspondence, draft settlement proposals and expert witness reports generated during four-way conferences are inadmissible in future litigation. However, courts have been known to overrule collaborative divorce agreements.

> Financial experts in collaborative divorce encourage value-based discussions and settlements that "expand the pie" before divvying it up.

Moreover, the court is peripheral in collaborative divorce. The lack of court involvement may preclude formal discovery of financial information, which can lead to incomplete or inaccurate disclosure. It also allows the parties to negotiate without formal court-imposed deadlines, which can sometimes prolong the settlement process.

To collaborate or not to collaborate?

Though collaborative divorce offers numerous benefits, it isn't a realistic option for everyone. It works best when the participants are open, honest, committed to settlement and willing to compromise. Before selecting this alternative path, consult an impartial financial expert who's experienced in collaborative divorce proceedings. He or she can identify potential roadblocks to the collaborative process. ■

Fraud prevention

Audit committees are a critical defensive tool

An audit committee can be an effective antifraud mechanism. But it's not enough for audit committee board members to simply review financial statements and audit results — it takes a far more proactive approach to catch a thief.

Does the committee follow best practices?

Audit committees have gained prominence since the 2008 financial crisis. Over the last decade, several best practices have emerged. Among other things, today's audit committees typically:

Conduct fraud risk assessments. It's important for the committee to identify the types of risks the company faces and their likelihood of occurrence. These assessments should include an evaluation of existing internal controls.

Understand the accounting issues. The committee must be more than just a passive receptacle for financial reports. Members should be familiar with relevant issues and recent developments, ask open-ended questions and challenge management on the accounting for complex transactions. If the company's industry has specialized accounting rules, the committee members should consider consulting outside specialists who can bring them up to speed.

Communicate with external auditors. The committee needs to regularly communicate with outside auditors, because the external audit team performs many fraud prevention techniques. This communication includes formal meetings before the audit to elicit input on issues auditors should examine and formal meetings after the audit is complete to follow up on those issues.

Ensure compliance. The committee should verify that management is performing annual reviews of the company's compliance programs and reporting systems. Members also need to familiarize themselves with ethics requirements, such as those in the Dodd-Frank Act, the Foreign Corrupt Practices Act and any applicable whistleblower laws.

Set an ethical tone at the top. Employees can't reasonably be expected to abide by antifraud standards and processes if they don't see proper behavior modeled and reinforced from the top of the organizational chart. Among other things, the audit committee can help foster a culture of accountability and integrity by establishing anonymous reporting mechanisms and requiring prompt investigation of, and follow-up on, whistleblower complaints.

Communicate with staff. Committee members shouldn't restrict their internal communications to upper management or the CFO. They need to reach out to lower-level employees, too, so those employees feel comfortable reporting concerns and suspicions.

Need help?

Audit committee members have a fiduciary duty to protect investors and lenders from fraud. Forensic accounting experts can help board members follow best practices and stay on top of fraud trends and compliance requirements. Such outside expertise can prove invaluable should a company find itself facing fraud allegations. ■

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