Valuation & Litigation
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Appraiser not required to verify facts, but client should be notified

The issue that this column addresses is the appraiser's duty to independently verify information provided by management.

Issue arises in recent case

The subject arose as a result of a case which we reported in our last issue, Olympic Coast Investment, Inc. (OCI) v. Gadini. OCI had hired Paul Iverson to appraise a gasoline station and convenience store, Toppenish Texaco Food Mart (TTFM), for the purpose of making a loan in connection with the sale of the business.

Iverson valued the business in 1998 at $800,000 based on sales and gallonage records provided to him by Louis Gadini, one of the sellers. OCI made the loan based on Iverson's appraisal. The buyer defaulted on the loan, and the investigation revealed that Gadini had presented highly inflated sales and gallonage records, which Iverson relied on in his appraisal.

Perpetrator of fraud claims appraiser negligent

OCI sued Gadini for misrepresentation. Although Gadini acknowledged the misrepresentation, he used as his defense the theory that the appraiser was the proximate cause of the damages because he was negligent in not verifying the records presented. Therefore, OCI should be suing the appraiser instead of Gadini.

In support of his theory, Gadini presented an affidavit by J. L. Haney, a certified general real estate appraiser in the State of Washington. Haney's affidavit alleged that Iverson's failure to independently verify the records presented to him by the seller's management constituted negligence under USPAP Standards Rules 1-4(b), 2-2(b)(vi) and 1-1 (b) and (c).

Content of USPAP relied on

Rule 1-4(b) deals with collecting, verifying, analyzing, and reconciling data. Rule 1-1(b) (1998 version) states that:

> In performing appraisal services an appraiser must be certain that the gathering of factual information is conducted in a manner that is sufficiently diligent to ensure that the data that would have a material or significant impact on the resulting opinions or conclusions are considered.

Rule 1-1(c) says that the appraiser must "not render appraisal services in a careless or negligent manner..."

Rule 2-2(b)(vi) (1998 version) requires that the report:

> state the extent of the process of collecting, confirming and reporting data. This requirement is designed to inform the client and intended user whose expected reliance on an appraisal report may be affected by the extent of the appraiser's investigation.

Few would interpret USPAP to require independent verification of facts presented

Few, if any, of us would interpret the foregoing language in USPAP (or its more current counterpart) to imply that the appraiser had a duty to independently verify information presented to him by management as facts. In fact, I spoke with Mr. Iverson, and he told me that he included in his statement of limiting conditions that "information is assumed to be accurate but not guaranteed."

However, on the basis of Haney's affidavit, the trial court dismissed the suit by OCI against Gadini. Fortunately, OCI did not act on the trial court's implication that they should sue Iverson rather than Gadini, but instead appealed.

Appellate court reverses

The appellate court reversed the trial court. The appellate court quoted a prior case:

> A party to whom a positive distinct and definite representation has been made is entitled to rely on that representation and need not make further inquiry concerning the particular facts involved...When applying this rule, it is immaterial that the means of knowledge are open to the complaining party, or easily available to him, and that he may ascertain the truth by proper inquiry or investigation.

In the ASA BV E-Letter, my Associate Editor, Noah Gordon (not an appraiser) wrote, "to avoid such malpractice, appraisers should make sure they do not fail to independently verify reports and representations made to them by interested parties to a transaction." We (justifiably) received a lot of flack about this comment.

To protect appraiser have disclaimer in engagement letter

In the BVU case summary, we said:

> Although the appraiser was not the defendant in this case, the court intimated that OCI could have a case against him for negligence/malpractice. This is contrary to appraisal practice because appraisers commonly rely on managements' representations and include language in their reports that an investigation into the veracity of such representations is beyond the scope of normal business valuation work.

My suggestion to protect the appraiser is to have a disclaimer to the effect of accepting management's representation without further verification not only in the report but also as an attachment to the engagement letter.

Fairness opinions not always "fair"

***Opinions Labeling Deals "Fair" Can be Far from Independent*, Ann Davis and Monica Langley**. *The Wall Street Journal*, December 29, 2004.

When **J.P. Morgan Chase & Co.** merged with **Bank One Corp**., J.P. Morgan claimed to its shareholders that they had paid a fair price because they had obtained an opinion from one of "the top five financial advisors in the world." This renowned "advisor" was none other than the in-house bankers at J.P. Morgan.

Interestingly, Bank One Chief Jamie Dimon purportedly was ready to sell for billons of dollars less if he would become chief of the merged firm. This suggestion was denied, and has sparked a lawsuit brought by J.P. Morgan shareholders who believe the in-house evaluators endorsed a higher price to keep CEO William Harrison in power.

J.P. Morgan has denied these allegations, but cases such as this have caused the NASD to launch an enforcement inquiry over "fairness opinions." Boards of directors get fairness opinions to show that they have independently checked out the price of the deal, giving them some legal protection.

Unfortunately, fairness opinions are not often arms-length. Investment bankers frequently write fairness opinions for clients whom they have had business relationships with and with whom they hope to have relationships in the future. Often, the opinion is written by the bank that suggested the merger in the first place and that now is acting as an adviser on that deal. Additionally, the banks typically receive the majority of their advisory fee only if the deal goes through.

This creates financial incentives to see that the deal goes through, as a fee is collected for both the "fairness opinion" as well as for the successful completion of the merger or acquisition (known as the "success fee"). Some have commented that "fairness opinions are one of the highest profit margin businesses on Wall Street." In addition to these conflicts of interest, when there is a merger between financial institutions, the fairness opinion often comes from insiders instead of an independent, uninterested party.

Quality financial information crucial in a business transaction

***The importance of financial information for M&A transactions*, Holger Erchinger and Thomas A. Rowels**, *Valuation Strategies*, September/October 2004, pp. 32-35.

It is critical in every M&A transaction that the financial information of the subject company be reliable, relevant, transparent, and consistent. It is a significant part of the M&A process to perform financial due diligence, which is strongly tied to the business valuation process, especially in predicting cash flows. Financial due diligence has a profound impact on the completion of the valuation, on the price willing to be offered for the subject, and on the completion of the transaction.

The determination of the quality of financial information has in large measure been shaped by the FASB, which requires that all past, present, and future financial information be relevant and reliable to make accounting, financial information, and financial planning useful for decision making.

Financial information is reliable so long as it is verifiable, is a faithful representation, and is reasonably free of error and bias. Noncompliance with expectations regarding the quality of financial statements can create uncertainty, which can lead to discounts by investors. In an M&A transaction, the lack of financial transparency will provoke the investor to increase the risk profile attached to the investment, causing a reduction in value of the investment.

Because it is so critical that the potential investors have strong financial information for the valuation, the seller should aim to assure the investors that all presented information is of the highest quality, as well as being completely candid in the communication of financial information.

One key to communicating qualitative financial information successfully is by establishing internal processes, which generate financial information independently of existing or anticipated M&A transactions. The seller should also provide the buyer with timely updates regarding financial information.

If the seller can provide interrelated and reconcilable financial information consisting of the past, current, and future financial data, he will then be able to maximize the selling price by reducing the risk perceived by the potential buyer.

With proper planning, ESOPs don't have to be a grim affair

***ESOP's Fables: Increased Scrutiny for ESOP Fiduciaries*, Timothy R. Lee.** *Mercer Capital Value Added*, No. 4, Vol. 16, 2004, pp. 1-3.

Recently, there has been increased scrutiny of processes and the propriety of conduct relating to ESOP's and their fiduciaries. As a result, ESOP trustees and boards of directors have sought highly skilled and experienced service providers to enhance their knowledge of the valuation process and to improve the credibility of their valuations.

Preparation is important when it comes to ESOPs. Has the ESOP pool been examined for diversification and retirement needs? Furthermore, if the company has experienced volatile or declining performance, has the valuation report changed to reflect the impact? The valuation report should neither seek consistency with past reports nor ignore the seriousness of real threats.

Aesop's fables hold many relevant morals concerning the planning and structuring of ESOPs. Some relevant themes are, "An ounce of preventions is worth a pound of cure," and "They who act without sufficient thought, will often fall into unsuspected danger."

Imputed income approach only has to be reasonable to be upheld

***In re the Marriage of Covell*, 2005 Cal. App. Unpub. LEXIS 1321 (February 16, 2005)**. *Judge Garcia.*

The issue in this marital dissolution case was whether husband's real estate and business investments provided him with positive or negative income.

Husband was not a typical income earner but rather engaged in sophisticated and complex real estate transactions to generate wealth. Therefore, the trial court determined that the appropriate method of income calculation was to calculate imputed income by valuing non-income-producing investment assets, and then applying a rate of return to those assets.

The court appointed **Karen Kaseno**, a forensic accountant, to value husband's investments. In addition to applying a rate of return to the value of non-income-producing investment assets, she also compared the difference in net worth over a period of time, but the court chose to use the first method. Husband retained **Alvin Golden** to review Kaseno's report.

Valuation evidence

Kaseno and Golden disagreed on the value of some of husband's properties, as well as the correct way to calculate husband's imputed income. As to asset valuation, the court adopted the valuations used by Golden for all of husband's assets, except one, and as to calculating income, the court adopted Golden's calculations, except it declined to use certain debt service reductions recommended by Golden. Essentially, Kaseno concluded that husband was involved in lucrative activities, whereas Golden concluded that husband had a negative income and was living off loans secured by his real estate.

After calculating a total asset value for all of husband's interests, and subtracting various mortgages and other liabilities, Kaseno calculated that the current net value of husband's assets was $4,994,325. Based on this net value, and using an annual rate of return between two and six percent, Kaseno calculated that his imputed income was $99,800 to $299,640 per year. Golden used a similar approach, but accounted for recent lender appraisals and information that one of the properties operated at a loss. Accordingly, he determined that the net value of Ralph's assets was $2,311,825. Using a 4.44 percent treasury bill rate of return, Golden calculated husband's imputed annual income from the net value of his assets was $102,645.

However, Golden recommended the annual imputed income be further reduced to account for husband's residence on one of the properties. To accomplish this, he suggested that $95,840—apparently representing husband's annual debt service costs (i.e., interest payments) for one of the properties—be deducted from the $102,645 imputed income. Accordingly, Golden reduced Ralph's annual imputed income under to $6,805.

Trial court holding

The trial court adopted Golden's approach, but found that husband's net equity in the assets was $1 million more than that calculated by Golden.

Holding and rationale on appeal

The court of appeals affirmed and found that the record supported the trial court's conclusions. The appellate court rejected husband's arguments that the trial court had to rely on lender appraisals, rather than an actual purchase price. However, the court did note that an independent appraisal would have been preferable. Finally, the court emphasized that there is no single methodology appropriate to all cases—rather, the reasonableness of an imputed income calculation depends heavily on the particular facts of the case.

Evidence of USPAP violation does not establish appraiser's negligence per se

***Olympic Coast Investment, Inc. v. Gadini*, 2005 Wash. App. LEXIS 198 (February 1, 2005).** *Judge Kurtz.*

Olympic Coast Investment, Inc., and individual investors (collectively "OCI") hired **Paul Iverson** to conduct an independent appraisal of a gas station and convenience store for the purpose of making a loan in connection with the sale of the business. In conducting his appraisal, Iverson relied on reports given to him by **Louis Gadini**, one of the owners, showing monthly sales reports for the gasoline and convenience store sales as well as gross revenues and gross profits. Iverson also relied on what turned out to be Gadini's misrepresentations as to monthly revenues.

Although Iverson visited the business, he failed to verify Gadini's reports and representations by reviewing the gasoline pump records, which recorded the amount of gasoline sold and pumped by shift and by the hour, day, month, month-to-date, and year-to-date, and also failed to review point-of-sale registers that allowed examination by day, shift, week, month, and business total to date. He also did not request the business's financial and business books and records. Nor did he contact the fuel distributor to obtain information. He did, however, obtain comparable market data shortly before preparing his appraisal, which was based on the income approach. He valued the business at $800,000.

In his appraisal, Iverson stated that the appraisal complied with "the reporting requirements set forth under Standards Rule 2-2(b) of the Uniform Standards of Professional Appraisal Practice."

OCI made the loan based on Iverson's appraisal. After the buyer defaulted on the loan, OCI started operating the business and discovered a discrepancy between actual sales and those that had been reported to Iverson. Accordingly, OCI brought suit for fraud and misrepresentation against Gadini and his business partners. Iverson testified that had he known the business's

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Evidence of USPAP violation does not establish appraiser's negligence per se

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true sales, he would have valued the business at $360,000.

The trial court dismissed on summary judgment, finding that Iverson's negligence, not Gadini's misrepresentations had proximately caused the claimed damages. In support of his position, Gadini submitted the affidavit of **J. L. Haney**, a certified general real estate appraiser. In his affidavit, Haney stated his opinion that Iverson violated the USPAP standards—and his duty to his client—in his preparation of the appraisal. Haney opined that Iverson violated the standard of care owed to his clients by basing the appraised value of the business exclusively on Mr. Gadini's unverified summaries of income and expenses.

Haney also concluded that the appraisal provided by Iverson did not meet the standard of care owed by a professional appraiser to his clients. Among the many grounds listed in the report, Haney included his determination that Iverson breached the standard of care by basing his income approach valuation analysis on Mr. Gadini's summaries of unverified and noncomparable market income and expense data without explanation or description to his clients and by failing to explain his departures from the USPAP Standards Rules 1-4(b) and 2-2(b).

Holding and rationale

The appellate court found that the trial court based its decision on Haney's conclusion that Iverson had violated various provisions of the USPAP, but ruled that this question is one for the jury to decide. The court emphasized that the jury must decide what weight should be given to expert opinion testimony. In effect, the court found that the trial court treated Haney's opinions as proof of negligence per se. The court said, "evidence of the violation of a legal standard—which is not established by Mr. Haney's affidavit—merely provides evidence of negligence.

Consequently, the court held that the trial court erred by concluding that Iverson was negligent as a matter of law; the question as to whether Iverson violated his duty to OCI was one for the jury to decide. Accordingly, the court reversed and remanded.

Comment: *Although the appraiser was not the defendant in this case, the court intimated that OCI could have a case against him for negligence/malpractice. This is contrary to appraisal practice because appraisers commonly rely on managements' representations and include language in their reports that an investigation into the veracity of such representations is beyond the scope of normal business valuation work.*

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