Business Valuation

Investment Banking

MERCER CAPITAL

BECAUSE VALUE MATTERS

VALUE ADDED™

Business Valuation • Investment Banking | No. 1 | Volume 18 • 2006

HEADQUARTERS
5860 Ridgeway Ctr. Parkway
Suite 400
Memphis, TN 38120
Phone: 901.685.2120
Fax: 901.685.2199

MIDWEST OFFICE
511 South 5th Street
Suite 206
Louisville, KY 40202
Phone: 502.585.6340
Fax: 502.585.6345

mcm@mercercapital.com
www.mercercapital.com

IN THIS ISSUE

MERCER CAPITAL

Mercer Capital Now an ESOP Company

"There was never any question that the right partner was the employees of Mercer Capital, with whom we have built this firm together"

Mercer Capital announces the formation of an Employee Stock Ownership Plan (ESOP) effective January 1, 2006. Under the terms of the plan, approximately half of Mercer Capital's stock has been acquired and will be apportioned to employees at no cost to the recipients.

In a joint statement, CEO Z. Christopher Mercer and President Kenneth W. Patton explain this historic change in structure as a long-term commitment to a fundamentally new operating vision. "Mercer Capital has been owned by myself and Ken Patton for over twenty years now. I'm pleased to say that the firm has grown over that time to become one of the largest and most prestigious business valuation and investment banking firms in the country. As we both looked to the future, we realized that for the firm's continuing success, we had to expand the ownership," commented Chris Mercer.

"We came to recognize many benefits of entering into a new partnership. We also recognized that those benefits would only be realized by making the right choice of whom to partner with. Chris and I could have entertained offers from buyers of niche financial services companies, but we were just not interested in that option. It has been our intention all along to reward the people here who make the firm's success possible," Ken Patton remarked on the analysis leading to the ESOP decision.

Chris Mercer added, "The ESOP provides our people with an ownership stake in the company and a vested interest in its continuing success. There was never any question that the right partner was the employees of Mercer Capital, with whom we have built this firm together."

Ken Patton has been pleased at how well the news of the ESOP has been received by both business colleagues and clients. "Our current and prospective clients have reacted very positively to the news of the ESOP. Not many professional service firms, especially in our profession, are employee-owned. People want to know more about it and more about Mercer Capital as a result."

Responding to the ESOP announcement, Timothy R. Lee, senior vice president, said, "I am ecstatic for all our people. We work hard to provide both the quality and client service our clients expect from us. This ESOP is another way to reward those people that make good things happen. Matthew R. Crow, senior vice president, commented, "Because of the business that we're in, our people innately understand the benefits and obligations of ownership, so an ESOP makes sense for us. It allows us to better live into the vision that we have for ourselves."

Coincident with the ESOP, Mercer Capital's management structure has also changed. Mercer Capital has added three members to its board of directors, Matthew R. Crow, Timothy R. Lee, and Barbara Walters Price, all currently senior vice presidents. In addition, Lisa L. Doble, senior vice president, and Travis W. Harms, vice president, serve as trustees of the ESOP.

Recently Gone or Going Public?

Watch Out for IRC Section 409A

Any issuer of deferred equity-based compensation should employ the services of an independent valuation expert in order to assure that the plan is not granting deferred compensation at a discount.

If you have an equity-based compensation plan, the stakes are higher than ever in making sure that you are valuing the compensation properly. Failure to do so can leave you subjected to excise taxes and penalties that can only be described as confiscatory. Executives in charge of maintaining equity-based compensation plans should seek advice from a qualified tax professional regarding the plan's compliance with IRC Section 409A. Furthermore, any issuer of deferred equity-based compensation should employ the services of an independent valuation expert in order to assure that the plan is not granting deferred compensation at a discount.

The 2004 passage of the American Jobs Creation Act brought with it the addition of Section 409A to the Internal Revenue Code. Section 409A carries potentially burdensome tax implications for individuals rewarded under non-qualified deferred compensation plans. Individuals charged with the responsibility of maintaining a plan of this type must take care to structure company plans in such a way as to abide by the stringent regulations of Section 409A. Otherwise, employees could face unexpected taxes, penalties, and interest on deferred compensation.

The IRS issued Notice 2005-1 in December 2004 in an attempt to provide guidance in the application of Section 409A. In September 2005, further guidance was issued in the form of proposed regulations on deferred compensation. While the latter material should be viewed as guideline in nature, it is widely assumed that the reliance upon these regulations by plan administrators and tax professionals will evidence good-faith compliance with Section 409A.

Notice 2005-1 attempts to curtail perceived frustration with Section 409A by elaborating on a few key topics mentioned in Section 409A. Most notably, explanations are made to clarify definitions of deferred compensation and non-qualified deferred compensation plans, and the federal income tax consequences of violations of Section 409A are clearly set forth. The preceding points are discussed in the following sections.

What Qualifies as a Deferral of Compensation?

The plan mandates that compensation must be recognized as deferred (and income taxes must be paid on any such deferred income as if it were ordinary income) if "the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year." However, if this legally binding compensation may be unilaterally reduced or eliminated and if this reduction or elimination is likely to occur, the participant is relieved from his obligation of reporting this deferred income and paying associated taxes until such income is realized.

Notice 2005-1 goes on to describe the various categories of deferred compensation. While it is not necessary for our purposes to enumerate each type, the category labeled as stock options, stock appreciation rights, and other equity-based compensation is worthy of discussion. Elaboration on the restrictions and the implications of these restrictions related to equity-based compensation can be found later in this article.

What Constitutes a non-qualified Deferred Compensation Plan Under Section 409A?

A non-qualified deferred compensation plan means any agreement (written or verbal) that provides for the deferral of compensation. An agreement with just one individual can still qualify , and these plans are not limited to arrangements between employers and employees. That is, Section 409A may apply to an agreement between a service recipient and an independent contractor as well as an agreement between a partner and a partnership. As noted above, this definition specifically includes *discount* stock options and *discount* stock appreciation rights. However, any equity-based compensation not issued at a discount does not apply to Section 409A.

IF THEY CALL YOU, BE SURE TO CALL US

In the past, private equity groups have positioned themselves and networked with bankers and investment bankers, saying "bring me deals." The pressure to invest has increased to the point that a number of private equity groups are now making direct contact with companies.

If you are approached by a private equity group or even another potential acquirer, be sure to call the professionals of Mercer Capital because chances are these acquirers know a lot more about buying companies than you, the business owner, do about selling. Remember, the potential acquirer may say "trust us," but they have their best economic interests at heart first and foremost – not yours.

So, if they call you, be sure to call us! Chris Mercer or Nick Heinz at 800.769.0967.

What Federal Income Tax Consequences Are Associated with a Violation of Section 409A?

If a non-qualified deferred compensation plan fails to adhere to the provisions set forth in Section 409A, tax penalties for the participant will be incurred. That is, all amounts deferred under the plan for the taxable year (and all prior taxable years) must be included in gross income for the taxable year to the extent that such income is contractual and not highly unlikely to occur. If a deferred amount is required to be included as income under Section 409A, then the participant must pay interest as well as an income tax penalty in addition to ordinary income taxes. The additional income tax penalty is equal to 20% of the compensation required to be included in gross income. The option or SARs holder would be taxable on the increase in value of the option at the time of vesting (regardless of whether the option is exercised at this point), and the holder would be required to pay an additional 20% penalty and interest on underpayment.

Discount Options and Stock Appreciation Rights Result in Negative Tax Consequences

Non-qualified stock option grants will be subject to deferred compensation taxation unless the plan provides that:

1. The exercise price may never be less than the fair market value of the underlying stock on the date of grant;
2. The receipt, transfer, or exercise of the option is subject to taxation under Section 83 provisions; and,
3. The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise date or settlement of the option.

Stock Appreciation Rights (SARs) will be subject to deferred compensation taxation unless the plan provides that:

1. The SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted;
2. The stock of the service recipient is traded on established securities markets;
3. Only such traded stock of the service recipient may be delivered in settlement of the right at exercise; and,
4. The SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

Notably, Notice 2005-1 indicates that for a non-qualified deferred compensation plan to be exempt from Section 409A, the stock of any plan issuing SARs must be traded on an established securities market (see number 2, above). The revised provisions, issued later, exempted SARs of private companies from Section 409A if the SARs were issued at fair market value without any discount or features for deferral.

In Summary

Notice 2005-1 and the proposed regulations taken together indicate that options and SARs issued at or above fair market value as determined by a *"reasonable application of a reasonable valuation method"* will be exempted from deferred compensation taxation under Section 409A. Notice 2005-1 indicates that a reasonable valuation method would include the valuation method described in Section 20.2031-2 of the Estate Tax Regulations. The revised provisions take this a step further by stating an appraisal will be acceptable for purposes of Section 409A if the appraisal would be acceptable for valuing stock held in an ESOP under the provisions of the Internal Revenue Code. Any such suitable appraisal will be acceptable for a twelve month period beginning on the valuation date.

If you have any questions or need our assistance with a matter such as this, call us at 901.685.2120.

Eden Gipson

Eden A. Gipson
gipsone@mercercapital.com

MERCER CAPITAL
HIGHLIGHTS

NEWS OF NOTE

Andrew K. Gibbs, CPA, CFA has been awarded the Accredited in Business Valuation (ABV) credential from the American Institute of Certified Public Accountants (AICPA). The ABV Credential program allows credential holders to brand or position themselves as CPAs who are premier business valuation service providers.

SPEAKING ENGAGEMENTS OF NOTE

May 2, 2006
"Viewpoints on Valuation: the Appraiser, the Attorney, the IRS & the Judge"
Philadelphia Estate Planning Council Annual Seminar
Philadelphia, Pennsylvania
Z. Christopher Mercer, ASA, CFA

May 3, 2006
Mississippi Financial Planning Conference
Jackson, Mississippi
Timothy R. Lee, ASA

June 1, 2006
"Buy - Sell Agreements: "Ticking Time-Bomb or Reasonable Resolution?"
NACVA's Annual Conference
San Francisco, California
Z. Christopher Mercer, ASA, CFA

Value Added

At Mercer Capital, we have considerable experience in valuing companies that are in the process of going public and have provided valuations for compliance with Section 409A.

Value Added

Second Fairness Opinions: A Closer Look

Many investment banking firms that are hired to complete a transaction are frequently retained to provide a fairness opinion on the same transaction. This creates obvious conflicts of interest...

Boards of directors may be relying upon fairness opinions that are not truly independent.

Recent headline-grabbing corporate scandals have focused attention on the importance of independence for public accountants. In a transaction environment, corporate governance best practices emphasize not only the independence of auditors but also the financial advisor issuing a fairness opinion. Since the landmark court case, *Smith v. Van Gorkom* (Delaware, 1985), fairness opinions have become quite commonplace in corporate control transactions. The purpose of the fairness opinion is to determine if the price being offered to shareholders is within a range of values that would be considered "fair" from a financial point of view.

Many investment banking firms that are hired to complete a transaction are frequently retained to provide a fairness opinion on the same transaction. This creates obvious conflicts of interest if any of the following conditions are met:

- The investment banking firm has a financial interest in the company that is being transacted;
- The investment banking firm has an existing relationship with the company or other parties involved in the transaction; or,
- The fee to be paid the investment banking firm is in any way contingent upon the successful completion of the transaction.

Although the third item generally receives the most attention, the National Association of Securities Dealers (NASD), in November 2004, proposed regulations that would serve to address all three items. Among other things, the new rule would require members (firms issuing fairness opinions) to:

- Disclose in any fairness opinion appearing in any proxy statement any significant conflicts of interest, including, if applicable, that the member has served as an advisor on the transaction in question, and the nature of compensation that the member will receive upon the successful completion of the transaction; and,
- Develop specific procedures that members must follow to identify and disclose potential conflicts of interest in rendering fairness opinions.

However, this rule is not yet final, and meanwhile shareholders and boards of directors may be relying upon fairness opinions that are not truly independent. An example of this was explored in a *New York Times* article dated August 21, 2005, entitled *"And They Call This Advice?"* Three fairness opinions were rendered for the merger of Providian Financial Corporation with Washington Mutual. Two of the three firms issued opinions recommending that the shareholders of Providian reject the proposed deal. The advisor recommending approval provides advisory and other services to issuers of securities, such as the companies involved in the transaction, while the two firms recommending rejection are independent and receive fees solely from institutional investors.

Fairness opinions that are truly fair and independent benefit not only shareholders, but boards of directors and management as well. A board member has a fiduciary responsibility to the company's shareholders. When the board solicits an opinion from a firm with conflicting interests, questions about their intent and motivations of the parties inevitably arise. Often, upper levels of management receive lucrative severance packages as a result of control transactions.

Other times, significant pay raises and benefits for remaining members of management are negotiated into the deal. In these instances, management and the investment banking firm have a similar interest in seeing the transaction go through. The investment banking firm may have been hired by the managers, and the managers want the deal to be successful; therefore, the investment banking firm wants the deal to be successful. In cases like this, a "pro-management" decision is much more likely than one that is in the best interest of the shareholders. Boards of directors would often be well-advised to retain a truly independent firm to issue a "second" fairness opinion in such cases. Some opponents argue that the firm issuing the second opinion could gain the opportunity to replace the incumbent investment banking firm, thereby giving the second firm a vested interest in the outcome of the opinion.

Others argue that the incumbent firm may be discouraged from introducing future investment opportunities to the company under consideration. Both of these possible problems, however, can be solved by hiring a firm that does not compete with the incumbent firm. Mercer Capital does not compete with large investment banking firms, and offers a solution for an independent and fair opinion.

A common misconception is that only large investment banking firms have the experience and ability to render a fairness opinion for large, multi-million dollar or even billion dollar, corporate transactions. This, however, is not the case. At Mercer Capital we have issued independent fairness opinions for a wide range of industries and purposes, and also have experience dealing with larger, public corporations.

In summary, the effectiveness of a fairness opinion for a corporate control transaction depends on who renders it, their relationship with all involved parties, and their own interest in the outcome of the pending transaction. A "second" fairness opinion issued by a truly independent advisor will benefit all those involved in a proposed transaction.

Travis W. Harms, CPA/ABV, CFA
harmst@mercercapital.com

Laura J. Hoffmeister
hoffmeisterl@mercercapital.com

A common misconception is that only large investment banking firms have the experience and ability to render a fairness opinion for large, multi-million dollar or even billion dollar, corporate transactions.

MERCER CAPITAL NAMED ONE OF TENNESSEE'S TOP INVESTMENT BANKING FIRMS

Mercer Capital has been named one of the top investment banking firms in Tennessee, according to *Business Tennessee* magazine's TopRank Tennessee Survey. The TopRank Tennessee Survey is a yearly examination of the industries that bolster the economy in the state of Tennessee. Below is a sampling of recent transactions.

MemphisFirst Corporation
Memphis, Tennessee

Mercer Capital provided a fairness opinion on behalf of MemphisFirst Corporation regarding the sale of newly issued common shares to an outside investor group

MERCER CAPITAL

Collateral Investment Corporation
Birmingham, Alabama

Mercer Capital served as Financial Advisor regarding the Reorganization and Liquidation of Collateral Investment Corporation

MERCER CAPITAL

CTB Financial Corporation
Ruston, Louisiana

Mercer Capital represented CTB Financial Corporation in the acquisition of First United Bank, Farmerville, Louisiana

MERCER CAPITAL

Cumberland Gap Provision Company
Knoxville, Tennessee

Mercer Capital provided a Fairness Opinion on behalf of Cumberland Gap Provision Company regarding the proposed merger with Cumberland Acquisition Group

MERCER CAPITAL

For more information or to discuss a transaction in confidence, call Nick Heinz at 901.685.2120.

MERCER CAPITAL
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120

Value Added

In This Issue...

RESERVE YOUR COPY OF MERCER CAPITAL'S NEWEST BOOK AT SPECIAL PRICE!

Buy - Sell Agreements

THE DO'S AND DON'TS FROM A BUSINESS APPRAISER'S PERSPECTIVE

Coming Early Summer 2006

In this book, we speak from our own experiences valuing hundreds of buy-sell agreements. You will gain insight into the folly of fixed-price or formula pricing, the different appraisal mechanisms, common misunderstandings that can end up as big money issues, and the pitfalls of buy-sell templates. This information can save you or your clients thousands, if not hundreds of thousands, of dollars and years of frustration dealing with buy-sell agreements that, in the end, don't say what you think they say! If you are an attorney, CPA, insurance provider, business owner, or a business appraiser, you have to have this book.

Chapters include:

- Fixed priced agreements
- Formula agreements - Do they work?
- Understanding process agreements
- The six defining elements
- Real world examples
- Buy-Sell valuation audit

YOUR PRE-PUBLICATION DISCOUNT OF 25%

$59

REGULAR PRICE: $79

To reserve your copy at the 25% pre-publication discount
visit our pre-publication website,
www.mercercaptial.com/products/buysellbook.htm
And enter the reservation code **VA0601**

Note: Shortly before the book is published, you will receive an invoice with the special pre-publication discount. You are under no obligation to purchase. Upon publication, the book will be sent to you. If you are not satisfied with the book, return it for a 100% refund.