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IN THIS ISSUE

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Multiple Appraiser Process Buy-Sell Agreements

Chapter 12 excerpted from the now-published book "Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"

The interests of shareholders (or former shareholders) and corporations (and remaining shareholders) often diverge when buy-sell agreements are triggered.

In the real world, motivations, whether actual or perceived, are embedded in many process agreements. These motivations are clear for buyers and sellers whose interests are obviously different. The motivations for the appraisers are less clear. Appraisers are supposed to be independent of the parties. Nevertheless, based on our experience, it is rare for the appraiser retained to represent a seller to reach a valuation conclusion that is lower than that reached by the appraiser for the buyer. This does not at all imply that both appraisers are biased. Consider the following possibilities:

» Valuation reflects both art and science and is the result of the exercise of judgment. It seems that many buy-sell agreements call for two appraisal conclusions to be within 10% of each other for the two to be averaged. Given the potential for differences in judgments, a range of 10% may be too small.[1] In other words, the process may create the appearance of bias by creating the expectation that two appraisers will reach conclusions so close to each other.[2]

» The buy-sell agreement may be unclear as to the engagement definition. In such cases, two independent appraisers who interpret the agreement differently from a valuation perspective may reach conclusions that are widely disparate.

Legal counsel for each side desires to protect the interests their clients. As such, in the context of buy-sell agreements, the thinking may occur as follows:

> "If my client is the seller, we need to be able to select 'our' appraiser, because the company will select its appraiser. Since I am concerned that the company will try to influence its appraiser on the downside, I want to be able to try to influence our appraiser on the upside. Since we are selling and they are buying, this is only natural."

For purposes of this discussion, if the two appraisals are not sufficiently close together, they can be viewed as advocating the positions of the seller and buyer, respectively. All the parties and their legal counsel may begin to think:

> "What is needed now is a 'truly' independent appraiser to finalize the process."

Many process agreements call for the two appraisers to select a third appraiser who is mutually acceptable to them because:

> "Surely, 'our' appraiser and 'their' appraiser, working together, can select a truly independent appraiser to break the log jam since neither side has been successful in influencing the outcome of the process. But, now that we have a third appraiser, what should his or her role be?"

---

1 *See "How Close Should Appraisals Be Before Requiring a Third Appraiser?" in Chapter 11.*

2 *Appraisers try to estimate the kind of value specified in buy sell agreements. Consider the real world of actual transactions. In a typical auction process for a company, the range from the low bid to the high bid may be 50% to 100% or more, based on the varying interests and motivations of the group of buyers.*

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The purpose of process buy-sell agreements, however, regardless of their limitations, is to reach reasonable conclusions

The role of the third appraiser will be determined by the agreement reached by the parties. Consider the following:

» Chances are, it is not a good idea for the third appraiser's conclusion to be averaged with the other two since the first two conclusions create a broader specified range than the range giving rise to the third appraisal. Averaging could provide too much influence to an outlier conclusion.

» Often, the third appraiser's conclusion will be averaged with that of the conclusion closest to his own. Since the first two appraisers often know this on the front end, they should be motivated to provide independent conclusions, since no one desires to have the outlier (ignored) conclusion. (See "Two and a Tie-Breaker in Chapter 11.)

» On the other hand, wouldn't the process be more independent if the third appraiser had to select, in his opinion, the more reasonable of the first two conclusions? Surely, that would tend to influence the first two appraisers to reach more similar conclusions. It would be embarrassing to have provided the conclusion that was not accepted. (See "Two and a Back-Breaker" in Chapter 11.)

» Still further, the first two appraisers would be under pressure if the third appraiser were to provide the defining conclusion. As discussed previously, some processes provide for the selection of the first two appraisers whose sole function is to mutually agree on the third appraiser, whose conclusion will be binding. Then all the pressure falls on the third appraiser. (See "Two and a Determiner" in Chapter 11.)

We speak here from personal experience. Professionals at Mercer Capital have been the first, second, and third appraisers in numerous buy-sell agreement processes. Clients sometimes do attempt to influence the appraisers, either in blatant or subtle fashion. This is to be expected and is not nefarious. Clients are naturally influenced by their desire for a conclusion favorable to them.[3] The purpose of process buy-sell agreements, however, regardless of their limitations, is to reach reasonable conclusions.

ADVANTAGES. Multiple appraiser buy-sell agreements have advantages.

1. They provide a defined structure or process for determining the price at which future transactions will occur.
2. All parties to the agreements know, at least generally, what the process will entail.
3. Multiple appraiser agreements are fairly common and generally understood by attorneys. Many believe that process agreements are better than fixed price or formula agreements, particularly for substantial companies.
4. Parties to such agreements may think that they are protected by the process since they will get to select "their" appraiser. This is an illusory benefit.

DISADVANTAGES. There are several disadvantages to multiple appraiser buy-sell agreements:

1. *The price is not determined now*. The actual value, or price, is left to be addressed at a future time, i.e., upon the occurrence of a trigger event. No one knows, until the end of an appraisal process, what the outcome will be.
2. *There is potential for dissatisfaction with the process, the result, or both, for all parties*. Multiple appraiser process agreements are designed with the best of intentions, but they have a number of potential flaws. At best, they are time-consuming and expensive. At worst, they are fraught with potential for discord, disruption, and devastating emotional issues for one or all parties.
3. *There is danger of advocacy with multiple appraiser agreements*. Even if there is no advocacy on the part of the appraisers, the presumption of advocacy may taint the process from the viewpoint of one or more participants.
4. *There is considerable uncertainty regarding the process*. All parties to a multiple appraiser agreement experience uncertainty about how the process will work, even if they have seen another such process in the past. In our experience, the process, as it actually operates, is different in virtually every case, even with similar agreements.
5. *There is considerable uncertainty as to the final price*. The price is not determined until the end of the process. As a result, there is great and ongoing uncertainty regarding the price at which such future transactions will occur.
6. *Process problems are not identified until the process is invoked*. We noted in Chapter 10 that five defining elements are necessary to determine the price (value) at which shares are purchased pursuant to process agreements. Problems with agreements, such as a failure to identify the standard of value or the level of value, or the failure to define the qualifications of appraisers eligible to provide opinions or the appraisal standards they are to follow, are deferred until the occurrence of a trigger event. At this time,

3 I have said many times to young appraisers, "Don't be surprised if a client tells you or hints at the appraisal result they desire." In most cases, our clients are parties with particular interests in appraisal outcomes. They cannot help that. What is important in these situations is our response, which must be to provide our independent conclusions of value – ones we can support and defend.

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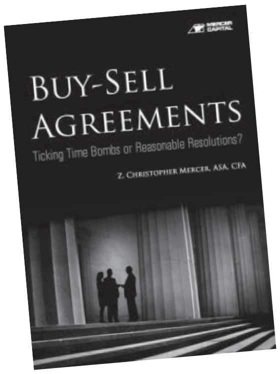
Buy-Sell Agreements

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?



In this book, the professionals of Mercer Capital speak from their own experiences valuing hundreds of buy-sell agreements. You will gain insight into the folly of fixed-price or formula pricing, common misunderstandings that can end up as big money issues, and the pitfalls of buy-sell templates. Single and multiple appraiser process agreements are explored in depth. In addition, the six defining valuation elements of buy-sell agreements are presented in depth for the first time. This book is a must-have for attorneys, CPAs, business owners, business appraisers, and other professional advisors to business.

CHAPTERS INCLUDE:

- The six defining valuation elements of buy-sell agreements
- Fixed price agreements
- Formula agreements - Do they work?
- Understanding process agreements
- Single & multiple appraiser agreements
- Real world examples of problem agreements
- The Buy-Sell Audit Checklist

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Based on our experience, multiple appraiser process agreements seem to be the norm for substantial private companies

the interests of the parties are financially adverse and problems tend to be magnified. Based on our experience, the failure of multiple appraiser agreements to "pre-test" the process can be the most significant disadvantage on this list.

7. *Multiple appraiser agreements can be expensive*. The cost of appraisals prepared in contentious, potentially litigious situations tends to be considerably higher than for appraisals conducted in the normal course of business.

8. *Multiple appraiser agreements are time-consuming.* The typical appraisal process takes at least 60 to 90 days after appraisers are retained. The search for qualified appraisers can itself take considerable time. If a third appraiser is required, there will be additional time for his or her selection as well as for the preparation of the third appraisal. It is not unusual for multiple appraiser processes to drag on for six months to a year or more.

9. *Multiple appraiser agreements are distracting for management*. The appraisal process for a private company is intrusive. Appraisers require that substantial information be developed. They also visit with management, both in person and on the telephone, as part of the appraisal procedures. We worked with the CEO of a sizeable private company to determine the price for the purchase of a 50% interest of his family business. The selling shareholder hired another, very qualified business appraiser and we both provided appraisals, with the intention of negotiating a settlement rather than invoking the burdensome, formal procedures of the buy-sell agreement. During the nearly three months that this "less burdensome" process was underway, the CEO (and his CFO and his COO) could scarcely think about anything else.

10. *Multiple appraiser agreements are potentially devastating for shareholders.* If the seller is the estate of a former shareholder, there is not only uncertainty regarding the value of the stock, but family members are involved in a valuation dispute (yes, that's pretty much what it is) with the friends and associates of their deceased loved one. Combine these issues with the fact that some agreements require that selling shareholders pay for their share (side) of the appraisal process and there is even more cause for distress.[4]

We summarize the disadvantages of multiple appraiser process agreements in Figure 1 for comparison with other options as the discussion progresses.

Disadvantages	Multiple Appraisers
1. Price *not* determined now	x
2. Potential for dissatisfaction with the process for all parties	x
3. Danger of advocacy	x
4. Uncertainty over what will happen when a trigger event occurs	x
5. Uncertainty over final price if the process is invoked	x
6. Problems or issues with definition of value, qualifications of appraisers, or any other aspects of the operation of the agreements are deferred until a trigger event – when the interests of the parties are adverse	x
7. Expensive	x
8. Time-consuming	x
9. Distracting for management	x
10. Potentially devastating for affected shareholders and their families	x

Figure 1

CONCLUDING OBSERVATIONS. Based on our experience, multiple appraiser process agreements seem to be the norm for substantial private companies and in joint venture agreements among corporate venture partners. The standard forms or templates found for process agreements at many law firms include variations of multiple appraiser processes.

As business appraisers, we participate in multiple appraiser buy-sell agreement processes with some frequency. Because of the reputation of our senior professionals and our firm, we are called into valuation processes around the country. Speaking personally, I have been the appraiser working on behalf of selling shareholders and companies, and I have been the third appraiser selected by the other two on other occasions. As the third appraiser, I have been required to provide opinions where the process called for the averaging of my conclusion with the other two as well as averaging with the conclusion nearest mine. I have also been asked to pick the better appraisal, in my opinion, given the definition of value in agreements. I have also been the third appraiser who provided the only appraisal. Others at Mercer Capital have also performed similar roles. This experience is mentioned to emphasize that the disadvantages of multiple appraiser appraisal processes outlined here are quite real. We have seen or experienced first hand every disadvantage in the list above. We hope to provide alternatives with more advantages and fewer disadvantages based on our collective experience at Mercer Capital.

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4 See Chapter 15 for a discussion of "Who Bears the Costs of the Appraisal Process?".

Fair Value and SFAS 157:
The Times They Are A-Changing

The definition, or standard, of value is a foundation of every valuation assignment in that it defines what exactly the valuation process aims to measure with respect to the subject asset or liability. A lack of clarity in the definition of value often leads to unreliable valuation results. In the past, the FASB definition of "fair value" has been troublesome; FASB even admits this in the opening paragraphs of SFAS 157: "Prior to [SFAS 157], there were different definitions of fair value and limited guidance for applying those definitions in GAAP." Well, as Bob Dylan said, "the times they are a-changing," as FASB made a huge stride towards solving this fair value definition conundrum in September 2006 with the issuance of SFAS 157.

Prior to SFAS 157, fair value was defined in SFAS 142 as "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." While SFAS 142 included guidance to supplement this sentence, there was still silence on a number of issues. For example, while the concept of "market participants" had been around since SFAC 7 (which was issued to provide guidance related to using present value techniques in accounting measurements), there was no clear profile of the market participant in the context of SFAS 142. Did the parent company, already operating in said market, constitute a marketplace participant? With limited FASB guidance, there was room for reasonable people to disagree on the specification of whether the "willing parties" constituted identifiable or hypothetical parties. Issues were not limited to the specification of the transacting parties: Did the definition of fair value preclude the possibility that a buyer could be motivated by a unique set of circumstances? What about the degree of knowledge possessed by the transacting parties? Did the definition of fair value suggest something closer to investment value than fair market value?

While SFAS 157 will not completely eliminate future controversy related to the definition of fair value, FASB has certainly clarified what they mean by "fair value." FASB now defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Additional discussion found in the body of the statement clarifies much of the previous uncertainty associated with fair value.

The most helpful clarification is the definition of a "market participant" : a party that is: 1) unrelated to the other party in the hypothetical transaction, 2) knowledgeable regarding the subject asset, 3) able to transact in the subject asset, and 4) not subject to any compulsion to transact in the subject asset.

Further guidance emphasizes that fair value includes characteristics specific to the subject asset and should not consider transaction costs. Consideration of characteristics specific to the subject asset seems intuitive for assets; the location or condition of a particular asset impacts value not only for the specific entity that owns the asset, but market participants as a whole.

Most of the remaining guidance relates to the assumed marketplace and the participants that comprise these markets. Essentially, fair value represents the "exit price" of the subject asset for a market participant in the "principal" or "most advantageous" market. The concept of the exit price is rooted in the idea that the price to enter a market and the price to exit a market are not always equal. Fair value measures the price a hypothetical party could expect to receive from another hypothetical party in exchange for the asset. The market specification of "principal" or "most advantageous" provides boundaries for the assumed collection of market participants; fair value is determined within the context of the most active market for a given asset, or in the absence of such a market, the market within which one could expect to maximize the amount received for the asset.

In the context of SFAS 142, some valuation professionals interpreted fair value to represent something closer to "investment value" than "fair market value." This interpretation stemmed from unclear language that could be read to imply that fair value was from the context of a specific parent company, rather than a specific asset. The clarification that fair value is from the context of a hypothetical party rather than an identifiable market participant pushes the understanding of fair value closer to fair market value.

While SFAS 157 has clarified the definition of fair value in many ways, the dynamic nature of fair value (as evidenced by the need for this article), as well as the subtle differences between fair value and other standards of value, make it important to rely on a qualified valuation professional for fair value measurements. If you have any questions related to valuation for financial reporting, feel free to contact a professional at Mercer Capital. We would be happy to discuss your questions in confidence.

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