A Special Note to
Value Matters™ Subscribers

It is finally here:
Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?

Readers of this newsletter know that we have been talking about buy-sell agreements in a variety of ways for many months. You have also seen several promises that our new book, Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions? would be available soon. The wait is over.

The book is finished and we will be shipping books by year-end – yes, that’s year-end 2006!

THIS BOOK IS COULD BE THE MOST IMPORTANT BUSINESS BOOK YOU READ IN 2007

You might be asking yourself: “Why the hype? Mercer Capital has published books before. What’s the big deal about this one?”

The answer is simple. Buy-sell agreements are pervasive in American business. If a business has multiple owners, there is a need for a contractual way to assure orderly transfers of ownership interests. The problem is that many, if not most, buy-sell agreements will likely not provide the results the parties intended when they are ultimately triggered.

At 350+ pages, Buy-Sell Agreements addresses the title topic from a business and valuation perspective. The goal of the book is to provide a roadmap for business owners and their advisers to develop good buy-sell agreements. Once the business agreements are settled, they can be documented into appropriate legal documents. Buy-Sell Agreements is also an aid to corporate attorneys who must draft these agreements.

I could tell you lots more about the book. However, to keep this introduction reasonably short, let’s touch on two topics:

1. **Two Complimentary Chapters Offered.** Chapter 12, which addresses “Multiple Appraiser Process Buy-Sell Agreements,” is reprinted in this newsletter. To read an additional chapter (Chapter 11 – “Process Buy-Sell Agreements”) visit www.mercercapital.com and download the chapter. While you are on the website, you can also purchase your copy of the book.

2. **This Book Will Be Good for Your Business.** A knowledge and understanding of buy-sell agreements from business and valuation perspectives will prove helpful to your clients, which, in turn, will be helpful to your business, whether you are an appraiser, an accountant, an attorney, or another kind of adviser.

To make the point clear about being good for business, let me describe a few engagements – all regarding buy-sell agreements. We have obviously been writing and speaking about the topic – and have been discussing the topic with our clients and referral sources.
• A company had a right of first refusal to acquire the interest of a minority shareholder at a formula price. The company's offer was less than the formula price and an outside offer was more than the formula price. We were asked to help shepherd this transaction to completion.

• A firm's shareholder was terminated, triggering the provisions of the company's buy-sell agreement. There have already been two appraisals and the ox is in the ditch.

• A company sold a division to another company, receiving a minority interest of the acquiring company as part of the consideration. We were retained by the company and another appraiser was retained by the shareholder. Our appraisal conclusions were sufficiently close together to average them for the purchase price.

• We met with the ownership and management of a group of companies about the type of process buy-sell agreement that was best for their companies and the kind of value that should be called for in the expected appraisals.

• A minority shareholder had a put to a company for his interest. The shareholder unexpectedly exercised the put, acquiring an appraisal in the process. The company had a short time period in which to obtain its own appraisal, else the first appraisal was binding. We prepared a valuation analysis for the company which became the basis for a reasonable settlement.

• A shareholder died owning a large percentage of a company. The company owned life insurance on his life and received the proceeds. The buy-sell agreement required the company to purchase the shares of the deceased shareholder based on an appraisal but was silent as to whether the life insurance should be treated as a funding mechanism or as a corporate asset (this issue is addressed specifically in Chapter 21 of the book). We were contacted to help make sense of a difficult situation.

The book, *Buy-Sell Agreements*, will help you address similar situations with confidence. The book talks about what goes wrong – and things often do go wrong with buy-sell agreements – and how to avoid the major land mines when discussing them at the outset. The book also provides assistance if you are asked to review a buy-sell agreement from a business or valuation perspective.

We can't guarantee that if you buy the book and put it on your shelf that your business will increase. But I will personally guarantee the purchase price of the book if you buy it, read it, and then talk to ten of your clients or referral sources about their buy-sell agreements and are not satisfied that *using* the book is helpful for your business.

So read the chapter excerpt in this newsletter and then download the second complimentary chapter from www.mercercapital.com. Then, go ahead and order your copy. We'll get it to you as quickly as possible and in plenty of time to have reading it at the top of your New Year's Resolutions.

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Multiple Appraiser Process
Buy-Sell Agreements

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. 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.

» 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 of 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.”

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.
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?”

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. 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 as we have seen, 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. This is true because the parties, including the seller, company management and its directorate, and the appraisers are all different.

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. First, before a trigger event occurs, no one has any idea what the price would be in the event that one did occur. Second, following a trigger event, there can be great uncertainty regarding the ultimate price for many, many months.

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, 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 — perhaps much 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. Our appraisals were about 10% apart and the parties agreed to average them. 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

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4 See Chapter 15 for a discussion of "Who Bears the Costs of the Appraisal Process?".
We summarize the disadvantages of multiple appraiser process agreements in Figure 1 for comparison with other options as the discussion progresses.

<table>
<thead>
<tr>
<th>Disadvantages</th>
<th>Multiple</th>
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<tbody>
<tr>
<td>1. Price not determined now</td>
<td>x</td>
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<td>2. Potential for dissatisfaction with the process for all parties</td>
<td>x</td>
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<tr>
<td>3. Danger of advocacy</td>
<td>x</td>
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<tr>
<td>4. Uncertainty over what will happen when a trigger event occurs</td>
<td>x</td>
</tr>
<tr>
<td>5. Uncertainty over final price if the process is invoked</td>
<td>x</td>
</tr>
<tr>
<td>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</td>
<td>x</td>
</tr>
<tr>
<td>7. Expensive</td>
<td>x</td>
</tr>
<tr>
<td>8. Time-consuming</td>
<td>x</td>
</tr>
<tr>
<td>9. Distracting for management</td>
<td>x</td>
</tr>
<tr>
<td>10. Potentially devastating for affected shareholders and their families</td>
<td>x</td>
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**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 similar to those described previously.

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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<th>DESCRIPTION</th>
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# BUY-SELL AGREEMENTS: TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

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Buy-Sell Agreements

Ticking Time Bomb or Reasonable Resolution?

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 for attorneys, CPAs, business appraisers, and other professional advisors.

CHAPTERS INCLUDE:

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» 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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