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THE COMPLIMENTARY NEWSLETTER FOR ATTORNEYS AND OTHER PROFESSIONAL ADVISORS TO BUSINESSES

Volume 2007-01 » January 25, 2007
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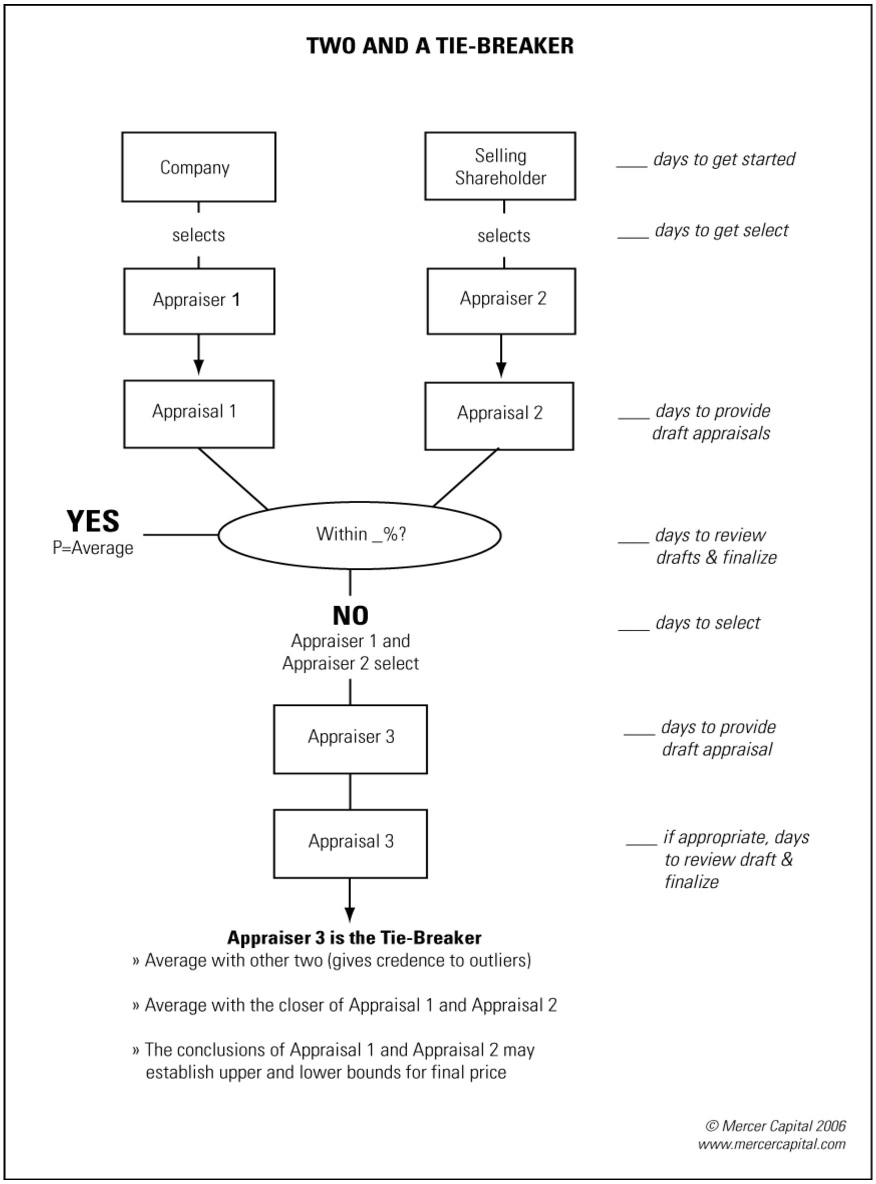
Buy-Sell Agreements

Two and a Tie-Breaker

Many buy-sell agreement templates call for an appraisal process to resolve the price (i.e., the valuation) for transactions under companies' agreements upon the occurrence of specified trigger events. We call such agreements *process agreements*. Quite often, the descriptions of the valuation processes are quite short. A representative example might go like this:

> **Price**. The Purchase Price per share for the Shares to be purchased shall be the Agreed Value divided by the number of shares outstanding. If there has been no Agreed Value within ___ months of the event giving rise to the determination, the parties may, within 30 days, mutually agree upon such a value. If, within 30 days no such agreement has been reached, the Company shall select an appraiser and the Selling Shareholder shall also select an appraiser. The selected appraisers shall, within 60 days of being retained, provide their opinions of the fair market value of the Company ("Appraised Values"). In their determinations of their Appraised Values, the appraisers shall determine the fair market value of the shares of the Company. They shall apply no discount for the fact that any shares represent a minority interest or due to the fact that they lack marketability. If the two Appraised Values are within 10% of each other, the Purchase Price shall be the average of the two Appraised Values. If the two Appraised Values are not within 10% of each other, the two selected appraisers shall mutually agree upon a third appraiser. The third appraisers will determine his opinion of Appraised Value. The Purchase Price shall then be determined by the average of the third Appraised Value with that of the first two Appraised Values closest to it.

There are a number of problems with this price determination clause which are discussed in our new book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* I touch on a few of them below; however, the purpose of this article is to discuss the process by which the called-for Purchase Price is to be determined. We call this process "Two and a Tie-Breaker." The third appraiser's role is to break the logjam and resolve the valuation issue. The process can be diagrammed as follows [*Buy-Sell Agreements*, p. 63]:



Quite often, the parties to buy-sell agreements have only the vaguest notion of how the processes in their agreements might work. Reading the sample text above, things seem like they might work fairly simply. However, in operation, things are less simple and often not smooth at all. It takes time to get an appraisal process started, for example. If the buy-sell agreement is triggered by the death of a shareholder, there is a natural grieving process that must take place before his or her family can engage in a process. When the process begins, time can drag on for a variety of reasons:

1. It takes time to select appraisers. Note in the example above, appraiser qualifications were not specified. [See Chapter 19 of *Buy-Sell Agreements* for a discussion of appraiser qualifications]

DID YOU KNOW?

The Quantitative Marketability Discount Model (QMDM) was mentioned in court again on May 4, 2006 in the case *Juan Armstrong v. LaSalle Bank National Association*, No. 05-3417 (7th Cir. May 4, 2006),

To see what the Court said, see page 4 of this newsletter.

If you are interested in a summary of the history of the QMDM and its acceptance in the business appraisal profession, download the complimentary ***QMDM FACT SHEET*** *from our website at www.mercercapital.com.*

2. It takes time for the appraisers to accomplish their appraisals. Regardless of the time specified in the document, the appraisal process often takes 60-90 days or more, depending on the focus on the process from the appraisers and the company.

3. If draft appraisals are provided to each party by the first two appraisers, time passes while reviews are conducted and discussions held.

4. If the drafts are shared between appraisers, more time will pass.

5. Assume that the two Appraised Values were not within 10% of each other. [see pp. 72-73 of *Buy-Sell Agreements* for a discussion of issues with this seemingly simple item].

6. It takes time for the first two selected appraisers to agree upon the third appraiser.

7. It then takes time for the third appraiser to conduct his or her appraisal. Since by this time, the parties have not agreed, the third appraiser will likely proceed with caution. He or she will have to review the two other appraisals carefully in addition to preparing the third appraisal.

8. When the third appraisal is completed, the process should be resolved. However, that will depend on the contentiousness that has developed along the way.

The bottom line is that it can take a long time – 6-12 months or even longer, for the typical appraisal process to work itself to resolution. The processes often leave all parties dissatisfied, feelings hurt, relationships damaged, or worse.

I wrote the book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* to assist business owners, attorneys, accountants, financial planners and other business advisers in the process of implementing new buy-sell agreements and reviewing and improving existing agreements.

Please share this article with anyone you think can benefit from it. And, if your organization is interested in a teleseminar or webinar on the topic of buy-sell agreements, give me or Barbara Price a call (901-685-2120) or e-mail either of us (mercerc@mercercapital.com or priceb@mercercapital.com).

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This article originally appeared on Chris Mercer's blog, Mercer on Value (www.merceronvalue.com).

LOOK FOR MERCER CAPITAL'S REDESIGNED WEBSITE IN THE FIRST QUARTER OF 2007

Mercer Capital's redesigned website will have a totally new look and enhanced functionality. Users will be able to more easily access the wealth of information offered via the website. The site's "search" function has been strengthened and the ability to print and e-mail information will be as simple as the click of a button.

In addition to the hundreds of articles currently on our website, we will be adding presentation overheads and podcasts.

This focus on content has consistently made Mercer Capital's site the most visited in the business appraisal profession and the redesigned site will not disappoint. Look for it in the first quarter of 2007.

THE QUANTITATIVE MARKETABILITY DISCOUNT MODEL IN COURT AGAIN

THE QMDM FACT SHEET

THE QMDM FACT SHEET

Download this complimentary summary of the history of the QMDM and its acceptance in the business appraisal profession from www.mercercapital.com

In *Juan Armstrong v. LaSalle Bank National Association*, No. 05-3417 (7th Cir. May 4, 2006), the U.S. Court of Appeals for the Seventh Circuit determined that the appropriate standard of review to apply when considering whether an employee stock ownership plan trustee adopts a valuation of the subject stock is the abuse of discretion standard. It noted that one method for testing a trustee's abuse of discretion is whether a marketability discount should have been applied.

In making this recommendation, the court stated:

> "There are techniques for calculating a marketability, or illiquidity, discount, see Z. Christopher Mercer, "A Primer on the Quantitative Marketability Discount Model," *CPA Journal*, July 2003, www.nysscpa.org/cpajournal/2003/0703/dept/d076603.htm, visited Apr. 6, 2006...."

Brief summary above provided by John J. Stockdale, Jr. and appeared in the Summer 2006 issue of the Business Valuation Review

MERCER CAPITAL PROFESSIONALS TRAINING THE BUSINESS APPRAISAL PROFESSION

Z. Christopher Mercer, ASA, CFA
Business Valuation Association of Chicago
February 22, 2007
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"

Travis W. Harms, CFA, CPA/ABV
Advanced Business Valuation Seminar sponsored by the American Society of Appraisers
July 18, 2007
"Developing Reliable Valuation Models"

The Integrated Theory of Business Valuation - SECOND EDITION
by Z. Christopher Mercer, ASA, CFA and Travis W. Harms, CFA, CPA/ABV
Offered by Wiley & Sons
To be published in the Summer of 2007

Title	Description	Investment	Release Date
Quantifying Marketability Discounts ***Valuing Shareholder Cash Flows***	*Quantifying Marketability Discounts* has been updated and is now offered as an e-book. This edition provides a brand new chapter which discusses each of the assumptions of the QMDM in-depth. As a bonus, when you purchase the e-book, you will also receive the QMDM Companion, the latest edition of the QMDM in spreadsheet format.	**$95.00**	*Currently available*
Valuing Financial Institutions	We are responding to requests to put this book back into print and we are doing so as an e-book.	**$65.00**	*Currently available*
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corporation vs. C Corporation debate.	**$19.95**	*Currently available*
Embedded Capital Gains ***The History and the Issues***	A closer look at the embedded capital gains issue.	**$19.95**	*Currently available*
Employee Stock Option Valuation Issues	We have compiled some of our latest thinking on the subject of valuation of employee stock options.	**Complimentary**	*Currently available*
Rate & Flow ***An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions***	In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution. In states where an owner/spouse's active management of a business does not preclude the consideration of passive appreciation, we offer a fresh approach based on rate and flow analysis.	**Complimentary**	*Currently available*
The QMDM Fact Sheet	A summary of the history of the QMDM and its acceptance in the business appraisal profession.	**Complimentary**	*Currently available*

New Series: "Understand the Value of Your ..."

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Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. Why is this so? After all, beer distributors are typically street wise and business savvy. They increasingly employ skilled professionals at all levels of their organizations and the evolving disciplines of their trade are largely mandated by sophisticated, international breweries. Indeed, given the scrutiny of the IRS, the control of the breweries, the evolution of product mix, and the wide ranging concerns of shareholders, it is critical that value be determined and articulated in a credible fashion. The purpose of this article is to provide insight into the situational (when and why) and analytical (how) aspects of valuing beer distributorships.	**Complimentary**	*Currently available*

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MERCER CAPITAL ON THE ROAD

The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

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Investment Banking. Mercer Capital's investment banking division and specializes in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

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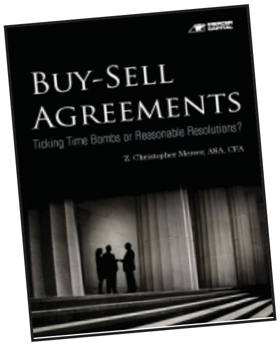

TICKING TIME BOMB OR REASONABLE RESOLUTION?

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. If you are an attorney, CPA, business owner, insurance professional, financial planner, or other advisor to business, you must have this book.

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