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# VALUE ADDED™

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## Buy-Sell Agreements

### The Three-Appraiser Pricing Mechanism

Buy-sell agreements among shareholders of privately owned businesses have to provide for a valuation mechanism in the event that their "buy" or "sell" provisions are triggered. We have found that the majority of buy-sell agreements have several things in common, including:

- The initial value for the agreement is established at the outset.
- The agreement calls for annual or periodic updating of the value.
- The periodic update valuations seldom occur.
- When events give rise to requirements for a valuation and the parties have not agreed, the latest valuation generally favors the buyer if the value of the business has been rising.
- In the alternative, the agreement calls for a "formula valuation," citing a multiple of book value, a multiple of earnings, or some other mechanistic determination. No "formula valuation" will provide a consistently reasonable valuation indication for a subject private company over rapidly changing market circumstances.

**A three-appraiser pricing mechanism for a buy-sell agreement is a cumbersome, time-consuming and expensive way to determine value**

Most agreements are designed with the idea that the other person will die first. An agreed-to value that becomes outdated with the passage of time will tend to favor the party(ies) who survive. For example, a controlling shareholder may favor a low buy-sell price because it facilitates the acquisition of minority blocks of shares. The minority shareholder(s) might also favor a low price with the thought that the controlling shareholder may die first. In any event, the failure to update the pricing of buy-sell agreements that call for periodic revision will inevitably cause problems for one side or the other or both.

Many buy-sell agreements have different valuation mechanisms, whether automatically built into the agreement or triggered by events enacted by the provisions of the agreement. We can call this the "one-appraiser, two-appraiser, three-appraiser valuation mechanism," or, for short, the "three-appraiser pricing mechanism." This multiple-appraiser option typically goes something like this:

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## Precedents and Rules of Evidence

### *What Do They Mean in the World of Business Appraisal?*

Appraisal work often involves litigation. Appraisers may be called to present evidence of the value of a business in estate matters or divorces. The decisions in these cases create a history of judicial treatment of a particular subject which appraisers often look to for guidance in performing their valuation work. In this article, we will discuss why we look to case law for guidance, the wisdom of using such case law in support of valuation conclusions, and some rules of evidence related to presenting testimony before a court.

Historical judicial treatment of a particular issue is termed "precedent." Precedent is a legal principle created by one or more decisions of a state or

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Manhattan Beach, CA

11/02-05 American Soc. of Appraisers (BV203)
Manhattan Beach, CA

- The one-appraiser valuation mechanism: The company hires an appraiser, who provides an opinion of value for purposes of the agreement. If the parties agree on the value, this may be the end of the process. But if they do not agree . . .
- The two-appraiser valuation mechanism: The shareholder(s) hire a second appraiser. Sometimes the second appraiser is hired concurrently with the first and sometimes after reviewing the first appraisal. Now the parties (or sometimes the appraisers) have an opportunity to look at two appraisals and to negotiate, or agree on a value. If the parties agree on the value, this may be the end of the process. But if they do not agree . . .
- The three-appraiser valuation mechanism: It is now time to hire a third appraiser. The usual mechanism calls for the first and second appraisers to get together and agree on an acceptable third appraiser. Some agreements call for the third appraisal to be binding on the parties. Others call for some form of averaging process (of either all three appraisals, or of the two closest together).

  Another form of the three-appraiser mechanism occurs when a court, seeing disparate values from two appraisers, suggests that a third appraiser be appointed. The court can then make a decision based on the third appraiser's conclusion(s) or by some averaging process from the three conclusions.

A three-appraiser pricing mechanism for a buy-sell agreement is a cumbersome, time-consuming and expensive way to determine value. As an alternative valuation mechanism some attorneys are writing a single-appraiser option into buy-sell agreements. It is becoming increasingly common for the shareholders of companies to agree on an appraiser to provide the initial valuation for purposes of the agreement and then to provide revaluations on a scheduled or as-needed basis.

Please call if you have any questions or to discuss a valuation of a buy-sell agreement in confidence. ◆

## Precedents and Rules of Evidence

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federal appellate court. These rules provide a point of reference or authority for judges deciding similar issues in later cases.

Lower courts do not always follow precedent. Courts may be presented with different facts or arguments that could persuade the judges to go against precedent. If these decisions are upheld on appeal, new precedent is established.

It is important to understand the hierarchy of state and federal court systems. Each state has lower courts, the equivalent of federal district courts. These will follow decisions issued by appellate courts, which, in turn, will follow decisions issued by the state's highest court, often called the supreme court.

When addressing issues related to the U.S. Tax Court, a Tax Court Memorandum is issued by a single judge, whereas, Tax Court Opinions are issued by the full panel of judges. Arguably, a Tax Court Opinion would hold more precedential value because the entire panel has issued the opinion.

One situation appraisers might face is a definition of "fair value" for dissenting shareholders according to the state statute. If the laws of the state do not define what level of value (controlling interest or marketable minority) dissenting shareholders should receive for their shares, appraisers would have to look to judicial interpretation of fair value. The appraiser should follow that interpretation when performing the valuation. If the appraiser does not, the lower court may reject the opinion because it does not represent the appropriate level of value.

While precedent is an essential element in our judicial system, appraisers and attorneys must realize that it is not

always applicable to the analysis at hand. This is because many issues in a business valuation are based on the specific facts of the case. Blindly applying past judicial decisions ignores the reality that the facts in the current situation may be quite different from previous cases. Judge Jacobs makes this distinction in *Foote v. Commissioner* (TCM 1999-37). In that case, one of the appraisers applied a blockage discount that was supported in part by calculating the average of the mean and median discount allowed in eighteen previous cases before the Tax Court. Judge Jacobs found fault with this approach stating, "each case is different, and the determination of a blockage discount depends upon the particular facts and circumstances involved."

Before supporting a particular argument or conclusion in a valuation, an appraiser must examine the facts of the prior case as well as the current one. If the facts are dissimilar, which they often are, the appraiser must support the conclusion with sound economic reasoning and analysis pertinent to the facts of the current case. A court will be unwilling to apply precedent if the facts do not support the application.

When preparing a valuation report, appraisers should be aware of some basic rules of evidence that may be applicable. The appraiser is submitting evidence because Federal Rule of Evidence 702 (or some similar state statute when applicable) states that "if scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact at issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise." (28 USCA §702)

Even though an appraiser has been hired to present expert testimony, the court may not deem him or her an "expert" and the opinion may be excluded. The trial court is considered a "gatekeeper" and must determine whether it is appropriate for a particular expert to testify. Recent case law has mandated that the trial court must ensure that the expert's testimony is reliable and relevant. According to *Daubert* (*Daubert v. Merrell-Dow*, 509 U.S.579 (1993)), several factors (while not definitive) may be considered when determining the admissibility of an expert's opinion, including: (1) whether the theory or technique has been/can be tested, (2) whether the theory or technique has been subject to peer review, (3) known or potential error rates, and (4) acceptance within the relevant scientific community. *Daubert* did not include skill or experience-based testimony, which characterizes business valuation.

A subsequent case, *Kumho Tire Company Ltd., et al. v. Patrick Carmichael et al.* (119 S. Ct. 1167 (1999)), clarified *Daubert* and indicated that these factors apply to scientific knowledge as well as technical and other specialized knowledge. Therefore, appraisers and those using appraisers to present expert testimony must be aware of the heightened scrutiny of their evidence and be prepared to meet these challenges in trial.

In addition to scrutiny of the admissibility of an expert's opinion under *Daubert* and *Kumho Tire*, appraisers must realize that individual courts will have specific rules regarding the submission of evidence. Each state promulgates its own rules of evidence that must be followed in its courts. When presenting evidence to the U.S. Tax Court, the appraiser should realize that often his report represents his direct testimony. This means the report must be clear, accurate, and reasonable in its conclusions because there may be no opportunity to provide explanation to the Court in the form of direct testimony.

It is essential to follow the rules of evidence because an appraisal report that contains the soundest conclusions is useless if it is excluded from evidence. Your attorney will be aware of the pertinent rules of evidence and will coordinate the process to ensure the most successful proceeding. ◆

# Understanding the Valuation Process

It has been our experience that few business owners have their company appraised just to satisfy their curiosity about value. Typically, a specific event will precipitate the need for a business valuation, such as the death of a shareholder, an estate planning need, the formation of an Employee Stock Ownership Plan (ESOP), satisfaction of a buy-sell agreement, some litigation experience or other event normal to the life cycle of a business and its owners.

Business owners can plan for and control some of these events to minimize the surprise factor and maximize value for the shareholders. An estate tax appraisal cannot be timed precisely without divine foresight, but effective estate planning, using valuation resources, can help minimize the estate tax bite. Selling the business may be a once-in-a-lifetime event, but ensuring that the business is ready for sale and presenting its valuation attributes in a coherent and positive manner to prospective buyers is a timing device that can be implemented over time, clearly to the advantage of the seller.

Most business owners discuss these precipitating events routinely with their professional advisors. In turn, the advisor, typically the attorney or

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the accountant, will contact a valuation professional on behalf of their client to begin the valuation process.

**The Introductory Phase.** During the introduction, we will request certain descriptive and financial information (usually recent audits and marketing brochures) to help determine the scope of the business. Defining the project is a critical phase of the business valuation and can be accomplished with telephone and personal visits.

**The Engagement Phase.** Once the valuation project has been defined, we will issue an Engagement Letter or Proposal setting forth the key elements of the appraisal assignment, including the name of the client, the name of the person or entity responsible for accepting the assignment, the official name of the entity to be appraised, its state of incorporation or organization, its principal business location and the specific business interests to be appraised. Additionally, the Engagement Letter will indicate the appropriate standard of value (often, fair market value), the premise of value, the effective date of the appraisal, and the type of report to be produced. The Engagement Letter or Proposal will also provide a descriptive project overview, the qualifications of the appraiser and the timetable and fee agreement.

Often accompanying the Engagement Letter is our comprehensive checklist request for information. This checklist requests the company's historical financial statements along with operating and structural information about the business and the market in which it operates.

**The Valuation Phase.** Once the checklist has been completed we begin our preliminary analysis of the company, which includes appropriate industry background research. We recognize that an appraisal of common stock represents an appraisal of the future at a current point in time; however, most of the information available to the analyst is historical. The future will likely change relative to the past, and we know that management will play an important role in making that future happen. Accordingly, upon review of the checklist and industry information, we will schedule an on-site appointment with management to discuss the operations of the business. The company visit provides an important perspective to the business valuation since it puts us in direct contact with the individuals responsible for shaping the future performance of the company.

During the on-site or due-diligence visit, we will: (1) review in detail the company's background, financial position, and outlook with appropriate management personnel, (2) review appropriate corporate documents not normally exchanged by mail, (3) tour the operations, and (4) respond to questions from management.

Following the due-diligence visit the analysis is completed, making specific documented adjustments discussed with management, in context with more subjective conclusions involving the weighting of some factors more than others. The client's review of the draft report is an important element in the process. It is important to discuss the appraisal in draft form with management to assure the factual correctness and to clarify any possible misunderstanding from our company interview.

Upon final review the valuation report is signed by the major contributing appraiser, and is reproduced in sufficient number for the company's distribution or documentation requirements.

To discuss a valuation assignment in confidence, please call. ◆

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