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Use business appraisers for buy-sell and arbitration agreements

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Lawyers often only think of engaging a business appraiser in the event of litigation. Such thinking prevents the lawyer from engaging the business appraiser in non-litigation settings where to do so would be beneficial to the client.

This is the second in a series of columns giving tips from my own experience about getting maximum benefit from the services that business appraisers can provide. In this column, I focus on drafting and implementing buy-sell agreements and arbitration agreements.

Wording defines standard of value

A business appraiser should be consulted in conjunction with drafting the valuation provisions of buy-sell agreements, and also arbitration agreements when arbitrating a business valuation. The wording of the valuation provision can have an enormous impact on the value finally determined when the provisions of the agreement are implemented.

For example, I have seen hundreds of buy-sell and arbitration agreements that specify the standard of value as "the fair market value of these shares." The shares that are the subjects of the buy-sell and arbitration agreements almost always are minority shares. This wording implies both minority interest and marketability discounts, usually totaling 50% or more, from a pro rata portion of the value of a controlling interest.

That may or may not be what the parties to the agreement really wanted. The valuation analyst should find out what the parties to the agreement actually want and help to draft language to accomplish the desired objectives. There may even be different provisions depending on different triggering events.

The analyst should also be present at a meeting where the parties, preferably including spouses, actually review and execute the agreement. Most minority owners (and even some lawyers) think that "fair market value of these shares" means a pro rata portion of the value of the whole company. The analyst should explain the valuation implications of whatever language is used so that all parties understand the contract that they are executing.

Use appraisers as arbitrators

A very important feature of an arbitration agreement or an arbitration clause in a buy-sell agreement is the procedure and criteria for selecting arbitrators. My experience is that the fairest results usually ensue when the arbitrators are professional business appraisers.

The most common clause calls for each party to appoint an arbitrator and the two arbitrators appoint a third. I think that the best case is to require that all three arbitrators be qualified business appraisers. Short of that would be to require that the third appointed arbitrator be a qualified business appraiser.

If the clients are not able to agree on this requirement in the written document, then be sure that your client appoints a qualified appraiser and that he holds out for one as the third appraiser. My experience is that, if the two appraisers can't agree and submit their lists to a neutral party to select the third arbitrator, the neutral party will almost always select a top-flight business appraiser over persons with other types of qualifications.

Avoid "formula" valuations

Clients often seek "formula" valuations in their buy-sell agreements. If they insist on a formula for valuation, a business appraiser can help set one up, reflecting the type of business and other factors.

However, conditions change, often in unforeseeable ways. It is almost always impossible to devise a formula that is not in danger of being unfair to one party or the other when the triggering event occurs. Therefore, I tend to prefer arbitration clauses as discussed above.

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In summary:

- Use the business appraiser to help draft language in the valuation provision that will meet the objectives of all parties to the agreement.
- Have the business appraiser explain, in person, the implications of the buy-sell agreement valuation language to all parties to the agreement before they execute the agreement.
- If there is an arbitration clause, try to arrange for the arbitrators to be qualified business appraisers.
- Try to avoid "formula valuations," but use a business appraiser to consult on the language if the client insists on a formula.

Bullet-proofing a Buy-Sell: Problem Areas to Address Before Signing the Agreement

Many parties negotiate a buy-sell agreement under the assumption that the "other guy will go first." Whether naïve or optimistic, the premise can prove true for only one of them, and a triggering event such as death, divorce, shareholder dissent, or other departure can expose parties to a buy-sell agreement to a multiplicity of problems.

A better tactic would be to identify the concerns of the parties at the outset while their interests are still aligned. Even better would be to engage a valuation appraiser during the negotiation of the buy-sell to propose "up-front" solutions to the problems that are likely to arise and to ensure that the agreement addresses both the amount and liquidity of the transferred shares. Although some clients may balk at the additional professional fees, these are minimal compared with the expensive—and extensive—litigation that can ensue from a poorly drafted or incomplete buy-sell agreement.

Most common pitfalls

Often, it's less important how clients resolve certain valuation issues, as long as their buy-sell agreements are clear and unambiguous and reflect the parties' intent. A business appraiser can help resolve the "how," while the following checklist will help the parties as well as their attorneys and accountants identify the most troubling issues associated with buy-sell agreements:

- *Standard of value.* A buy-sell agreement must clearly specify the standard of value. Some agreements simply mention "the value" of the company or interest: Does this mean fair market value, fair value, or some other standard? Each of these terms denotes a significantly different interpretation. If the agreement is not clear, the parties will have to try to agree on a standard of value upon a triggering event, long after their interests have diverged.
- *Book value.* One of the biggest problems is using the book value standard, as this often does not compensate the withdrawing or deceased shareholder for the value of intangible assets, for example, or contingent liabilities not reflected on the balance sheet. An inference that the book value of the shares equals their fair market value may depend on unwarranted or unreasonable assumptions, which may not account for changed conditions from the negotiation of the buy-sell to its triggering event.
- *Goodwill.* The agreement should also specifically address whether goodwill stays with the remaining shareholders.
- *Level of value.* Values can range from a controlling interest in a company to a nonvoting or nonmarketable minority interest to an illiquid, minority interest. Different assumptions apply to each level, such as the application of discounts or control premiums. If possible, buy-sell provisions should clearly identify which, if any, discounts and/or premiums apply.
- *Valuation date.* The "as of" date clearly identifies when the appraiser should value the interest and grounds the appraisal in such relevant and time-sensitive factors as the company's financial performance, the local and national economic conditions, etc.. The "as of" date could be the triggering event, the last fiscal year, an annual ESOP appraisal, or some other date or event.
- *Appraisal/arbitration process.* This is a key provision, defining the rights of each party to obtain an appraisal, and involving a single arbitrator/appraiser or a panel of two or three appraisers. The agreement must decide when the arbitrator(s) will be chosen—at the start of the engagement (preferable) or after a dispute has arisen; and who will choose the appraiser(s). A "shotgun" approach permits one party to provide the value, the other party to choose the share. Rights of first refusal can also provide a sanity check.
- *Appraiser qualif cations.* Some buy-sell agreements identify a specific appraiser or list of appraisal firms; others address the credentials and specific qualifications of the appraiser, such as practice scope, industry expertise, education, and training. Without these, a real estate appraiser or general

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accountant could qualify. Provisions can also identify specific appraisal standards of various professional societies or the IRS.

- *Payment provisions.* How will the agreed-upon value be provided to the departing or deceased shareholder? Can the company afford the price? What funding mechanism will be used?
- *Miscellaneous.* Additional provisions can address time limits for each step of the appraisal, provisions to break deadlocks, alternative dispute mechanisms, and third party involvement. Some buy-sell agreements even provide for psychological or "family" counseling to reduce conflict and ease the transition.

Intangible Asset Valuations: Spot These Common Errors Before Going into Court

When reviewing your expert's intangible asset valuation, it's critical to identify the most common errors that can cause a court to discredit or even disregard a report. The following checklist serves as a quick guide to avoid the most obvious deficiencies:

—*Is the standard of value followed?* Has the analyst carefully disclosed and defined the applicable standard of value? Has the standard of value been followed consistently throughout?

—*Are all three valuation methods considered?* These include the income, market, and asset approaches.

—*Is the internal analysis consistent?* For example:

- Did the analyst match pricing multiples or capitalization rates to the wrong economic income measure?
- Are current intangible asset operational data matched to different time periods, without appropriate adjustment?
- Did the analyst "normalize" financial statements without also normalizing the corresponding data for selected comparable companies?
- Was a "highest and best use" analysis performed?
- Was an "actual use" analysis also performed?
- Did the analyst make extraordinary, subjective, or speculative assumptions?

—*Is there suff cient support for selected variables?* Any analyst should document the data used, the procedures performed, and the valuation conclusions reached. There should also be sufficient tracing from the data in the quantitative analysis to the intangible asset in the owner/operator financial statement.

—*Do the numbers add up?* Mathematical errors are more common than anyone cares to admit; check all numerical calculations for accuracy, and make sure rounding conventions are consistent.

—*Does the analyst rely too heavily on 'rules of thumb'?* These serve only as a "sanity check," not as a basis from which to derive substantial intangible asset valuations.

—*Is there suff cient data and research?* The analyst should have conducted all relevant research, clearly threading the data into the quantitative analysis and valuation conclusions.

—*Is there adequate due diligence?* The analyst should have reviewed all relevant contracts and corporate documentation, including internal financial statements and external marketing statements. Sales, licenses, contingent liabilities, and litigation should have also been considered.

Classic Case of Expert v. Expert Won by Attention to Intangibles, Discounts

***Keener v. Keener*, 2006 Iowa App. LEXIS 659 (June 28, 2006)**

The Keener couple got married the day after incorporating their business, Alpha International, Inc., a toy manufacturer and seller. Over the next ten years, the husband acted as "the primary management force" and the wife was the sole shareholder, her consent required for all financial decisions. The toy company flourished, acquiring manufacturing equipment as well as sale rights to several notable toy brands. When they divorced in 2002, the wife received the business in her apportionment of the estate, apparently without notable disagreement. But the valuation of the company came down to a "classic battle of the expert witnesses," according to the appeals court, with a several million dollar disparity in their competing reports.

Wife's expert ignores intangibles

The wife's expert issued an initial report valuing the company at $9.035 million. He used an asset approach, including a 15% discount for lack of marketability (DLOM) of the closely held corporation. He valued the company as a going concern, assuming that it would remain in operation, but he assigned zero

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value to the intangible assets (intellectual property rights, etc.), because, according to his testimony, they produced no positive cash flow.

Six months after his original report, this same expert reduced the valuation by $0.937 million, to account for possible litigation to defend against infringement of intellectual property rights in one of the major toy lines. He reduced the value further by the sum of $2.89 million "to book" a contingent liability (another lawsuit where a settlement was pending, but no final agreement had been reached). Due to the perceived high level of litigation risks, he also increased the DLOM from 15% to 30%, for a final amended valuation of $4.750 million.

Husband's expert reads the footnotes

However, a footnote in the wife's expert's initial report stated that management viewed the pending litigation as "ordinary routine matters incidental to the normal business…not expected to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows." Accordingly, the husband's expert argued that the wife's 30% discount was excessive. The better approach, he said, was to reduce the overall value by 5% to 10% and book the contingent and speculative liabilities. His net asset valuation of the company came to approximately $10.170 million.

The husband's expert also disagreed with the zero valuation of the intangibles in light of the company's recent sale of two name brands for $7.7 million and the pending (post-divorce) sale of a third brand for another $7 million. Although he had not received the relevant financial documentation and so could not issue a firm opinion, the expert estimated the rights to "hundreds" of other brand names would add another $20 to $30 million of intangible asset value, increasing the company's overall net worth to the $30 to $40 million range.

Court agrees with valuing intangibles

The trial court wasn't persuaded by the wife's expert's valuation, in part for its failure to value the intangibles and also for its "speculative" discounts concerning marketability and contingent liabilities. It found the husband's expert's report more credible, adopting his net asset value of $10.170 million and finding that the company's intangibles were worth an additional $5 million. On review, the appeals court confirmed, finding that the "undisputed" evidence of name brand sales supported the intangible valuation.

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