

### Top Ten Ways to Succeed in a Judicial Appraisal Action

Judicial appraisal actions often involve sophisticated financial applications, analyses, and assumptions. To present appraisal evidence with the greatest likelihood of success, attorneys and their business appraisal experts will want to heed these “top ten” suggestions:

10. *Be familiar with precedent and the judge’s prior decisions.* Which valuation methods have met with the particular court’s prior approval? A new or less-favored method requires a well-prepared explanation by the experts and persuasive reasoning by the attorneys.
9. *Present an effective witness.* You’ll want the business appraiser to tell a clear story about how the company makes money and how that ties into its valuation. The analyst needs to describe the approaches and methods, explain the inputs and assumptions, and determine an appropriate weight for each method. If a particular method is not appropriate, the expert should be prepared to explain. Mistakes and last-minute changes will undermine credibility.
8. *Present an effective report.* The valuation report should be written in plain, understandable terms, with ample use, where appropriate, of charts, graphs, and spreadsheets. Take advantage of available resources and technology - but don’t bury the court with paper.
7. *Decide whether to prepare a rebuttal report.* This is a tactical decision, for which sensitivity analysis is critical. If the court is not completely persuaded by your expert’s report, then submission of a rebuttal or alternate valuation report gives the court a basis on which to rule (other than adoption of your opponent’s expert report.)
6. *Use reliable management projections.* By and large, courts prefer contemporaneous management projections, prepared in the ordinary course. Projections prepared when a fairness opinion, acquisition, or other major deal is in the offing are generally considered less reliable.
5. *Be prepared to justify a DCF.* All inputs and aspects of a discounted cash flow analysis (DCF) will come under the court’s scrutiny, including the discount rate and its inputs, and the terminal value. Attorneys and

their experts should make sure the analysis will “hold together” under cross-examination.

4. *Check your ‘reality-checks.’* In many appraisal actions, courts have found reality or “sanity” checks helpful. Examples of “sanity” checks include market prices, control premiums, evidence of a “thorough and fair auction,” etc.
3. *Don’t forget interest.* If the parties bear the burden of proof in determining interest in a statutory appraisal action, make sure your experts assist with this calculation. Absent reliable evidence, courts will fall back on the statutory rate.
2. *Expert should be skeptical.* The appraiser should also test all management assumptions and projections against a reasonableness or “reality” check.
1. *Expert must be independent.* Business appraisers are important members of the “litigation team,” but they must retain their independence. Experts who appear “too cozy” with their own side risk losing their credibility in the court.

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# SFAS 157: What You Need to Know About FASB's Fair Value Measurements

The Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements, is the latest evidence that the FASB is indeed moving from rules-based to principle-based standards. Effective for fiscal years ending November 2007, SFAS 157 is now a fixture on the fair value landscape, and business appraisers as well as attorneys need to understand its implications and applications.

## Parsing the New Statement

The best way to understand the new FASB pronouncement is to parse its elements. SFAS 157 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."

- **Price.** The Statement does not contemplate a strict entry or exit price; rather, it seeks to include assumptions concerning market participants (see below) to realize the price they would pay on the measurement date.
- **Orderly transaction.** Although SFAS 157 specifies a valuation date, it assumes the asset's exposure to the market for a prior period, to allow for customary marketing activities.
- **Market participants.** Closely aligned with the hypothetical willing buyer and seller, market participants in a fair value assessment are:
  - Unrelated parties:** Independent of any specific entity, including the reporting entity;
  - Knowledgeable:** Having a reasonable understanding of the transaction, the asset or liability, based on all available information, including due diligence; and
  - Willing and able:** Under no compulsion to transact for the asset or liability

The reporting entity need not identify specific market participants, only the characteristics that distinguish them generally, considering the specific asset or liability, its principal market, and the market participants with whom the entity would transact.

- **Application to assets.** Fair value measurement assumes the "highest and best use" of the asset that is: (1) physically possible; (2) legally permissible; and (3) financially feasible. The valuation premise is "in use/in exchange," which seeks to maximize the value of the asset or group of assets in which the asset will be used but bases this value on the use

by market participants - *even if the reporting entity intends a different use.* In this case, even if an acquiring company has a clear strategy for the deployment of an asset, conformity with the SFAS 157 may require eliminating buyer-specific strategies.

- **Application to liabilities.** The Statement assumes that the liability is transferred to a market participant and that the non-performance risk is the same before the transfer as after. In other words, the liability continues - it is not settled.
- **Valuation approaches.** The Statement requires "techniques that are appropriate in the circumstances and for which sufficient data are available." They should be consistently applied; a change is appropriate only if it is "a better representation of fair value."

## Fair Value Hierarchy

SFAS 157 prioritizes the valuation inputs according to whether they are: observable (reflecting market assumptions based on independent data) or unobservable (reflecting reporting entity assumptions from its own data). This hierarchy allows the user of financial statements to assess the relative reliability of fair value measurements, ranked as follows:

**Level 1 inputs** are quoted prices (unadjusted) in active markets for identical assets or liabilities, which the reporting entity can access at the measurement date.

**Level 2 inputs** are those other than Level 1 quoted prices, directly or indirectly observable, such as:

- quoted prices for similar assets or liabilities in active markets;
- quoted prices for identical or similar assets or liabilities in inactive markets; or in which there are few participants; or in which prices are not current or vary substantially among market makers (brokered markets); or in which little information is released publicly (principal-to-principal market);
- observable inputs, other than quoted prices, such as interest rates, yield curves, volatilities, prepayment speeds, loss severities, credit risks, and default rates; and
- inputs that are derived principally from or can be corroborated by market data.

**Level 3 inputs** are unobservable inputs; i.e., inputs that reflect the reporting entity's own assumptions about what market participants would use to price the asset or liability (including risk), developed using the best information available without undue cost and effort. There is no verification requirement, so long as the assumptions are in line with those of market participants.

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## Blockage Discounts

SFAS 157 affirms the fair value of actively traded positions in a financial instrument (including a block) as the product of its quoted price times the quantity held ( $p \times q$ ), without adjustment for a blockage factor; and extends this requirement to broker-dealers and investment companies. But as for broader discounts such as control premiums, swing votes, and non-financial assets (real estate), FASB will most likely examine these in future statements.

## ***The Importance of Buy-Sell Agreements: Two Cases Spell Out What Can Go Wrong***

***Fausak's Tire Center, Inc. v. Blanchard, 2006 Ala. Civ. App. LEXIS 719 (December 8, 2006); and *Bullet Land, Inc. v. Thal, 2006 U.S. Dist. LEXIS 88521 (December 7, 2006)****

These two cases highlight the many problems associated with buy-sell agreements - and the ways attorneys and business appraisers can help clients avoid them.

### **Death of a Shareholder**

In the *Fausak* case, the decedent was a shareholder of Fausak's Tire Center, Inc. (the Corporation") and a member of FTC Properties, LLC (the "LLC").

In January 2000, the decedent (dod 11/03) and four others purchased the stock of the Corporation for a total price of \$1.1 million, or \$2,100 per share. From the outset, the shareholders discussed the need for a buy-sell agreement, drafted at least four different versions, and purchased life insurance policies to fund a buy-sell. However, the terms were never formalized. At the April 2002 shareholders' meeting, the shareholders agreed the value of the stock was \$2,500 per share. In January 2003, the LLC was formed. Its sole asset was real estate improved with a tire store which was leased to the Corporation. In November 2004, the remaining shareholders executed a buy-sell (stock valuation price of \$2,500 per share).

At the time of death, the decedent owned a 20% membership interest in the LLC which was valued at nearly \$17,000 (the record does not clarify how this value was reached) and 125 shares of stock of the Corporation valued at \$312,500 ( $\$2,500 \times 125$ ). The remaining shareholders offered the widow a total of just under \$330,000 less the \$15,000 advance.



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The check was cashed and the proceeds disbursed to the decedent's spouse. The administratrix, alleging there was no valid buy-sell in place, requested the Corporation and the LLC release the stock and membership interest, respectively, to the estate.

The Corporation argued that the shareholders' agreement to modify the purchase price of the stock to \$2,500 was a "note or memorandum" sufficient to establish the terms of a buy-sell agreement at the time of the death - as further evidenced by the widow's cashing of the \$15,000 advance. The probate court disagreed, as did the Court of Appeals on review. To satisfy the applicable Statute of Frauds, any writing must contain the "essential terms" of the alleged agreement, including, in the case of a buy-sell, the "mutual assent" of the signing parties to its purpose:

The problem with considering the stock-valuation document as a memorandum...is not that the document might have been intended for some purpose other than a buy-sell agreement, but, more fundamentally, that it is simply insufficient to evidence a buy-sell agreement at all.

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## Even Written Buy-Sells Cause Problems

The *Fausak* case shows what can happen when parties delay too long in implementing a buy-sell agreement. The *Bullet Land* case illustrates what can happen when the terms aren't sufficiently spelled out, especially those concerning the binding effect of the appraisal(s) involved.

The Bullet Land partnership was formed to renovate and operate a historic hotel. In early 2006, the general partner received and consented to a written notice of removal. The partnership's buy-sell agreement involved five basic steps: 1) each party selects an appraiser; 2) those two appraisers select a neutral third appraiser; 3) the three appraisers "collectively" determine a fair market value; 4) if the three appraisals differ, the lowest value is disregarded and the two higher values are averaged; and 5) the average is submitted to a CPA to determine the final purchase price.

All of the steps took place. The general partner and the partnership each selected an MAI appraiser, who then selected a third, neutral appraiser. The appraised values for the entire partnership came back at \$17.1 million, \$13.4 million, and \$12 million, respectively. The latter (from the neutral appraiser) was tossed

out, and the buyout price for the general partner's interest was calculated to be \$3.6 million, based on the remaining two appraisals. An independent CPA confirmed the buyout price, and the deal appeared ready to close, per a letter from Bullet Land's counsel confirming the "agreement of the parties."

But then the neutral appraiser sent a report to Bullet Land's lawyer, stating that the \$17.1 million appraisal was "not credible" because it was based on inappropriate comparable data and projections that were not "supported by market evidence and...conditions." What followed was a lawsuit in which both parties disputed the facts as well as the claims - the partnership attacking the \$17.1 million appraisal and the general partner trying to enforce the buyout price as an arbitration award.

## Buy-Sell is not an Arbitration Agreement

In the end, the parties' only agreement was that the appraisal process had failed to bring about a purchase. Despite the near closure of the buy-sell process, the Court found it did not constitute an arbitrated settlement agreement and denied the general partner's motion to dismiss—leaving all parties exposed to further litigation and costs.

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