

### **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.” Unfortunately, this premise can prove true for only one of them. Moreover, a triggering event such as death, divorce, shareholder dissent, or other departure can expose parties to a buy-sell agreement that may be problematic.

It would, therefore, be prudent to identify the concerns of the parties at the outset while their interests are still aligned. This can best be accomplished by engaging the services of a valuation appraiser during the initial negotiation of the buy-sell agreement 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**

From a valuation standpoint, it is important that the buy-sell agreement is clear, unambiguous, and reflects the parties’ intent. Some of the more common valuation issues that, left unaddressed, can result in different interpretations and disputes are:

- **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.** Book value is commonly used in buy-sell agreements mainly because it is easy to establish. Book value is determined by a company’s accountant and reflects certain accounting treatments. It is based on original costs, not the fair market values of the assets and liabilities. The fair market value of a business, however, is often significantly greater than (and

has no relation to) its book value. All parties should understand the implications of book value if it is used.

- **Level of value.** Values can range from a controlling interest in a company to an illiquid, non-controlling (minority) interest. Significant discounts often apply for lack of control and illiquidity. Unfortunately, most buy-sell agreements are silent as to the level of value.
- **Valuation date.** The “as of” date clearly identifies when the value is to be determined. Values are time-sensitive and can change quickly. The valuation date can be a triggering event (the departure of the shareholder/employee), the last fiscal year end, the written request to exercise the buy-sell agreement, or some other specified date or event.
- **Appraisal/arbitration process.** This is a key provision that defines the rights of the parties involved. Agreements may stipulate a single arbitrator/appraiser, or the right of each party to obtain an appraiser. The agreement should also state who will choose and pay for the appraiser(s).
- **Appraiser qualifications.** 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 designations, industry expertise, education, and training. Without these, a real estate appraiser or general accountant could qualify.
- **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 issues such as time limits for each step of the process, provisions to break deadlocks, alternative dispute mechanisms, and third party involvement.

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# Buy-Sell Agreements and Subsequent Transactions

**Kennedy v. Trustmark Nat'l Bank, 2006 U.S. Dist. LEXIS 59079 (August 22, 2006)**

This is a buy-sell case in which an ESOP appraisal furnished the fair market value of the stock. A stockholder was cashed out at a certain price, only to learn a year later that the company sold for nearly three times the price. But the plaintiff was unable to turn this into a case of corporate fraud and conspiracy—largely because the ESOP appraisal was competent and clear and the buy-sell agreement was unambiguous.

## A Case of Rightful Termination

After twenty-seven years at an insurance company, the plaintiff (a vice president) had been named a defendant in a criminal action and was lawfully terminated. At the time, he owned 300 shares in the company and, pursuant to the buy-sell agreement, was entitled to receive the stock's "fair market value" on the company's choice of either: (1) the ESOP valuation date coinciding with or immediately preceding his termination; or (2) the date on which he was terminated.

The company picked the former, using an annual ESOP valuation that took place at year's end, just fifteen days prior to the plaintiff's termination. The appraisal determined a fair market value of \$1,516 per share, which the plaintiff received. Ten months later the company sold for about \$4,000 per share.

The plaintiff claimed the sale amounted to a fraudulent scheme to cheat him out of the \$750,000 difference. He also alleged that the buy-out price was based on book value rather than fair market value and that the company had failed to inform the appraiser of its imminent sale.

On defendant's summary judgment motion, the District Court found it "unequivocal" that the buy-sell agreement provided for a fair market valuation of the stock as of the year-end ESOP appraisal. "The fair market value of plaintiff's stock was not required, or even permitted, to be determined ten months later when the sale...occurred."

Furthermore, the Court found "not even a scintilla of evidence" that the plaintiff received book value instead of fair market value. The valuation report specifically addressed the company's book value—which on a per-share basis equaled \$418—and noted that "book value, per se, is typically not given much weight...unless, on a liquidation basis, it exceeds the value as calculated using methods related to the earning power of the Company." Instead, the fair market valuation was based on "methods utilizing market comparable

data," according to the appraiser's affidavit, "and the capitalization of the Company's earning capacity."

## The Appraiser Knew About the Sales Discussions

The appraiser had been aware of management's "conversations" with a potential buyer. But as of the valuation date, there had been no letter of intent, no final terms, and no settled transaction. Not even the majority shareholders (whose approval would have been required for a sale) knew about the discussions. As such:

[I]t would have been inappropriate and pointless to utilize, reference, or give credence to such uncertain, imprecise information and unsettled activities...for determining the controlling interest value of the company for ESOP purposes. Even if there had been firm or finalized terms of the sale...prior to [the] issuance of the Valuation Report, this subsequent information would not have been used in making a [prior] year-end valuation determination.

Based on this evidence, the Court found plaintiff's allegations "unsubstantiated... obviously made before reasonable inquiry," and without any knowledge of the appraisal process. The appraised fair market value of the stock was "comprehensive and accurate" and did not need to consider a sale which was, on the date of valuation, purely "speculative and uncertain."

## 'What Not to Do' When Structuring a 'Fair' Merger

**Gesoff v. IIC Industries, Inc., et al., 2006 Del. Ch. LEXIS (May 18, 2006)**

In a going-private transaction that was "marked with grave examples of unfairness," the Delaware Chancery Court found, among other flaws in the merger process, a "plainly unfair price" for the company's minority stockholders.

### First Mistake: Parent Assumes all Authority for Attorney and Appraiser

A foreign holding company owned 78% of a publicly traded U.S. subsidiary which controlled various companies. To simplify its cost structure, the parent company sought to remove the subsidiary's minority stockholders by going private. In early 2001, the parent board authorized a bid at \$13 per share, and approved funds for a fairness opinion and a special committee. But then, the parent CFO invited only one subsidiary director to the special committee, allowing him no authority to choose an attorney or investment banking firm as the financial advisor for the special committee.

The negotiations that followed were "entirely inadequate," according to the Court. An internal email

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## RECORD YEAR FOR M&As IN 2006

### Private Equity Firms Buy Big

- According to data compiled by Thompson Financial, the world-wide dollar value of merger & acquisition transactions in 2006 totaled a record \$3.8 trillion. This compares to the old record of \$3.4 trillion set in 2000 and was 38 percent higher than the 2005 level of \$2.7 trillion.
- In the U.S., deals were valued at \$1.6 trillion in 2006. While not enough to surpass the U.S. transaction record of \$1.7 trillion set in 2000, it did, however, represent a 36 percent increase over 2005.
- Europe was a force in the 2006 merger swell, with European deal-volume jumping to \$1.4 trillion, a 39 percent increase over 2005.
- Steve Baronoff, Merrill Lynch & Co.'s global-mergers chief, predicts that in 2007, the total dollar volume of global transactions could beat the 2006 record by 10 to 15 percent.
- Big deals were up in 2006, with 55 transactions valued at more than \$10 billion each, surpassing the previous high of 39 in 2000.
- Private equity firms were involved in an estimated 20 percent of the world's mergers and acquisitions, and 27 percent of U.S. activity.
- According to Private Equity Intelligence's 2007 Global Fundraising Review, private equity firms raised \$401 billion worldwide in 2006, an increase of 29 percent over 2005.
- A total of 612 new funds held a final close in 2006.
- U.S.-focused funds continued to dominate the market, garnering 63 percent of the new commitments around the world. In total, 311 US-focused funds raised an aggregate \$252 billion.
- Private equity groups staged five of the ten largest transactions in the U.S. Firms such as the Blackstone Group and Kohlberg Kravis Roberts (KKR) have been closing deals at a record pace. Their recent announcements, such as the \$36 billion takeover of Equity Office Properties Trust, a \$32.9 billion buyout of hospital chain HCA Inc., and others, have drawn the attention of the financial markets.
- Some analysts believe that this could be the beginning of a long-term buyout boom as it is believed that buyout shops have an incredible \$750 billion of available capital. Additionally, the buyout shops have made extensive use of debt financing to fund the purchases, something corporations historically have been less willing to do.
- Some experts, such as Stefan Selig, global head of mergers and acquisitions at Bank of America in New York, believe this could signal an overall shift in the merger market. Selig states that "This M&A market is less tied to the economic cycle and is more linked to credit markets." Given the continued relatively low interest rates and the availability of credit, "we should prepare for a very busy 2007." Selig predicts that global merger volume will pass \$4 trillion in 2007.
- Frank Yeary, global head of mergers and acquisitions at Citigroup Inc. of New York, states "There is a broad-based assessment that mergers and acquisitions are adding more value than they ever have in the past." Additionally, "Investors are more convinced that companies can deliver on their promises, especially for estimates of cost reductions."

between the CFO and the attorney dictated that the parent would make a “lowish” bid to the subsidiary board, which would hire the investment bank to evaluate the bid. The bankers would then recommend a “slightly higher” bid, which the parent would meet and the bankers approve, and “the door would then be open for [the parent] to make its tender offer for the shares of” the subsidiary.

The parent company adhered to the plan by dropping the initial offer to \$10 per share. The investment bank conducted its appraisal but sent drafts with valuation ranges to the parent CFO without the special committee’s knowledge. On September 10, 2001, the CFO and the special committee member agreed on \$10.50 per share for the tender offer, and presented it to the subsidiary’s board with the fairness opinion that same day.

The Court made short shrift of the parent company’s defense in the unfair dealing class action suit:

[T]he defendants unilaterally imposed on the minority a price of the parent’s own choosing, established a deceptive negotiation between the parties, and left the minority’s putative special committee almost entirely powerless against its parent. This muddled, dishonest process is emphatically not what the Supreme Court meant by ‘fair dealing,’ ...and will not be tolerated here.

Particularly troubling was the free flow of “private” valuation information between the appraisers and the parent. This “sieve-like” separation contributed to a

process so “transparently corrupt,” according to the Court, that it could serve as a collective lesson to transactional planners and practitioners of how not to conduct a similar merger “by orchestrating a stylized mockery of arms’-length negotiations.”

To calculate damages, the Court reviewed both parties’ expert reports and then conducted its own DCF (discounted cash flow) analysis.

Among other things, they found that plaintiff’s appraiser had relied on subjective financial forecasts that differed markedly from management’s. He also used country-specific risk premia that were too low, incorrectly applied a control premia to DCF analysis, and overlooked a small-stock risk premium—such that the Court could not adopt his fair value conclusion of \$20.17 per share for the subsidiary.

#### **Defendants’ Valuation Offers Better Framework**

In contrast, the Court adopted the general framework provided by defendants’ expert, which posited a fair price of \$9.60 for the subsidiary’s shares on the merger date. However, the defendant’s analysis was still subject to several “material adjustments,” primarily to the specific company risk premium—which the Court found too subjective; and the small-company risk premia, which the Court declined to apply to all of the subsidiary’s foreign holdings, since the data had been developed from U.S. markets.

The Court accorded its own DCF analysis a 100% weight and awarded plaintiffs \$14.30 per share.

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