

Buy-Sell Agreements

How to Know Your Agreement Will Work
Without Triggering It

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Learning Objectives

- Identify areas of concern in your or your client's buy-sell agreement
- Understand formula agreements and fixed price agreements
- Learn how to "fix" out-of-date formulas or fixed prices in your agreement
- Know the differences between single appraiser process agreements and multiple appraiser process agreements
- Understand the six defining elements that must be present in every valuation process agreement
- Identify the process by which most problems can be averted for your or your client's buy-sell agreement

An Overview of Buy-Sell Agreements



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Pete and Sam

Pete: “Sam, I just buried a small bomb in your yard. It isn’t large enough to kill you, your wife, or another member of your family, but it would certainly maim you or them if one of you stepped on it.”

Sam: “Where is it?”

Pete: “I’m not going to tell you where it is. But don’t worry. Chances are it is so well-hidden that no one will ever step on it.”

Sam: “What do you mean, ‘chances are’? That’s a chance I can’t take! If it were just me it would be one thing, but you’re talking about hurting my wife and family!”

Pete: “Like I said, don’t worry. Maybe no one will ever step on it. Maybe it will never explode.”

Sam: “You must be crazy! I’ll bring in a bomb squad and dig up the entire yard to get rid of that it!”

Pete: “Now Sam, you know I’m just kidding about the bomb. However, your buy-sell agreement might very well be a ticking time bomb and you just don’t know it. How about taking some time to talk about your buy-sell agreement – say, dinner tomorrow night?”

What Is a Buy-Sell Agreement?

- Agreements by and between the shareholders (or equity partners of whatever legal description) of a privately owned business and, perhaps, the business itself that establish the mechanism for the purchase of stock following the death (or other adverse changes) of one of the owners. In the case of corporate joint ventures, they also establish the value for break-ups or for circumstances calling for one corporate venture partner to buy out the other partner.
- Buy-Sell Agreements...
 - Require agreement **at a point in time**
 - Relate to transactions that will or may occur **at future points in time**
 - Define the conditions that “**trigger**” the buy-sell provisions
 - Determine the **price(s)** at which specified future transactions will occur

Potential “Trigger Events”

- Q Quits
- F is Fired
- R Retires
- D Disabled
- D Death
- D Divorce
- B Bankruptcy

Others?

The 20 Ds

- Departure
- Discharge
- Death
- Divorce
- Disability
- Default
- Disqualification
- Disaffection
- Disagreement
- Disclosure
- Dispute resolution
- Dilution
- Dividends
- Distributions
- Drag-along rights
- Double entities
- Differential pricing
- "Don't compete" agreements
- Donate
- Distributions after a trigger event

Three Questions to Ask Yourself

Do you or your client have a buy-sell agreement?

If so, what type of agreement is it?

Do you know what the buy-sell agreement says?

There are six defining elements that must be in every process agreement if you want the valuation process and, therefore, the agreement, to work

How is the buy-sell agreement funded?

How life insurance proceeds are treated can make a big difference in the valuation of the company

Do You or Your Client Have a Buy-Sell Agreement?



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How Do Buy-Sell Agreements Come Into Existence?

POTENTIAL OPPOSING SHAREHOLDER CHARACTERISTICS THAT MAKE DISCUSSING BUY-SELL AGREEMENTS DIFFICULT

Characteristic	Shareholder 1	Shareholder 2
Age	Younger	Older
Ownership	Noncontrolling	Controlling
Involvement	Active	Inactive
Personal Outlook	Optimistic	Pessimistic
Investment Type	Sweat Equity	Real Money
Investment Amount	Smaller	Larger to Much Larger
Personal Guaranties	None	Substantial

Get Agreement. Now.

Just Do It.

Types of Buy-Sell Agreements

- Based on how price is determined
 - Fixed-price agreements
 - Formula agreements
 - Process agreements

Fixed-Price Agreements

DESCRIPTION

- You and the other owner(s) agreed on a price.
- That price of your agreement is likely years out of date.
- There are three possibilities regarding the price you set:
 - The value today is lower, perhaps far lower, than the realistic value.
 - The value today is higher, perhaps far higher, than the realistic value.
 - The value is the same as it was back then.
- You haven't agreed on a way to update the price.

Fixed-Price Agreements

REALITIES SELDOM DISCUSSED

- If the value is unrealistically low, you are betting that the other guy will die first and you'll get to buy at the low price.
- If the value is unrealistically high, you are betting that you'll be the one to leave the business so you and your family can benefit.
- The other guy(s) are making just the opposite bets.
- Why take a chance that you'll be on the wrong end of that bet?

Fixed-Price Agreements

ADVANTAGES

- Easy to understand, easy to negotiate – the first time only!
- Inexpensive
 - Easy for attorneys to draft
 - No appraisers required

Fixed-Price Agreements

DISADVANTAGES

- Fixed prices are seldom updated, even over periods of many years. Inequities are almost certainly a result of out-of-date fixed-price agreements
- Easy to set an initial price, but may be difficult to reset as time passes and interests diverge
- The longer period of time between updates to fixed-price agreements, the greater the potential for a divergence of the interests of the various parties
- The normal procedure to address to this problem is a flawed process agreement
- Betting that the other guy(s) will die first!

Fixed-Price Agreements

HOW TO “FIX” AN OUT-OF-DATE FIXED-PRICE AGREEMENT

- Update it annually
- So simple but rarely ever done

Formula Agreements

DESCRIPTION

- You and the other owner(s) established a formula to calculate price.
- Chances are, no one has calculated it lately.
- Chances are, it can give an unreasonable result now.
- Combined with changes in the company and the industry:
 - The formula price may be higher than a realistic value today.
 - The formula price may be lower than a realistic value today.
 - The formula price is realistic today.
- You haven't agreed on ways to make necessary/appropriate adjustments.

Formula Agreements

REALITIES SELDOM DISCUSSED

- If the value is unrealistically low, you are betting that the other guy will die first and you'll get to buy at the low price.
- If the value is unrealistically high, you are betting that you'll be the one to leave the business so you and your family can benefit.
- The other guy(s) are making just the opposite bets.
- Why take a chance that you'll be on the wrong end of that bet?

Formula Agreements

State a single formula to be applied to balance sheet and/or income statement metrics

EXAMPLES

- Multiple of EBITDA – (5 x EBITDA)
 - Less debt?
- Book Value
 - “Shareholders’ equity per the audited financial statements at the end of the fiscal year immediately preceding the valuation date.”

HOW TO “FIX” A FORMULA AGREEMENT

- Every year, calculate the price based upon the formula

Process Buy-Sell Agreements

DESCRIPTION

- You and the other owners agreed to let business appraisers set the price for your agreement if and when it is triggered.
- No one has the foggiest idea what will happen or what the price will be.
- No one knows what “kind of value” the appraiser will provide:
 - It could be the value of an illiquid interest.
 - It could be the value of the entire enterprise pro rata to ownership.
 - It could be reasonable and what you thought you agreed to.
 - It might not be reasonable and what you thought you agreed to.
- No one will know until the end of a lengthy & uncertain process what the outcome will be.

Process Buy-Sell Agreements

REALITIES SELDOM DISCUSSED

- You are betting that the ultimate price will be favorable (or at least reasonable) for you.
- The other owners are betting that the ultimate price will be favorable (or at least reasonable) for them.
- The company is betting that the process will work and that the price set will be affordable.
- Everyone is betting and someone will lose.

Process Buy-Sell Agreements

- A buy-sell agreement provides a valuation process employing one or more appraisers
- Value is determined by the appraisers in a manner defined in the buy-sell agreement
- Two types of process buy-sell agreements:
 - Multiple Appraiser
 - Single Appraiser

Process Buy-Sell Agreements

- Your (client's) buy-sell agreement should be

Understandable

Predictable

Likely to Achieve Reasonable Resolutions

Helpful in the Wealth Management Process

Multiple Appraiser Agreements

- Multiple appraiser agreements call for the selection of two or more appraisers to engage in a process that will develop one, two, or three appraisals whose conclusions form the basis for the final prices
- If that process sounds time consuming, cumbersome, and expensive, it is. Such processes can also be divisive and foster litigation

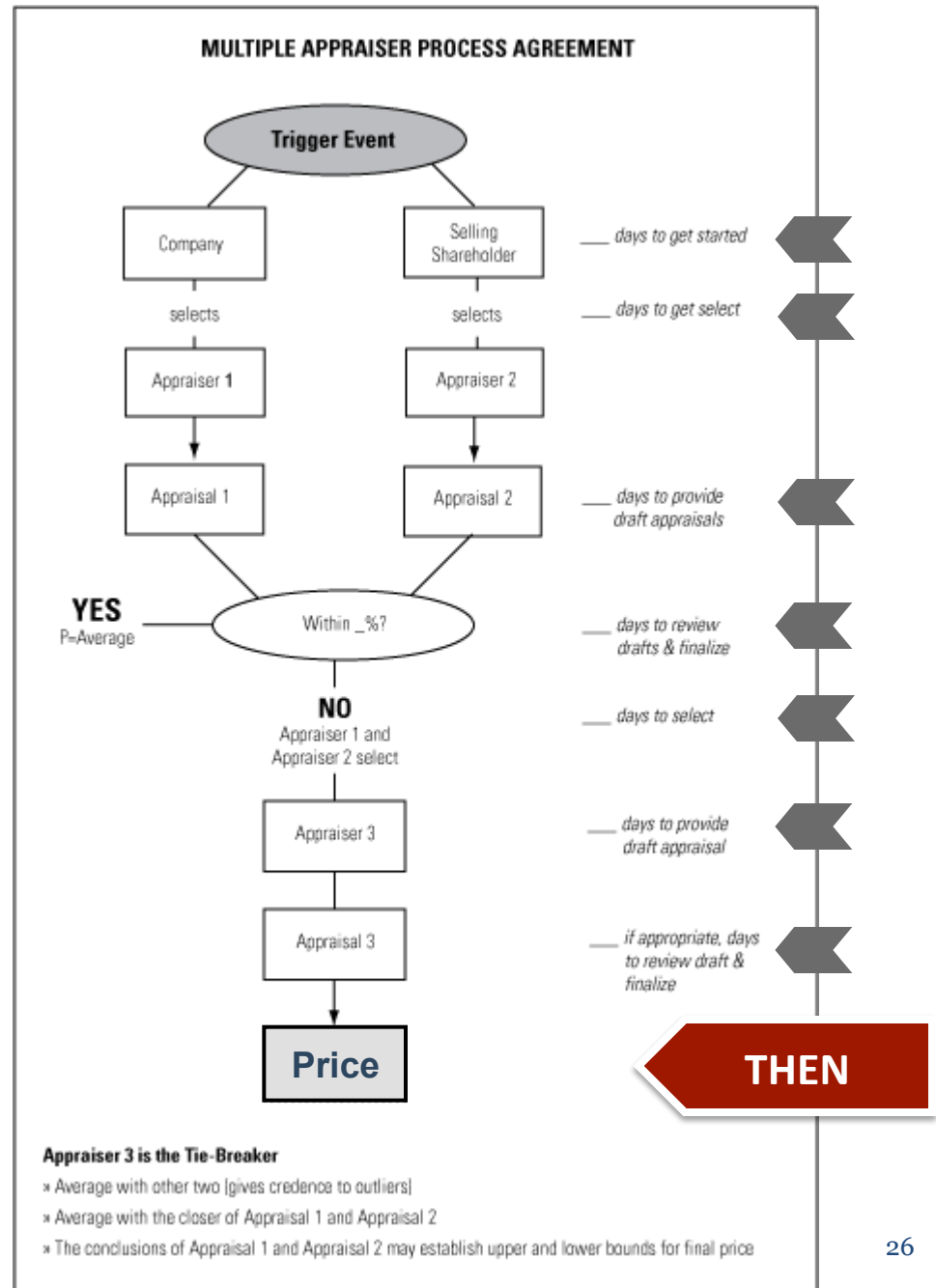
Third appraiser as **RECONCILER**

Third appraiser as **JUDGE**

Third appraiser as **DETERMINER**

Third appraiser as **MEDIATOR**

Multiple Appraiser Agreements



Multiple Appraiser Agreements

DISADVANTAGES		MULTIPLE APPRAISERS
1.	Price not determined now	x
2.	Potential for dissatisfaction with the process for all parties	x
3.	Danger of advocacy	x
4.	Uncertainty over what will happen when a trigger event occurs	x
5.	Uncertainty over final price if the process is invoked	x
6.	Problems or issues with definition of value, qualifications of appraisers, or any other aspects of the operation of the agreements are deferred until a trigger event – when the interests of the parties are adverse	x
7.	Expensive	x
8.	Time-consuming	x
9.	Distracting for management	x
10.	Potentially devastating for affected shareholders and their families	x

Let's Talk More About Process Agreements



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Single Appraiser Agreements

- Single appraiser agreements call for the selection of one appraiser whose appraisal conclusion forms the basis for the final price.

SINGLE APPRAISER
SELECT AND VALUE AT TRIGGER EVENT

SINGLE APPRAISER
SELECT NOW AND VALUE AT TRIGGER EVENT

SINGLE APPRAISER
SELECT NOW AND VALUE NOW

Key Recommendation

Single Appraiser, Select Now and Value Now



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Single Appraiser, Select Now and Value Now

SELECT NOW

- I have long recommended that parties creating buy-sell agreements name the appraiser at the time of agreement. This way, all parties have a voice and can sign off on the selection of the appraiser no matter how difficult the process of reaching agreement.

VALUE NOW

- Once selected, the chosen appraiser provides a baseline appraisal for purposes of the agreement. I suggest that the appraisal be rendered in draft form to all parties to the agreement, and that everyone has a reasonable period of time to provide comments for consideration before the report is finalized.

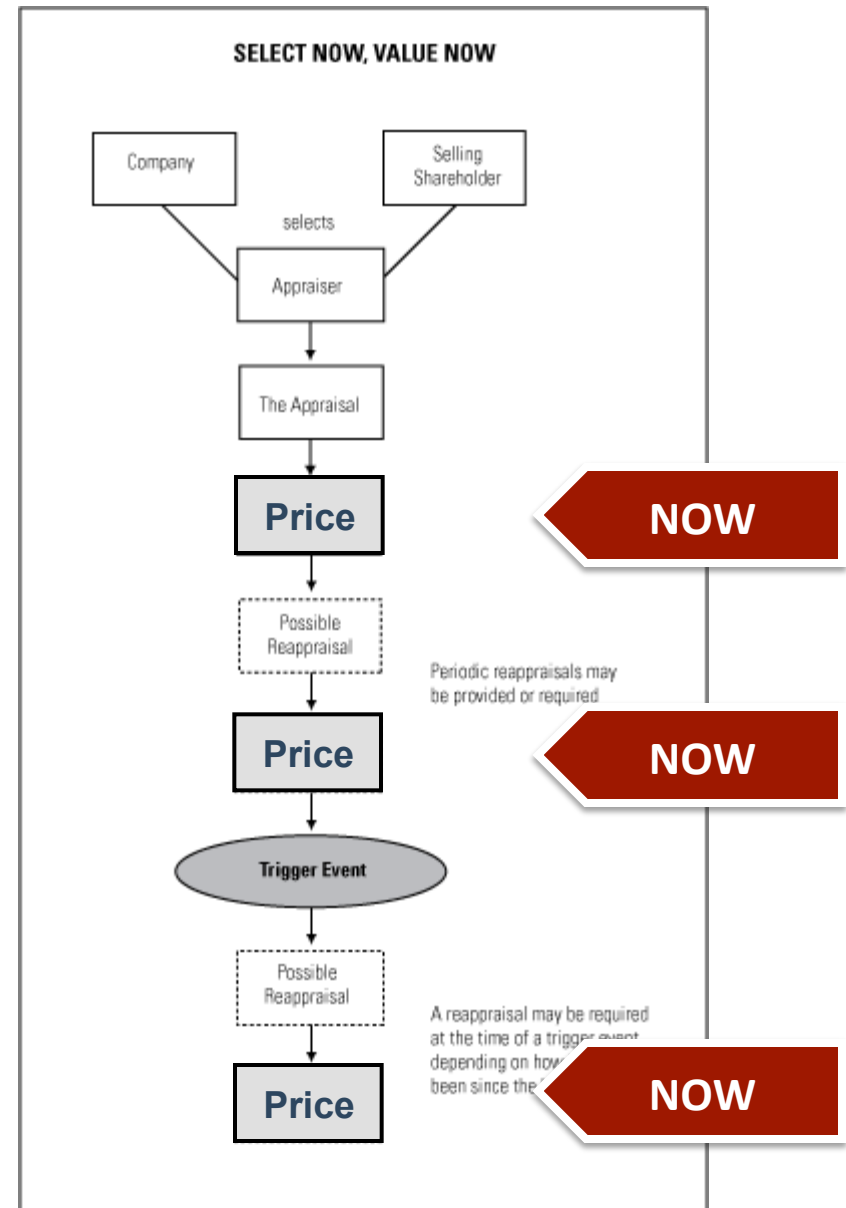
VALUE EACH YEAR (OR TWO) THEREAFTER

- Ideally, the selected appraiser will provide annual revaluations for buy-sell agreement purposes.

RECOMMENDATION

Single Appraiser Agreement

Select Now, Value Now



Single Appraiser, Select Now and Value Now

ADVANTAGES

- Selected appraiser viewed as independent
- Appraiser's valuation process is seen by all parties at the outset
- Appraiser's conclusion is known at outset and has established a baseline price for the agreement
- Because process is observed at the outset, all parties know what will happen when trigger event occurs
- Because the appraiser must interpret the "words on the pages" in conducting the initial appraisal, any issues regarding lack of clarity of valuation-defining terms will be resolved
- Selected appraiser must maintain independence with respect to process and render future valuations consistent with terms of agreement and with prior reports

Single Appraiser, Select Now and Value Now

ADVANTAGES (CONTINUED)

- Subsequent appraisals, either annually or at trigger events, should be less time-consuming and expensive than other alternatives
- Parties should gain confidence in the process
- Parties will always know the current value for the buy-sell agreement (helpful for planning all-around)
- Appraisers' knowledge of the company and its industry will grow over time, enhancing confidence for all parties with the process
- Creates a means of maintaining pricing for other transactions, thereby enhancing "the market" for a company's shares

Multiple Appraiser vs. Single Appraiser, Select Now and Value Now

DISADVANTAGES		MULTIPLE APPRAISER	SINGLE APPRAISER Select Now and Value Now
1.	Price not determined now	x	
2.	Potential for dissatisfaction with the process for all parties	x	Minimized
3.	Danger of advocacy	x	Minimized
4.	Uncertainty over what will happen when a trigger event occurs	x	Minimized
5.	Uncertainty over final price if the process is invoked	x	Minimized
6.	Problems or issues with definition of value, qualifications of appraisers, or any other aspects of the operation of the agreements are deferred until a trigger event – when the interests of the parties are adverse	x	Minimized
7.	Expensive	x	
8.	Time-consuming	x	
9.	Distracting for management	x	
10.	Potentially devastating for affected shareholders and their families	x	

Do You Know What Your Client's Buy-Sell Agreement Says?



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Do You Know What Your Client's Buy-Sell Agreement Says?

- From a business perspective?

- » Departure
- » Discharge
- » Death
- » Divorce
- » Disability
- » Default
- » Disqualification
- » Disaffection
- » Disagreement
- » Disclosure
- » Dispute resolution
- » Dilution
- » Dividends
- » Distributions
- » Drag-along rights
- » Double entities
- » Differential pricing
- » "Don't compete" agreements
- » Donate
- » Distributions after a trigger event

- From a valuation perspective?

The Six Defining Elements of Process Buy-Sell Agreements

Standard of Value

Level of Value

The “As Of” Date

Qualifications of Appraisers

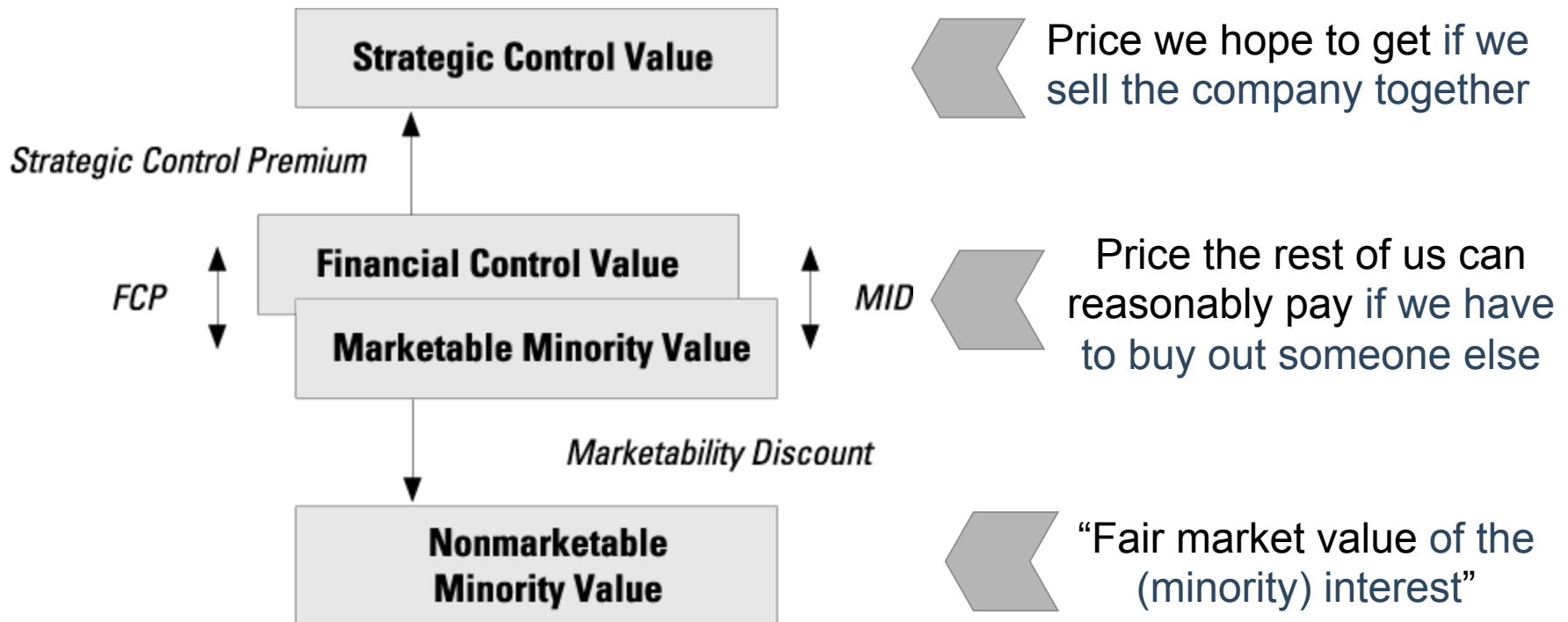
Appraisal Standards

Funding Mechanism

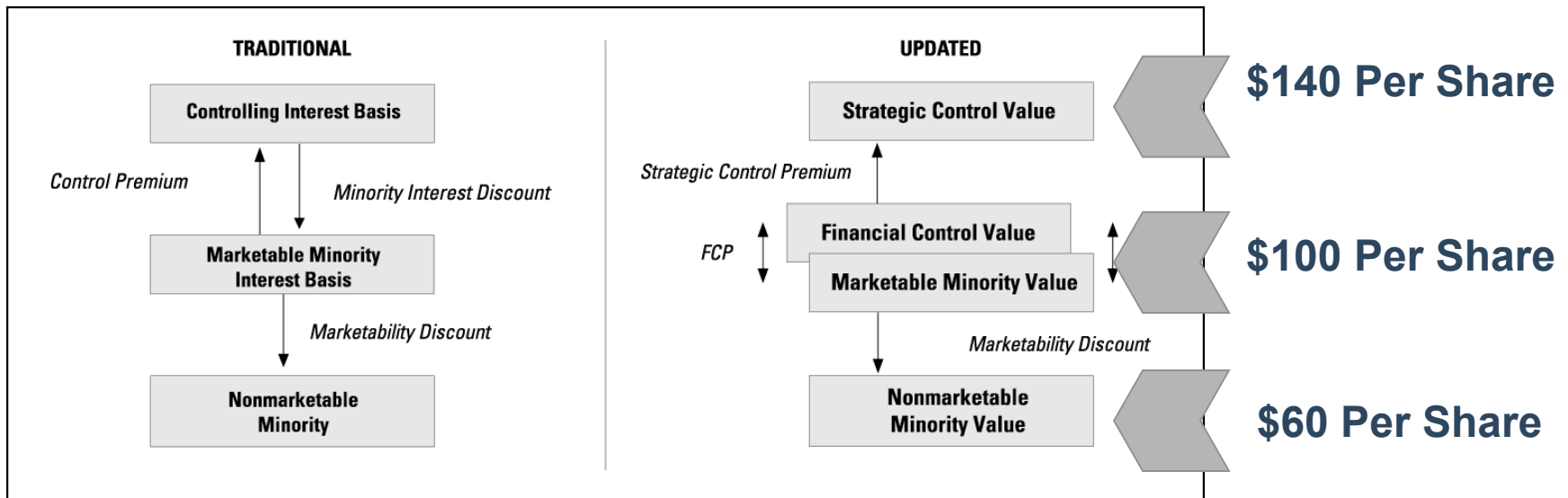
Defining Element #1: Standard of Value

- Normally fair market value
 - Willing buyer, willing seller....but buyers of what?
- Fair value
 - Defined under state law
 - A defined term, of sorts, under accounting rules
- Investment value
 - From the perspective of whom?
- “The Value,” “Going Concern Value,” and on and on and on...

Defining Element #2: Level of Value



Defining Element #2: Level of Value



Differences in Premiums and Discounts



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Defining Element #3: The “As Of” Date

- There is no such thing as “The Value”
 - Value is “as of” a specific point in time
 - Is based on information known or reasonably knowable
- The “as of” date can make a difference
 - Date of marriage
 - Date of separation
 - Date of trial/divorce

Defining Element #4: Qualifications of Appraisers

INDIVIDUAL

- Education
- Valuation training
- Appraisal experience
- Industry experience
- Continuing education
- Publishing
- Credentials

FIRM

- Size
- Longevity
- Specialization

Defining Element #5: Appraisal Standards

- Uniform Standards of Professional Appraisal Practice (USPAP)
- ASA Business Valuation Standards
 - Principles of Appraisal Practice and Code of Ethics
- AICPA Statement on Standards for Valuation Services (SSVS) No. 1
- Institute of Business Appraisers Business Valuation Standards and Rules of Professional Conduct
- NACVA Professional Standards
- CFA Institute Code of Ethics & Standards of Professional Conduct

What If Your Appraiser Has No Standards?



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Partial Example Write-Up – Agreement

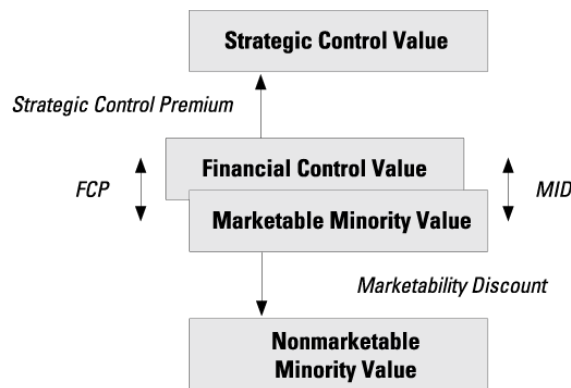
Page 3

A. Purchase Price. a) The purchase price paid will be the deceased Shareholder's proportionate ownership interest in the Corporation multiplied by the Corporation's **b) Fair Market Value**, as defined in Treasury Regulation §20.2031-1(b) of such shares of stock **c) as of the Shareholder's date of death.** The Fair Market Value shall be **d) determined by an independent appraiser e) with the cost of the appraisal being paid by the Corporation.** **f) In the event the deceased Shareholder's personal representative and the Corporation are unable to agree as to such appraiser, g) such deceased Shareholder's personal representative and the Corporation shall each select an appraiser, h) which appraisers shall agree upon a third independent appraiser, i) who shall then proceed to determine the Fair Market Value of such shares of stock. j) The value so determined shall be final and binding on the parties.**

Partial Example Write-Up – Analysis

Pages 3-4

- a) **Level of Value.** This provision is good in that it attempts to direct that the selected independent appraiser is to determine the Fair Market Value of the Corporation and that the purchase price will be the “proportionate ownership interest.” If that is the intent, then it should be specified that the value to be determined is a value at the **financial control level of value** (see accompanying Levels of Value chart from Chapter 14).



Some appraisers are so ingrained to develop nonmarketable minority values for minority interests that they might interpret “proportionate interest” to be the proportionate share of a nonmarketable minority level value (after perhaps applying minority interest and/or marketability discounts). And since the independent appraiser’s conclusion will be binding on all parties (j), this would be unfortunate.

Partial Example Write-Up - Agreement

A. Purchase Price. **a)** The purchase price paid will be the deceased Shareholder's proportionate ownership interest in the Corporation multiplied by the Corporation's **b) Fair Market Value, as defined in Treasury Regulation §20.2031-1(b) of such shares of stock** **c)** as of the Shareholder's date of death. The Fair Market Value shall be **d)** determined by an independent appraiser **e)** with the cost of the appraisal being paid by the Corporation. **f)** In the event the deceased Shareholder's personal representative and the Corporation are unable to agree as to such appraiser, **g)** such deceased Shareholder's personal representative and the Corporation shall each select an appraiser, **h)** which appraisers shall agree upon a third independent appraiser, **i)** who shall then proceed to determine the Fair Market Value of such shares of stock. **j)** The value so determined shall be final and binding on the parties.

Partial Example Write-Up – Analysis

Pages 4-5

- b) **Standard of Value.** The agreement specifies that Fair Market Value is the required standard of value and further provides a citation to the definition of Fair Market Value as Treasury Regulation §20.2031-1(b), which is quoted in the Partial Example Write-Up (with emphasis added)

Three reasons why reference to Section 2031-1(b) is not ideal

1. The definition relates to the “valuation of property in general,” and not to the valuation of business interests
2. The definition refers to other sections of the regulations for further discussion of the valuation of interests in businesses, which can cause confusion
3. The discussion relates to “an item of property,” which could be misinterpreted as the block of stock itself rather than the proportionate share of the value of the enterprise, as indicated in the paragraph

Partial Example Write-Up – Analysis

Pages 4-5

Reference to the *ASA Business Valuation Standards* [or your standards] could be preferable [or to other standards, as appropriate for the reviewing appraiser. This would also tend to ground the valuation in the context of relevant valuation standards

Alternatively, the definition from *Revenue Ruling 59-60* could be used

Either of the definitions from the *ASA Business Valuation Standards* or Revenue Ruling 59-60 is preferable to the reference to Section 2031-1(b) because of their focus on businesses and business interests

Partial Example Write-Up - Agreement

A. Purchase Price. **a)** The purchase price paid will be the deceased Shareholder's proportionate ownership interest in the Corporation multiplied by the Corporation's
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Partial Example Write-Up – Analysis

Page 6

c) **Valuation date**

The valuation date is specified as the date of death

That is crystal clear in the agreement

Without further guidance, this will leave the selection of financial statements to provide the basis for the appraisal up to the appraiser

Not necessarily bad, but if the Corporation prepares quarterly financial statements, for example, it might be good to instruct the appraiser to consider the most current financial statements available at the valuation date

Partial Example Write-Up - Agreement

A. Purchase Price. **a)** The purchase price paid will be the deceased Shareholder's proportionate ownership interest in the Corporation multiplied by the Corporation's
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Partial Example Write-Up – Analysis

Page 6

- d) **Qualifications of the appraiser/Standards to be followed.** The Agreement calls for the parties to attempt to agree upon an “independent appraiser,” a term not defined in the agreement. Unfortunately, that tent is so open it doesn’t have doors. Absent specific criteria describing qualifications (experience, credentials, size of firm, etc.), any accountant, business broker or college professor could qualify.

It is an excellent idea to provide a list of valuation credentials as minimum qualifications for the selection of an appraiser. I always recommend the ASA designations of the American Society of Appraisers. Members of the ASA are required to provide appraisals in accordance with the *ASA Business Valuation Standards* and the *Uniform Standards of Professional Appraisal Practice* (USPAP). This is important, because you definitely want your appraiser to provide a standards-compliant appraisal. [If you follow other standards, you obviously want to cite those standards in your write-ups of reviews of buy-sell agreements]

The Six Defining Elements of Process Buy-Sell Agreements

Standard of Value

Level of Value

The “As Of” Date

Qualifications of Appraisers

Appraisal Standards

Funding Mechanism

How is Your Client's Buy-Sell Agreement Funded?



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How Is Your Client's Buy-Sell Agreement Funded?

- The company will issue a promissory note...

BUYER-SELLER TENSIONS

	Buyer (Company)	Seller (Shareholder)
Price	Low	High
Terms	Lenient <i>Long Term</i> <i>Deferred Payments</i> <i>Low Interest Rate</i> <i>No Security</i>	Cash Now <i>Short Term</i> <i>Rapid Payments</i> <i>High Interest Rate</i> <i>Full Security</i>

Potential Funding Sources

- Life insurance
- Cash
 - Life insurance
 - Corporate assets
 - External borrowings
 - “Sinking fund”
- Selling shareholder notes
- Combination of cash and shareholder notes
- See “Basic Considerations Per Shareholder Notes” handout

Funding the Buy-Sell Agreement

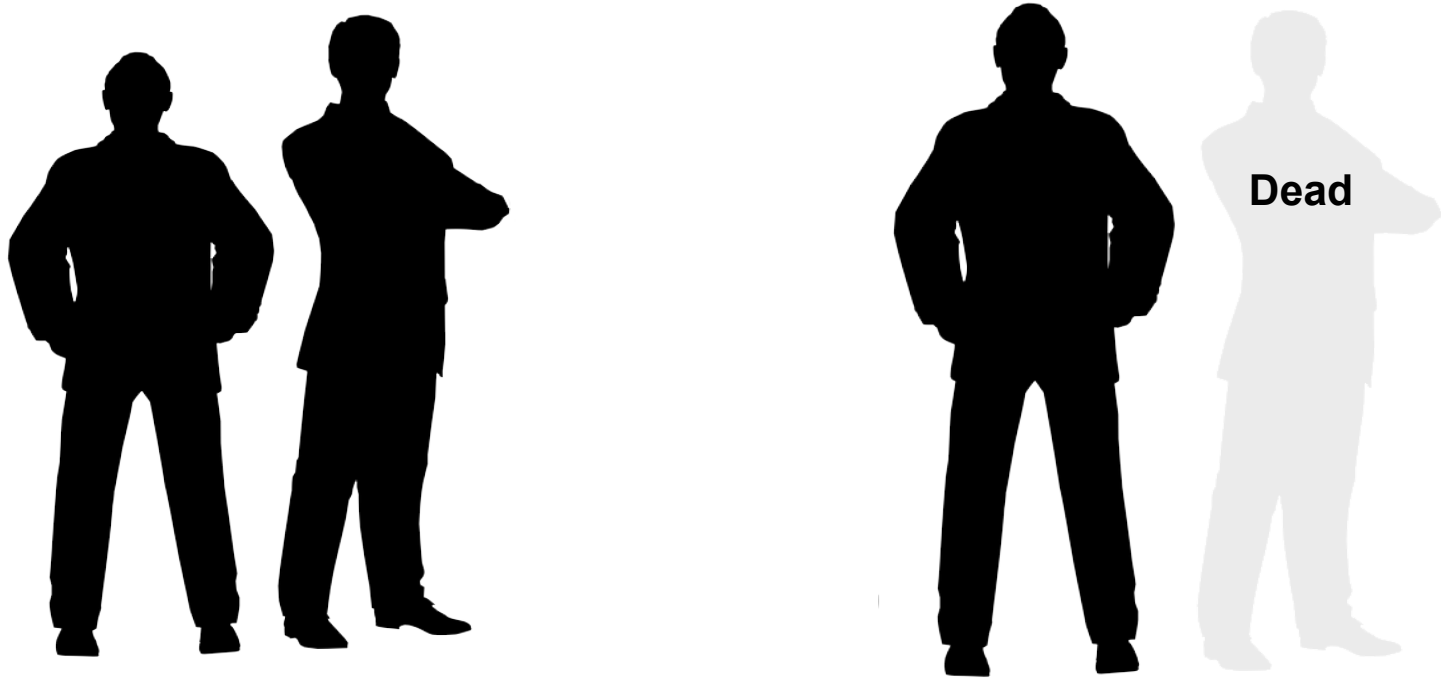
- Life insurance typically purchased by company for corporate buy-sell agreements
- Key question: Is life insurance intended as a:

Funding Vehicle

or

Corporate Asset

True Story: Life Insurance



What Happens Now?

What about Life Insurance Treatment for Valuation Purposes?

	Company	Harry (Estate)	Sam
Proceeds are a Funding Vehicle			
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre and Post Life Insurance Value (\$m)	\$10,000.0	\$5,000.0	\$5,000.0
4 Life Insurance Proceeds	\$6,000.0		
5 Repurchase Liability	(\$5,000.0)		
6 Post-Life-Insurance Value	\$11,000.0		
7 Repurchase Stock	(\$5,000.0)	\$5,000.0	
8 Retire / Give Up Stock	(50.0)	(50.0)	
9 Remaining Stock	50.0	0.0	50.0
10 New Stock Ownership (%)	100.0%	0.0%	100.0%
11 Post-Life Insurance Value of Co.	\$11,000.0	\$0.0	\$11,000.0
12 Post Life Insurance Proceeds		\$5,000.0	
13 Net Change in Value from Repurchase	\$1,000.0		

What about Life Insurance Treatment for Valuation Purposes?

		Harry (Estate)	Sam
Proceeds are a Corporate Asset	Company		
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre-Life Insurance Value (\$m)	\$10,000.0	\$5,000.0	\$5,000.0
4 Life Insurance Proceeds (\$m)	\$6,000.0	\$3,000.0	\$3,000.0
5 Post-Life Insurance Value (\$m)	\$16,000.0	\$8,000.0	\$8,000.0
6 Repurchase Liability	(\$8,000.0)		
7 Post-Life-Insurance Value	\$8,000.0		
8 Repurchase Stock	(\$8,000.0)	\$8,000.0	
9 Retire / Give Up Stock	(50.0)	(50.0)	
10 Remaining Stock	50.0	0.0	50.0
11 New Stock Ownership (%)	100.0%	0.0%	100.0%
12 Post-Life Insurance Value of Co.	\$8,000.0	\$0.0	\$8,000.0
13 Post Life Insurance Proceeds		\$8,000.0	
14 Net Change in Value from Repurchase	(\$2,000.0)		

Review Types of Buy-Sell Agreements

- Fixed-price agreements
 - Update it
- Formula agreements
 - Calculate price yearly
- Process agreements

The Six Defining Elements of Process Buy-Sell Agreements

Standard of Value

Level of Value

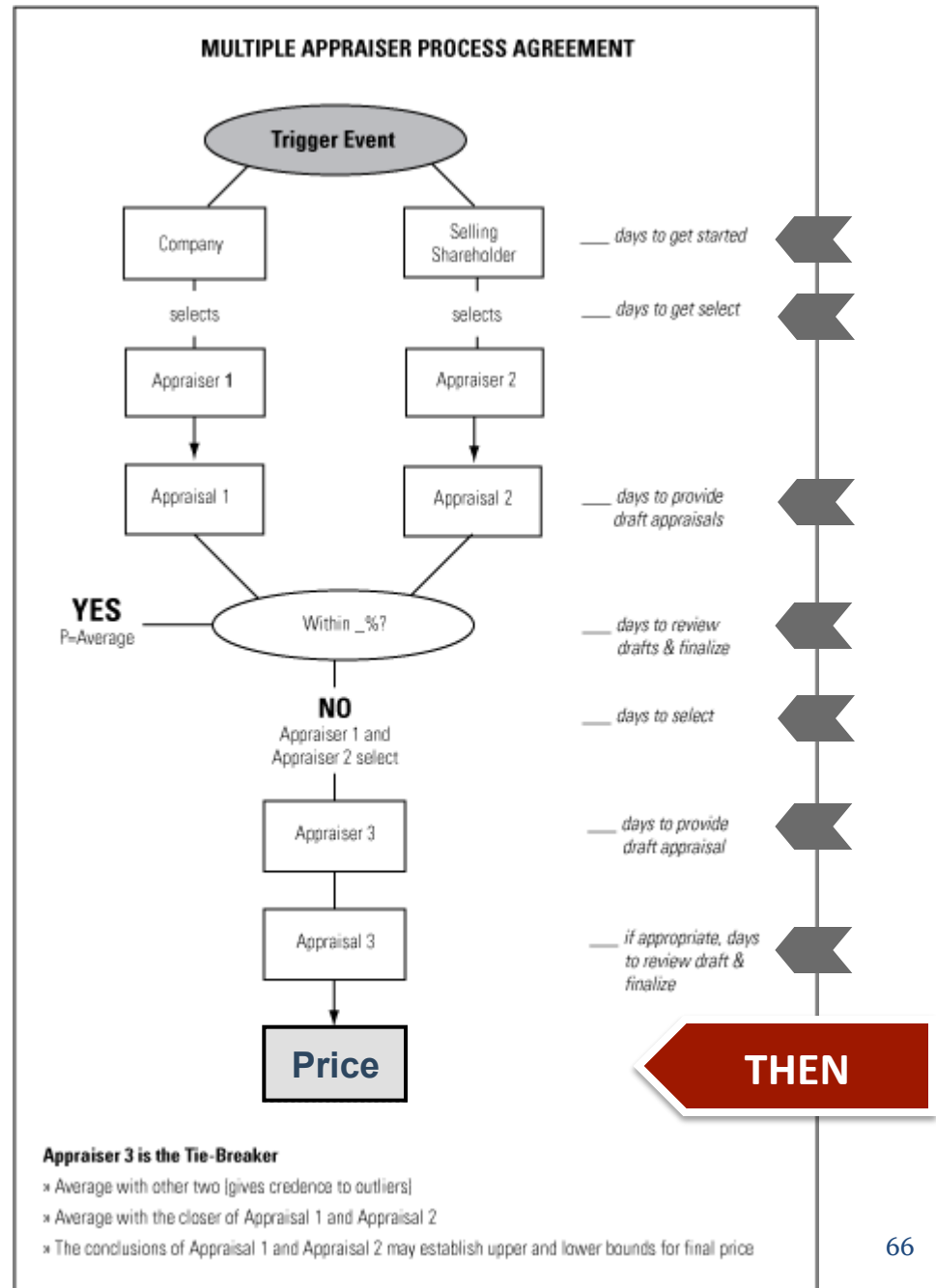
The “As Of” Date

Qualifications of Appraisers

Appraisal Standards

Funding Mechanism

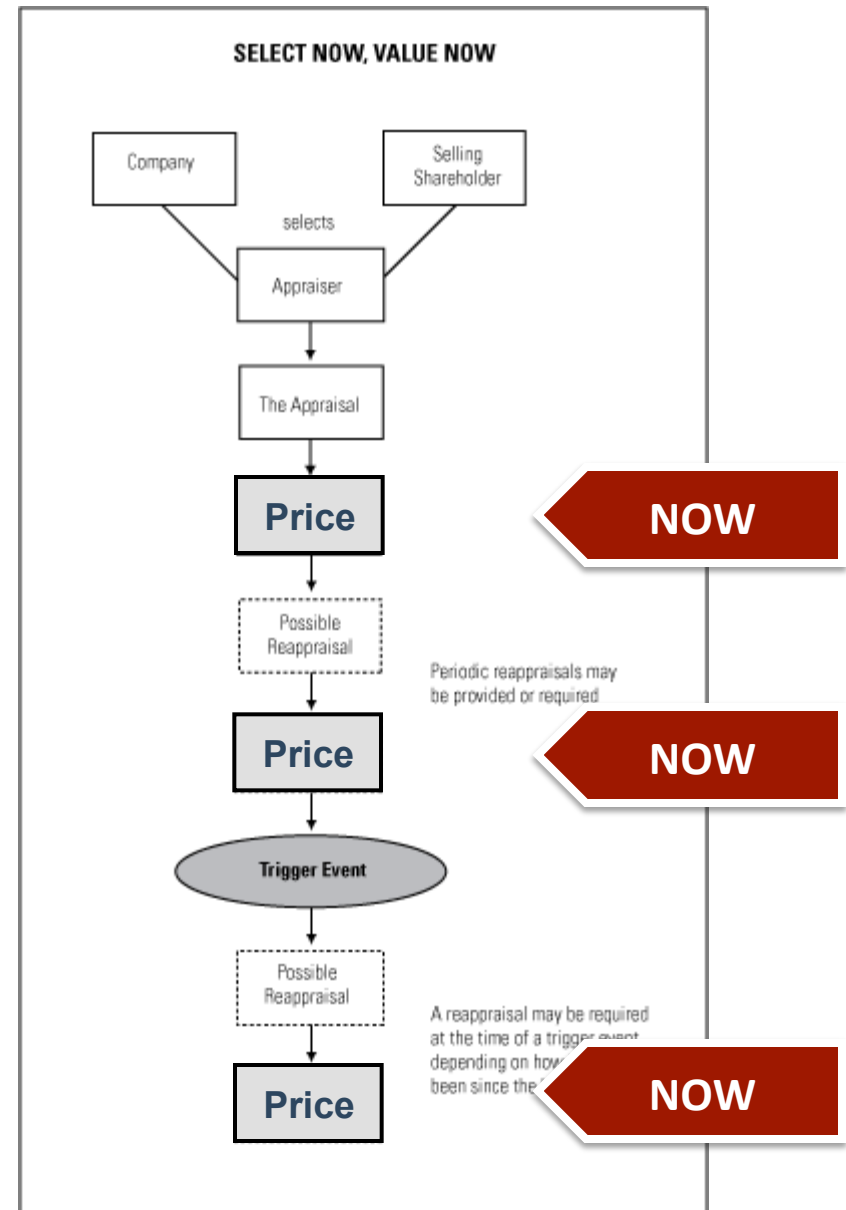
Multiple Appraiser Agreements



RECOMMENDATION

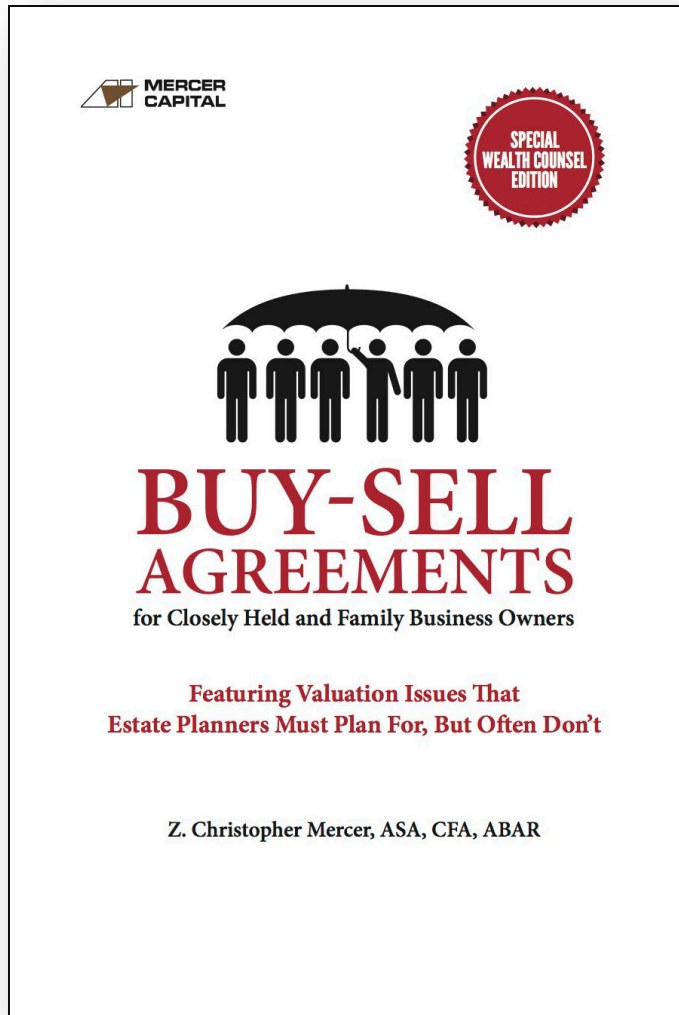
Single Appraiser Agreement

Select Now, Value Now



Review Learning Objectives

- Identify areas of concern in your or your client's buy-sell agreement
- Understand formula agreements and fixed price agreements
- Learn how to "fix" out-of-date formulas or fixed prices in your agreement
- Know the differences between single appraiser process agreements and multiple appraiser process agreements
- Understand the six defining elements that must be present in every valuation process agreement
- Identify the process by which most problems can be averted for your or your client's buy-sell agreement



Includes the Buy-Sell Agreement Review Checklist

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Questions?

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