SPECIAL ISSUE: BUY-SELL AGREEMENTS

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BUSINESS VALUATION » INVESTMENT BANKING | No. 2 | Volume 19 » 2007

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Often Overlooked Yet Important Items in Process Buy-Sell Agreements

Excerpted from Chapter 15 of the new book, Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?

Several other issues related to valuation should appropriately be addressed in your buy-sell agreements. The following discussion is by no means exhaustive, but includes items that are helpful in minimizing problems or uncertainties with the operation of process buy-sell agreements. While some of these items may seem obvious when identified, they are quite often overlooked or are unclear in buy-sell agreements.

Financial Statements. It is enormously helpful to specify the financial statements to be used by the appraiser(s). In the absence of specification, the parties must agree on the financial statements to be used, or else the appraiser(s) must decide. Significant differences in valuation conclusions can result from the selection of financial statements of different dates and quality. This confusion should be avoided.

Possible alternatives for specifying financial statements include:

1. *Most Recent Audit, or the audited financial statements for the most recent fiscal year relative to the valuation date.* Note that there is room for confusion here. Assume that the fiscal year is the calendar year. Suppose that the trigger date for a valuation process is January 15, 2007. The most recent audit was issued as of December 31, 2005 on April 27, 2006. If the buy-sell agreement calls for the use of the most recent audit available on the trigger date, the financial data may be more than one year old as in this example. The agreement might specify that if a trigger event occurs between the end of a fiscal year and the issuance of the audit for that year, the appraisers would rely on the audit when it becomes available. That audit would then be used for the rest of the fiscal year.

   In the alternative, if the trigger date was December 15, 2006, the most recent audit would be the 2005 audit issued in April 2006, but internal financial statements for the full year 2006 would be available within weeks, and the audit for 2006 would be available in three or four months, perhaps within the timeframe that appraisals would be prepared.

   Suffice it to say that disagreements over which audit (i.e., which fiscal year) to use as the base for financial analysis could cause material differences in the concluded results. Note that the confusion could result whether the buy-sell agreement required the use of either the most recent audit or the most recent fiscal year statements.

2. *Trailing 12-Months at the Most Recent Quarter-End (Month-End) to the Trigger Date.* In the absence of specific guidance, many appraisers, if not most, would utilize financial statements for the most recent twelve months as of the quarter-end (or

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Many buy-sell agreements provide for unrealistic timetables, and therefore, begin with process problems from the outset.

month-end) immediately prior to the trigger date. Use of the trailing 12 months would automatically include the most recent fiscal year (and audit, if available), and would also include any routine year-end adjustments for that year-end.

We generally recommend the use of the trailing 12-month financial statements for the most recent quarter-end preceding the valuation date (or month end, depending on the completeness and quality of the monthly financial statements).

Process Timetables. Many buy-sell agreements provide for unrealistic timetables, and therefore, begin with process problems from the outset. The typical buy-sell process contains a number of phases where time is required:

1. *Time to Get Process Started*. It takes time to kick off a valuation process. If the trigger event is the death of a shareholder, no one will be focused on the buy sell agreement until the passage of a reasonable time. On the other hand, if the trigger event is a retirement or termination, the parties may be ready to initiate the buy sell agreement process immediately.

2. *Time to Select Appraiser(s).*

   a. Most process agreements call for the parties to retain an appraiser. If a company or a shareholder is beginning from scratch to select an appraiser(s), it can easily take 30 to 60 days or more to identify firms, review qualifications, interview appraisers, and select an appraiser(s).

      i. Some agreements allow only 30 days for this process, which may be unrealistic for one party or the other.

      ii. Some agreements are silent regarding the selection process, thereby providing no pressure for the appraisal process to get started (or concluded).

   b. Many process agreements call for two appraisals at the outset. If they are within a designated percentage of each other, no further appraisals are required. If not, however, the two initial appraisers must agree on a third appraiser. This process takes time - often considerable time. Some agreements provide timetables for this process and others do not. In some agreements, the sole role of the first two appraisers is to select the third appraiser. The same time issues relate to this selection. Allow at least 30 to 60 days for this process. (The obvious way to avoid this time lag in getting appraisals started is to select the appraiser at the initiation of the buy-sell agreement using one of the single appraiser processes previously discussed.)

3. *Time to Prepare Appraisal(s).*

   a. Once selected, the appraiser(s) must prepare their appraisal(s). Experience has taught that the appraisal process normally takes from 60 to 90 days. Mercer Capital engagement letters typically state that we will use our best efforts to provide a draft valuation report for review within 30 days of an on-site visit with management. We hit that target the great majority of the time, and most often miss it because of client-related issues. Note that the entire process would still take 60 days or more, depending on how quickly the client responds to the information request, schedules the visit, and how long the client takes to review the draft. It takes many companies 30 to 60 days to provide the basic information that we require prior to the on-site visit because the activities of running their businesses preclude prompt action.

   b. If a third appraiser is retained, this appraiser will require time for his or her process. If this is the only appraisal being provided, the process normally takes from 60 to 90 days. If there have been two appraisals already, the third appraiser may be helped by the fact that the company has already developed most of the information that will be required. On the other hand, being the third appraiser can be a fairly dicey situation. In addition to preparing one's own appraisal as the third appraiser, it is also necessary to review the appraisals of the other two firms. Allow at least 30 to as many as 90 days or more for this process.

4. *Time to Review Draft Appraisals*. The procedures of many appraisal firms call for the preparation

of draft reports to be reviewed by management, and in the case of some buy-sell agreements, by all sides. This review process will generally take from 15 to 30 days or more, particularly in contentious situations.

5. *Time to Arrange Financing or to Close*. Once the appraisal process has been concluded, it normally takes some time to bring the process to closure. The company may be allowed 30 days, or some amount of time to close the transaction.

We can summarize the process timelines to get a picture of how the various types of process agreements might look in operation. You may be surprised at how the various processes actually lay out, regardless of what the written timetables suggest.

The existence of defined timetables in agreements serves to keep the parties focused on the timeline; however, they are seldom binding.

FIGURE 1: BUY-SELL AGREEMENT TIMELINES

Process Activities (in days)	Multiple Appraisers		Single Appraiser - Select Now, Value Now		Hybrid (Single Appraiser with Multiple Appraiser Option)	
	Low	*High*	*Low*	*High*	*Low*	*High*
Trigger Event Occurs	0	0	0	0	0	0
Time to React	1	30	1	30	1	30
Pick Appraiser(s)	30	60	0	0	0	0
Provide Appraisal(s)	60	90	30	60	30	60
Review Appraisal(s)	15	30	15	30	15	30
Earliest Time to Resolution	**106**	**210**	**46**	**120**	**46**	**120**
Select Other Appraiser(s)	30	60			30	60
Reviews by Appraiser(s) Prepare Additional Appraisal(s)	30	60			30	60
Review Appraisals/Reviews	15	30			15	30
Agree on Conclusions	15	30			15	30
Finalize Transaction	0	30			0	30
Additional Time for Process	**90**	**210**	**0**	**0**	**90**	**210**
Potential Time to Resolution	**196**	**420**	**46**	**120**	**136**	**330**

Figure 1 illustrates three examples, Multiple Appraiser processes, the Single Appraiser - Select Now, Value Now option, and the Single Appraiser with Multiple Appraiser Options.

» *Multiple Appraiser* processes can be accomplished in the broad range of 100 to 200 days or so if the initial process involving two appraisers is conclusive. If it is necessary to select and retain a third appraiser, it is likely that considerable additional time will pass before resolution occurs. It is not surprising for a multiple appraiser process involving three appraisers to take six months to a year or more to complete.

» *The Single Appraiser – Select Now, Value Now* option is potentially the most rapid option for process buy-sell agreements. If a trigger event occurs after the initial appraisal, the valuation process will be known by all parties, and the appraiser will be familiar with the company. This option should be able to be accomplished within six weeks or so, on the short end, and four months on the longer end.

» *The Hybrid or Single Appraiser with Multiple Appraiser Options* can take as long as the typical multiple appraiser option; however, the probability of it being accomplished in much shorter time is significant. If the parties agree on the concluded value of the "third appraiser," this option is akin to the Single Appraiser - Select Now, Value Now option and can be accomplished accordingly.

Note that the estimates here assume that there is no litigation and that the parties are generally cooperating to move the process along.

The bottom line is that it is good to agree on realistic timelines in your buy-sell agreements. It is then easier to ask the various appraisers and other parties to stick to them. The operation of process buy-sell agreements can take a long time. This means that the process may be a considerable distraction to management, particularly when significant transactions are involved. It should be obvious, but the prolonged operation of a buy-sell agreement can not only be distracting, but frustrating and confusing to the family of a deceased shareholder, or to a terminated employee.

The bottom line is that it is good to agree on realistic timelines in your buy-sell agreements. It is then easier to ask the various appraisers and other parties to stick to them.

Buy-Sell Agreements: War Stories

Buy-Sell Agreements are not just legal contracts - they can have very personal implications. Here are a few examples, submitted by readers of the book.

There were six owners of an S Corporation that had a three-page buy-sell agreement. Yes, three pages.

Lack of Details Leads to Problems

There were six owners of an S Corporation that had a three-page buy-sell agreement. Yes, three pages. The buy-sell agreement did not say much except how to calculate the value, which was based on an industry rule of thumb. It was set as a cross purchase agreement, which was surprisingly funded with life insurance for $2,000,000.

The president of the company died in 2005. The insurance company sent checks to the five individuals designated in the cross purchase agreement. The five individuals took the position that the insurance proceeds belonged to them and refused to "individually" buy out the president's interest. A lawsuit was filed and the insurance proceeds went to the registry of the Court. The surviving spouse had to move in with her children because she had no source of income.

I was engaged to value the company for estate tax purposes. The value based on the three-page, rule of thumb method was approximately $7 per share. We calculated the value using a DCF at approximately $11 per share.

The Company agreed to my value but never got a copy of my report. The surviving spouse engaged me and she refused to provide the Company with a copy. The Company contacted me directly to obtain a copy, and obviously, I did not give them a copy.

The solution I have recommended to the Company is that they have the insurance proceeds go into a Trust. Upon a triggering event, the Trust would automatically fund 50% of the pro rated ownership interest based on the most current "qualified appraisal." The balance would be due upon completion of a business valuation. Also, the Company will pay for the valuation and, therefore, know how the value was calculated.

Napkin No Substitute for Comprehensive Agreement

I have been a business consultant and wealth planner for over 20 years, primarily for privately held businesses. At the beginning of every engagement we conduct a "Needs Audit" to assess what has been done, what needs to be done, and clarify the business success objectives of the owners.

In the beginning conversation with a new client, as we went through our checklist of planning issues, the CFO indicated that the company had a current buy-sell agreement. When we asked to review a copy of it, he provided a single page document that had several paragraphs. You can imagine the unresolved issues. I was amazed at this since the approximate value of the business was $26 million with a very complex ownership structure of five separate families and three family limited partnerships.

As we dug deeper, the CFO finally confessed that he had tried for months to get the partners to agree on issues relative to a buy-sell agreement. Being unsuccessful, he finally wrote out the agreement on a napkin one day while having lunch with several of the partners, had it typed up and demanded everyone sign it, which they did. The partners justified their inaction by claiming that they did not want a complicated document that no one could understand.

We have since helped them implement a comprehensive buy-sell agreement using your book, *Buy -Sell Agreements* as a guide to evaluating client buy-sell agreements.

Fixed-Price Folly

A friend told me the true story of his family's experience with a buy-sell agreement. His father was an initial, minority shareholder and employee of a business during the early 1960s. At the outset of the enterprise, the shareholders implemented a buy-sell agreement with a fixed price. The father's shares were valued at his investment value of $250 thousand.

Fast forward to 1974. The business grew and was successful. My friend, who is quite knowledgeable about business valuation, said that his father's interest would have been worth more than $1 million by 1974 – the year his father died.

Neither the corporation nor the other shareholders offered to update the price in the buy-sell agreement to purchase the shares from the father's estate, so the shares were purchased for $250 thousand. My friend noted that receiving $250 thousand in 1974, and not $1 million, made a significant difference in his mother's independence for the remaining 25 years of her life. In addition, it caused a great deal of bitterness towards his father's former partners.

My friend's father probably did not think in terms of making a bet on his company's buy-sell agreement, but the fact that it was not updated did indeed create a betting situation. He bet and, we don't mean this in any personal way, his family lost.

Send us your war story and receive a complimentary copy of the **Buy-Sell Audit Checklist.** Please change all the names to protect the innocent and guilty, and send your favorite war story to us at mcm@mercercapital.com.

Mercer Capital Highlights

UPCOMING SPEECHES

September 8-9
"A Theoretical & Practical Review of the DCF Method"
CICBV Annual Conference
Montreal, Canada
Travis W. Harms, CFA, CPA/ABV

September 17, 2007
"The One Percent Solution"
Partners Financial Private Business Group Conference
Chicago, Illinois
Z. Christopher Mercer, ASA, CFA

September 18-19, 2007
"The Cash Flow IQ"
CFA Conference
Dallas, Texas and Houston, Texas
Z. Christopher Mercer, ASA, CFA and
Travis W. Harms, CFA, CPA/ABV

September 25, 2007
"Buy-Sell Agreements" and "The QMDM"
NACVA Illinois State Chapter Meeting
Chicago, Illinois
Brent A. McDade, CBA, BVAL

MERCER CAPITAL IN THE NEWS

Mercer Capital is pleased to welcome **Samad Samana** to our professional staff as a Financial Analyst.

Mercer Capital is proud to announce that **Kristin C. Beckman** has been promoted to the position of Senior Financial Analyst.

Z. Christopher Mercer, ASA, CFA, authored an article that appeared in the April 27-May 3, 2007 edition of the *Memphis Business Journal*, entitled "Buy-Sell Agreements Can Create Pitfalls If Not Managed Properly."

Jay D. Wilson, Jr., Senior Financial Analyst, was quoted in the February 23 – March 1, 2007 edition of the *Memphis Business Journal* in an article entitled "Increased Competition Takes a Bite Out of Earnings at Mid-South Community Banks."

He finally wrote out the agreement on a napkin one day while having lunch with several of the partners, had it typed up and demanded everyone sign it, which they did.

To summarize *Buy-Sell Agreements* in one word, that word would be "methodical." Mercer focuses like a laser beam on virtually all of the possible permutations of the pricing and valuation provisions of buy-sell agreements, together with the advantages and disadvantages of each.

A Review of Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?

This is a review of the newly written book by Chris Mercer, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* (Peabody Publishing, Memphis 2007), available through Mercer Capital at www.mercercapital.com or 901.685.2120.

The book offers a fresh look at buy-sell agreements through the lens of the business appraiser, who too often enters the picture after, as the book states, "the ox is in the ditch." *Buy-Sell Agreements* discusses in-depth the pricing and valuation provisions of buy-sell agreements, arguably the only important provisions, especially once a triggering event has occurred. However, this book also is written from the viewpoint of someone who has signed buy-sell agreements and who has had significant experience in dealing with signed buy-sell agreements. Mercer's experience shines throughout the tome.

To summarize *Buy-Sell Agreements* in one word, that word would be "methodical." Mercer focuses like a laser beam on virtually all of the possible permutations of the pricing and valuation provisions of buy-sell agreements, together with the advantages and disadvantages of each. Too many of the buy-sell agreements that I see have valuation methods that have far more disadvantages than advantages.

If you are looking for a book that has forms or that discusses the tax consequences of buy-sell agreements, this is not it. However, if you are looking for a book that has a comprehensive discussion of the pricing and valuation aspects of buy-sell agreements (which I've really not ever seen before), this is it.

Buy-Sell Agreements offers chapters with the following titles:

1. How buy-sell agreements come into existence
2. What are buy-sell agreements designed to accomplish?
3. Business considerations with buy-sell agreements
4. Categories of buy-sell agreements
5. Types of buy-sell agreements
6. Fixed price buy-sell agreements
7. Formula buy-sell agreements
8. Shotgun agreements
9. Rights of first refusal
10. Introduction to process buy-sell agreements
11. Process buy-sell agreements
12. Multiple appraiser agreements
13. Single appraiser agreements
14. A hybrid agreement
15. Items of importance in process buy-sell agreements
16. Defining element no. 1: the standard of value
17. Defining element no. 2: the level of value
18. Defining element no. 3: the "as-of" date
19. Defining element no. 4: appraiser qualifications
20. Defining element no. 5: appraisal standards
21. Defining element no. 6: funding mechanisms
22. War stories
23. Buy-sell audits & buy-sell checklist
24. The one-percent solution

Buy-Sell Agreements is peppered throughout with charts comparing and summarizing its discussion of the advantages and disadvantages of each form of valuation/appraiser provision of buy-sell agreements, as well as action steps. However, *Buy-Sell Agreements* offers a comprehensive buy-sell audit checklist that alone makes it worthy of purchase, serious use and study.

Perhaps not too surprisingly when coming from a business appraiser, *Buy-Sell Agreements* makes a case for beginning a buy-sell agreement with a valuation and for regular valuations, in a manner similar to ESOP's. Nevertheless, Mercer makes a very strong case for his position, which he backs up with reflections, actual situations (no case citations though), stating the advantages and disadvantages of the type of buy-sell agreement and probing questions.

Buy-Sell Agreements informs estate planners that there are six defining elements of valuation of a subject company in a buy-sell agreement: the standard of value (e.g., "fair market value"), the level of value (e.g., marketable minority), the "as-of" date, the qualifications of appraisers, the appraisal standards and funding mechanisms. Very few of the buy-sell agreements that I review contain all of these elements.

At $79, *Buy-Sell Agreements* is a no-brainer addition to the library of every one who works with or who drafts buy-sell agreements. It very neatly compliments books on buy-sell agreements such as Howard Zaritsky's seminal book on the subject that is available through RIA (800-950-1216) as well as Lou Mezzullo's book on buy-sell agreements for estate planners that is available through the ABA (800-285-2221).

Review written by L. Paul Hood, Esq. Published in Steve Leimberg's Business Entities Newsletter, Issue 119, February 13, 2007. Courtesy: Leimberg Information Services, Inc. (LISI) at www.leimbergservices.com.

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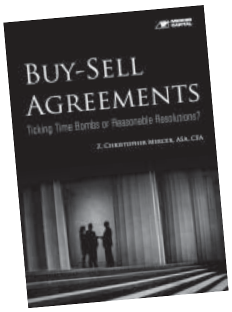
BUY-SELL AGREEMENTS

TICKING TIME BOMBS OR REASONABLE RESOLUTIONS?

"...is terrific - sophisticated, refreshingly thoughtful and the first really new ideas (to me, anyway) in this area I've heard or seen in a long time."

Putnam C. Smith, J.D., LLM, Partner, Lipscomb, Johnson, Sleister, Dailey & Smith, LLP, Cumming, Georgia



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Written for business owners, attorneys, CPAs, business appraisers, and other professional advisors to business, this book provides a roadmap for you (or your clients) to develop or improve your buy-sell agreement. The first book written from a valuation perspective which is important to note because business appraisers are usually consulted when there is a problem. Learn from our 25 years of experience working with well-constructed and terribly constructed buy-sell agreements (in almost every case no one realized there were problems until a trigger event occurred)!

HIGHLIGHT SECTIONS/CHAPTERS INCLUDE:

» **Categories & Types of Buy-Sell Agreements**
» **Process & Single Appraiser Buy-Sell Agreements**
» **Process Timetables -** *Why it takes more time than you think*
» **The Six Defining Elements of Buy-Sell Agreements -** *Process agreements must have all six but most do not!*
» **War Stories** from our experience
» **The Buy-Sell Audit Checklist** - *This alone is worth the price of the book*
» In addition, the **ASA BV Standards and USPAP Standards 3, 9 & 10** are reprinted in full for your convenience

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