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Life Insurance Proceeds in Valuation for Buy-Sell Agreements

Many buy-sell agreements are funded, in whole or in part, by life insurance on the lives of individual shareholders, who may be key managers, as well. Life insurance is a tidy solution for funding when it is available and affordable. It is important, however, to think through the implications of life insurance from a valuation perspective whether you are a valuation expert, a business owner or both.

The proceeds of a life insurance policy owned by a company naturally flow to the company. Should life insurance proceeds resulting from the death of a shareholder be considered as a corporate asset solely for the purposes of funding the repurchase liability created by a buy-sell agreement? Alternatively, should the life insurance proceeds could be considered as a separate corporate asset, i.e., as a non-operating asset, to be included in the calculation of value for the deceased shareholder's shares?

This decision as to the treatment for any particular buy-sell agreement is one that warrants discussion and agreement. Absent specific instructions in a buy-sell agreement, appraiser(s) may have to decide how life insurance proceeds are to be considered in their determination(s) of value. What they decide will almost certainly disappoint at least one side and may surprise both.

Two potential treatments of life insurance proceeds are noted above. Let's consider them specifically, and then look at examples of their treatment and the differing impacts that the treatments have on all parties to a buy-sell agreement, including the selling shareholder, the remaining shareholder(s), and the company.

» *Treatment 1 – Proceeds are a Funding Vehicle.*

This first treatment would not consider the life insurance proceeds as a separate, non-operating corporate asset for valuation purposes. This treatment would recognize that life insurance was purchased on the lives of shareholders for the specific purpose of funding the liability created by the operation of a buy-sell agreement. Under this treatment, life insurance proceeds, if considered as an asset in valuation, would be offset by the company's liability to fund the purchase of shares. Logically, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back into income as a non-recurring expense.

» *Treatment 2 – Proceeds Are a Corporate Asset.*

An alternative treatment would consider the life insurance proceeds as a corporate, non-operating asset for valuation purposes. In valuation, the proceeds would then be treated as a non-operating asset of the company. This non-operating asset, together with all other net assets of the business, would be available to fund the purchase of shares of a deceased shareholder. Again, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back into income as a non-recurring expense.

Obviously, parties to an agreement could make a decision for treatment of life insurance proceeds between these two extremes, but that is beyond the scope of our example.

Continued on Page Two

AN EXAMPLE: HIGH POINT SOFTWARE

The choice of treatment of life insurance proceeds can have a significant, if not dramatic, effect on the resulting position of a company following the receipt of life insurance proceeds and the repurchase of shares of a deceased shareholder. The choice of treatment also has an impact on the resulting positions of the selling shareholder and any remaining shareholders. Consider the following example:

- » Harry and Sam own 50% interests of High Point Software, and have been partners for many years. Both are key managers in this small, but successful enterprise.
- » The buy-sell agreement states that the Company will purchase the shares of stock owned by either Harry or Sam in the event of the death of either. The agreement is silent with respect to the treatment of life insurance proceeds. The agreement calls for the Company to be appraised by Mercer Capital (wishful thinking, perhaps, but I'm writing this example).
- » The Company owns term life insurance policies on the lives of Harry and Sam in the amount of \$6 million each.
- » Assume that Harry is killed in an unfortunate accident. Assume also that the Company is worth \$10 million based on Mercer Capital's appraisal prior to consideration of the proceeds of term life insurance owned by the Company on the life of Harry, and that earnings have been normalized in the valuation to adjust for the expense of the term policies.
- » Before finalizing the appraisal, Mercer Capital carefully reviews the buy-sell agreement for direction on the treatment of life insurance proceeds. It is silent on the issue. We call a meeting of Sam and

the executor of Harry's estate to discuss the issue, because we know that the choice of treatment will make a significant difference to Harry's estate, the Company, and to Sam personally as the remaining shareholder.

We do not have to resolve this issue because it is a hypothetical situation. However, the example illustrates the importance of reaching agreement on the treatment of life insurance proceeds for valuation purposes when buy-sell agreements are signed. The valuation impact of each treatment is developed below in the context of the High Point Software example.

Treatment 1 – Proceeds Not a Corporate Asset

Table One summarizes the pre- and post-life insurance values and positions for High Point Software, Harry's estate and Sam if life insurance proceeds are not considered as a separate, non-operating corporate asset in valuation.

On Line 3, we see that High Point Software is worth \$10 million before consideration of life insurance, and both Harry and Sam have 50% of this value, or \$5 million each. Upon Harry's death, the company receives \$6 million of life insurance and recognizes the liability of \$5 million to repurchase Harry's stock. The post-life insurance value is \$11 million (Lines 4-6).

Lines 7-10 reflect the repurchase and retirement of Harry's shares. The remaining company value, after repurchasing Harry's shares for \$5 million, is \$11 million. Since Sam owns all 50 shares now outstanding, his post-transaction value is \$11 million. Harry's estate has received the \$5 million of life insurance proceeds from the sale of 50 shares for \$5 million, which is the amount he would have received had he and Sam sold the company the day before he died.

Continued on Page Four

TABLE ONE: PROCEEDS ARE A FUNDING VEHICLE

| | Harry | | |
|---|-----------|----------|----------|
| | Company | (Estate) | Sam |
| 1 Stock Ownership (Shares) | 100 | 50 | 50 |
| 2 Stock Ownership (%) | 100% | 50% | 50% |
| 3 Pre and Post Life Insurance Value (\$m) | \$10,000 | \$5,000 | \$5,000 |
| 4 Life Insurance Proceeds | \$6,000 | | |
| 5 Repurchase Liability | (\$5,000) | | |
| 6 Post-Life-Insurance Value | \$11,000 | | |
| 7 Repurchase Stock | (\$5,000) | \$5,000 | |
| 8 Retire / Give Up Stock | (50) | (50) | |
| 9 Remaining Stock | 50 | 0 | 50 |
| 10 New Stock Ownership (%) | 100% | 0% | 100% |
| 11 Post-Life Insurance Value of Co. | \$11,000 | \$0 | \$11,000 |
| 12 Post Life Insurance Proceeds | | \$5,000 | |
| 13 Net Incremental Assets | \$1,000 | | |

TABLE TWO: PROCEEDS ARE A CORPORATE ASSET

| | Harry | | |
|-------------------------------------|-------------|----------|---------|
| | Company | (Estate) | Sam |
| 1 Stock Ownership (Shares) | 100 | 50 | 50 |
| 2 Stock Ownership (%) | 100% | 50% | 50% |
| 3 Pre-Life Insurance Value (\$m) | \$10,000 | \$5,000 | \$5,000 |
| 4 Life Insurance Proceeds (\$m) | \$6,000 | \$3,000 | \$3,000 |
| 5 Post-Life Insurance Value (\$m) | \$16,000 | \$8,000 | \$8,000 |
| 6 Repurchase Liability | (\$8,000) | | |
| 7 Post-Life-Insurance Value | \$8,000 | | |
| 8 Repurchase Stock | (\$8,000) | \$8,000 | |
| 9 Retire / Give Up Stock | (50) | (50) | |
| 10 Remaining Stock | 50 | 0 | 50 |
| 11 New Stock Ownership (%) | 100% | 0% | 100% |
| 12 Post-Life Insurance Value of Co. | \$8,000 | \$0 | \$8,000 |
| 13 Post Life Insurance Proceeds | | \$8,000 | |
| 14 Net Incremental Liabilities | (\$2,000.0) | | |

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Treatment 2 – Proceeds Are a Corporate Asset

Table Two summarizes the pre- and post-life insurance values and positions for High Point Software, Harry's estate and Sam if life insurance proceeds are considered as a separate non-operating corporate asset in valuation.

Line 3 shows the same \$10 million pre-life insurance value of \$10 million as in the treatment where life insurance is not a corporate asset. Now, however, the \$6 million of proceeds from the policy on Harry's life is treated as a non-operating asset and added to value, raising the post-life insurance value to \$16 million, and the interests of Harry's estate and Sam to \$8 million each (Lines 4-5). After recognizing the repurchase liability of Harry's shares (\$8 million), the post-life insurance value of High Point Software is \$8 million (Lines 6-7).

The shares are repurchased and new ownership positions are calculated on Lines 9-11. Harry's ownership goes to zero, and Sam's rises to 100% of the now 50 shares outstanding. This result is the same as above. However, Harry's estate receives \$8 million as result of the purchase of his shares, rather than \$5 million. Note that the company's value has been reduced from the pre-death value of \$10 million to a post-death value of \$8 million (Line 12).

The decrease in value is the result of Harry's value of \$8 million, which is in excess of the life insurance proceeds of \$6 million, suggesting that the company had to issue a note to Harry's estate for the remaining \$2 million (Line 14). So the company is in a more leveraged position as result of the buy-sell transaction than it was before. Sam, on the other hand, owns 100% of the remaining value, or \$8 million, rather than \$11 million in the prior treatment.

WHAT'S FAIR?

It should be clear that the decision of how to treat life insurance for valuation purposes is important for all parties. Which treatment reflects the intentions of the parties? The fact is that life insurance proceeds create an asset that is unrelated to the operation of a business. The parties, therefore, should decide on the treatment of that insurance asset just like they decide on the investment or distribution of the company's earnings.

Was it Harry and Sam's intention for Sam to end up with \$11 million in value while Harry's estate only receives \$5 million if life insurance is not treated as a corporate asset? Sam and the company receive an increment in value, but Harry's estate got precisely the amount that Harry would have received had he and Sam decided to sell the

company prior to his death.

On the other hand, when life insurance proceeds are treated as a corporate asset, both Sam and Harry's estate benefit from the increase in value from the proceeds. However, the company is saddled with additional debt to repurchase Harry's shares at the moment of its greatest vulnerability, the death of one of the two key owner-managers. Is that the intention of the parties? The answers to these questions may not be immediately clear.

CONCLUSION

What is clear from this example is that the issue of the valuation treatment of life insurance proceeds is far too important not to be addressed specifically in buy sell agreements. If an agreement is silent on the issue and the life insurance proceeds are significant in relationship to the value of a business, rest assured that there will be an issue – probably litigation – when a significant shareholder dies.

With out-of-date fixed price agreements where value rises over time, the parties to that agreement make a bet that “the other guy” will die first. And one of them will be right! With life insurance proceeds, there is something of a similar bet if life insurance is treated as a funding vehicle only. In this case, however, the seller who dies first will get what his stock was worth before life insurance proceeds. His only “loss” is in not sharing in the incremental asset created by the insurance.

Parties to an agreement may feel differently about this “loss” or incremental gain depending on whether a company is entirely family-owned or the ownership is comprised of unrelated parties. However, regardless of they feel about it, the Internal Revenue Service may have a say about the treatment of life insurance proceeds in family-owned businesses.

The bottom line. If a buy-sell agreement is funded in whole or in part by life insurance, take the time to review the agreement to see what it states regarding the treatment of proceeds in the event of the death of a partner/shareholder. If it is silent, now is the best time to get together with all parties to the agreement and to discuss the impact of life insurance. Valuation advisors should be called upon and asked to make calculations like those above – or they can be made internally by corporate personnel based on an assumed value for the business. Armed with this information, the parties should decide now what will happen to the incremental proceeds.



Z. Christopher Mercer, ASA, CFA

mercerc@mercercapital.com

Focus on IRS Section 409a

Not All Classes of Equity Were Created Equal

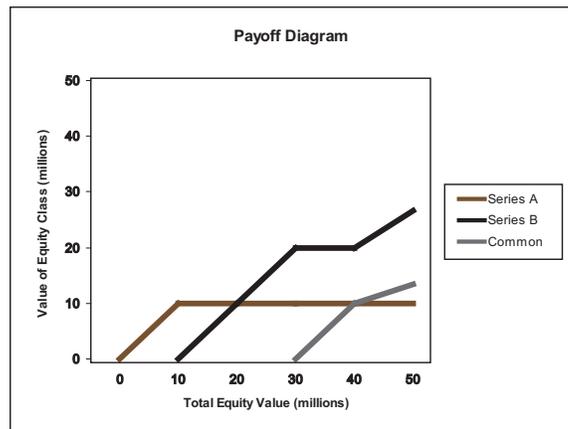
IRS Section 409a requires that companies issuing stock options (or stock appreciation rights) determine the fair market value of the underlying shares at each grant date. Compliance with Section 409a may be particularly troublesome for start-up companies in various stages of corporate development. Such companies frequently grant options, and are often capitalized with several classes of preferred and common equity securities with differing associated economic and control rights. While the presence of several classes of equity can prove vexing when valuing the individual securities, valuation professionals have developed methods to tackle these problems, three of which are discussed in the *AICPA Practice Aid: Valuation of Privately-Held Company Equity Securities Issued as Compensation*.

Due to the substantial risk that is often involved in investing in early-stage startup companies, investors often demand higher returns and greater corporate influence. As a startup company matures, capital needs tend to increase while the perceived risk often decreases, leading to multiple rounds of financing (generally structured as preferred equity). A thorough understanding of the different rights associated with the various classes of equity is necessary to properly allocate a company's value between the different equity securities.

The rights pertaining to different classes of preferred or common equity can be generally categorized as economic rights or control rights. Basically, economic rights are intended to provide economic protections and preferences relative to lower classes of equity, while control rights are designed to provide discretion and influence with respect to significant corporate decisions. Typical economic rights include preferred dividends, liquidation preferences, mandatory redemption rights, and conversion rights, among others. Typical control rights include voting rights, veto rights, board composition, and first refusal rights, among others.

To illustrate, consider an equity capital structure with three classes of equity: common stock (10 million shares), Preferred Series A (10 million shares), and Preferred Series B (20 million shares). Assume that Series A is senior to Series B, both carry a \$1 liquidation preference, and Series B carries conversion rights at \$1 per share. As shown in the payoff diagram below (which describes the liquidation value of each equity class based on total equity value), Series A, being senior to both common stock and

Series B, increases in value up until total equity value reaches the total liquidation preference of \$10 million (10 million shares at \$1 / share). Series B, being senior to only common stock, increases in value until total equity value reaches \$30 million (the combined total liquidation preference of both series of preferred stock). It is not until the total liquidation preference of all preferred stock is met that common stock would receive any payout at the time of a liquidation event. When the common stock value reaches \$1 per share (total equity value of \$40 million), Series B would exercise its conversion rights and share in further appreciation on a pro rata basis with the common shareholders.



The *AICPA Practice Aid* discusses three methods of allocating enterprise value across various equity classes in a company: the probability-weighted expected return method (“PWERM”), the option-pricing method (“OPM”), and the current-value method (“CVM”). The *Practice Aid* also clearly states that “no single enterprise value allocation method appears to be superior in all respects and in all circumstances over the others.”

Under the PWERM, the company's enterprise value is estimated at the date of various assumed potential future outcomes (which could include an IPO, liquidation, continued private operation, etc.). Each enterprise value is allocated across the different classes of equity based on the rights and characteristics of each equity class assuming the equity-holders maximize the value of investments (i.e. holders of convertible preferred stock convert when appropriate, etc.). Each estimated scenario value is then discounted to the present at an appropriate rate and probability weighted to determine the fair market value of each class of securities. This method is conceptually

appealing in its forward-looking consideration of different liquidity events; however, at the same time, it is heavily reliant on assumptions (indications of value are only as good as the assumptions on which they stand) and certain circumstances can require very complex probability modeling.

The OPM considers the various classes of equity as a group of call options on the company's total enterprise value. Under this method, exercise prices reflect the

respective liquidation preferences and conversion rights of each class of preferred stock. In the case of the example capital structure we discussed previously, Series A would be modeled as a call option with an exercise price of zero, Series B with an exercise price of \$10 million. Common stock is modeled as a call option with an exercise price equal to the enterprise value of the company remaining after each class of preferred stock has been liquidated (or \$30 million in the case of the example above). Conversion features, such as those accruing to Series A, may also be modeled in an option-pricing method. Although somewhat less intuitive, the OPM is attractive in that it does not require as many assumptions as the PWERM, while still considering differences in equity classes from a forward-looking perspective. On the other hand, the method requires an assumption of volatility which can be difficult to accurately estimate for a private company.

The CVM values each equity class based on the greater of conversion value or liquidation preference in the context of the company's current enterprise value (as determined through an appropriate application of traditional valuation approaches). The simplicity and clarity of the CVM can make it an appealing method to use in certain circumstances; however, this method does not consider value from a forward-looking perspective. Despite this shortcoming, this method can be useful in situations where a liquidity event appears imminent or where the company is at an early stage of development such that predictions of future performance are highly speculative.

Even in relatively simple circumstances where a company is capitalized by only two or three classes of equity, judgment related to the appropriate method and assumptions must be exercised based on the subject company's stage of development, industry, expectational factors, and any other material factor that could impact value. In cases where the capital structure is not so simple as only two or three classes of equity, the valuation models can become substantially more complex. Given the high stakes of IRS Section 409a compliance, it is important to choose a valuation professional with industry knowledge, familiarity with IRS and FASB standards, and experience tackling complex valuation issues through a variety of methods. The professionals at Mercer Capital have this experience and expertise, and are available to talk with you about any valuation issues related to equity securities in complex capital structures.

Mercer Capital Highlights

IN PRINT

Nicholas J. Heinz was quoted in the September 22-28, 2006 edition of the *Memphis Business Journal* in an article entitled "Many Signs Point to Possibility That a Company May Be Up For Grabs."

Andrew K. Gibbs, CFA, CPA/ABV, was quoted in the August 18-24, 2006 edition of the *Memphis Business Journal* in an article entitled "Interest Rate Environment, Quality of Loans Could Put Pressure on Banks' Earnings."

Z. Christopher Mercer, ASA, CFA, wrote an article entitled "The Six Defining Elements of Buy-Sell Agreements" for the October 2006 issue of *Business Valuation Update*.

SPEAKING ENGAGEMENTS

November 6, 2006

"Marketing with the Newest Technology Tools"
IGAF Marketing Directors Conference
Las Vegas, Nevada

Barbara Walters Price

November 30, 2006

"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"
Arkansas Tax Institute
Little Rock, Arkansas

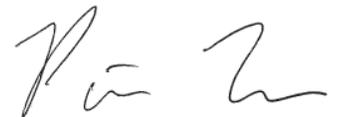
Timothy R. Lee, ASA

December 3-4, 2006

"Buy - Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"

"Ask the Experts Panel"
AICPA Business Valuation Conference
Austin, Texas

Z. Christopher Mercer, ASA, CFA



B. Patrick Lynch

lynchp@mercercapital.com

The Quantitative Marketability Discount Model

FACT SHEET

Fall/Winter 2006

For a full list of citations, visit our website at www.mercercapital.com.

- » The QMDM is a shareholder-level discounted cash flow model designed to help the valuation expert derive and explain a reasonable and transparent conclusion based upon the facts and circumstances of each case. The discounted cash flow model is a defined method in the ASA Business Valuation Standards, falling under the income approach to valuation.
- » The QMDM was introduced in 1994.
- » The QMDM is currently taught in the education programs of each of the business appraisal professional associations: the American Society of Appraisers, the Institute of Certified Business Appraisers, the American Institute of Certified Public Accountants; and the National Association of Certified Valuation Analysts.
- » Three books have been published on the subject and the QMDM is discussed in other valuation textbooks.
- » Valuation experts use the QMDM either as a primary means of determining a discount for lack of marketability or to test or to corroborate the concluded discount developed using other methods.
- » Other quantitative models to determine a marketability discount have been developed in the business appraisal profession.
- » The QMDM provides information to facilitate conformity with the Uniform Standards of Professional Appraisal Practice.
- » The QMDM is marketed by ValuSource, formerly Wiley-ValuSource, as a stand-alone software product.
- » The professionals of Mercer Capital have presented the application of the model in training sessions to the Internal Revenue Service.
- » The QMDM has been presented in both written form and in speeches dozens of times at each of the business appraisal professional associations beginning in 1994.
- » The QMDM is applicable not only in gift and estate tax appraisals but is also helpful in non-tax situations.
- » Mercer Capital has presented the Tax Court with appraisals containing the QMDM dating back to the mid-1990s in *Thompson (1996)*, *Marmaduke (1999)*, and *Noble (2005)*.
- » The QMDM has been mentioned explicitly in three Tax Court cases to date: *Weinberg*, *Janda*, and *Temple*. Mercer Capital has written about each of these cases and takes the position that if one disagrees with the underlying assumptions used in a discounted cash flow model, the integrity and validity of the valuation method is not impugned.
- » At no time has a *Daubert* challenge to the QMDM been sustained by the Court.

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...LOOKING FOR A GOOD HOME



With so much money in today's marketplace "looking" for deals, chances are that you will be contacted by another company, investor, or private equity group with an offer. You've got only one shot - don't regret not getting the best deal. Mercer Capital can help you discern if an offer is indeed a good one, help you negotiate for a better offer, and help you through the sales process. Call Nick Heinz, Tim Lee or Travis Flenniken at **800.769.0967**.

If you've been approached about selling your business, **call Mercer Capital first.**