Often Overlooked Yet Important Items in Process Buy-Sell Agreements

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 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 timelines in Figure 9 are estimated based on actual experiences with the operation of buy-sell agreements. Three kinds of process agreements are listed to provide a realistic overview.
The existence of defined timetables in agreements serves to keep the parties focused on the timeline; however, they are seldom binding.

Figure 9 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

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

FIGURE 9

To receive your free copy of the 40-page "Buy-Sell Audit Checklist" in a 8.5 x 11" format ready for your use (a $50 value), send us your favorite buy-sell agreement war story (please change all the names to protect the innocent and guilty!).

One of the reasons we wrote the book, Buy-Sell Agreements, was to help business owners and their advisors craft workable agreements. Examples of agreements gone wrong (and those that operated as planned) serve as a powerful reminder of what could happen to you.

Send your war story to Chris Mercer at mercerc@mercercapital.com and include your name. Once we receive it, we’ll e-mail you your FREE copy of the 40-page "Buy-Sell Audit Checklist."
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. ...

[Also discussed in this chapter is “Who Bears the Costs of the Appraisal Process?” and “Who Benefits (or Loses) from Unavoidable (or Avoidable) Delays?” To order your copy of the book, visit our website at www.mercercapital.com or see the order form at page 14.]

Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com
Timothy R. Lee, ASA  
New York Society of CPAs Business Valuation Conference » May 21, 2007  
“Application of Industry & Economic Data in Business Valuation”

Andrew K. Gibbs, CFA, CPA/ABV  
SNL Securities » May 22, 2007  
“Core Deposit Intangible Asset Valuation”

Matthew R. Crow, ASA, CFA  
BV Resources Teleconference » May 23, 2007  
“SFAS 141(R)”

Z. Christopher Mercer, ASA, CFA  
The Institute of Business Appraisers Annual Conference » June 21, 2007  
“Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?”

Travis W. Harms, CFA, CPA/ABV  
Advanced Business Valuation Seminar sponsored by the American Society of Appraisers » July 18, 2007  
“Developing Reliable Valuation Models”

Travis W. Harms, CFA, CPA/ABV  
CICBV Regional Conference » September 8-9, 2007  
“A Theoretical and Practical Review of the DCF Model”

Z. Christopher Mercer, ASA, CFA & Travis W. Harms, CFA, CPA/ABV  
Dallas & Houston CFA Chapter Meetings » September 18-19, 2007  
“Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?”

Z. Christopher Mercer, ASA, CFA  
AICPA Business Valuation Annual Conference » December 2, 2007  
“Discounts for Lack of Marketability Panel”

Z. Christopher Mercer, ASA, CFA & Travis W. Harms, CFA, CPA/ABV  
AICPA Business Valuation Annual Conference » December 3, 2007  
“An Integrated Theory of Business Valuation”

Z. Christopher Mercer, ASA, CFA  
Baltimore Estate Planning Council » June 21, 2007  
“Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?”

Z. Christopher Mercer, ASA, CFA  
ING International Forum » January 12, 2008  
“Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?”

An Integrated Theory of Business Valuation - SECOND EDITION  
by Z. Christopher Mercer, ASA, CFA and Travis W. Harms, CFA, CPA/ABV  
Offered by John Wiley & Sons  
To be published in the October, 2007
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Valuing Shareholder Cash Flows

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NEW TELESEMINAR SERIES
Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?

Sponsored by Mercer Capital and BV Resources

ATTORNEYS, CPAs, BUSINESS APPRAISERS: Are you missing a business opportunity to assist your clients with their buy-sell agreements?

BUSINESS OWNERS: Does your buy-sell agreement say what you think it says? Are you sure?

Buy-sell agreements are found in every business of size. Yet, they are often misunderstood. The parties involved may believe the “words on the page” say one thing only to discover after a trigger event, that, in fact, they say something else entirely or are simply unclear. Attorneys work diligently with shareholders to craft these agreements and shareholders want the agreement and the resulting process to be fair. Why then do so many buy-sell agreements fall short upon a trigger event?

After working with buy-sell agreements for over thirty years, we offer some answers from a valuation perspective in this three-part teleseminar. In addition, we offer advice and insight that can help you craft and/or review a buy-sell agreement so that the “words on the page” indeed communicate clearly your intentions.

This series will present information on buy-sell agreements that you’ve never heard before.

You are invited to attend all three sessions of this teleseminar series:

PART 1: YOU’LL NEVER THINK ABOUT BUY-SELL AGREEMENTS THE SAME WAY AGAIN
Featuring Chris Mercer
100 minutes » Noon – 1:40pm CST
Thursday, MAY 24, 2007

HIGHLIGHTS:
- Identify the six defining elements that every buy-sell agreement should possess but most do not
- Learn which pricing mechanisms typically work and which typically do not
- How to review a buy-sell agreement from a valuation perspective, not only for business appraisers but also for business owners and their professional advisors
In this first session, we focus on providing useful information that can be beneficial to you and/or your clients immediately! Specifically, you do not want to miss the section on how to review a buy-sell agreement (from a valuation perspective). We walk through the 40-page “Buy-Sell Audit Checklist” from the book. This is alone worth the price of admission!

To receive your FREE copy of the 40-page “Buy-Sell Audit Checklist” in a 8.5 x 11” format ready for your use (a $50 value), send us your favorite buy-sell agreement war story (please change all the names to protect the innocent and guilty!). Chris just might use your story in the teleseminar series yet even if he doesn’t, you will still receive your FREE copy of the “Buy-Sell Audit Checklist”. Send your war story to Chris at mercerc@mercercapital.com and include your name.

**PART 2: THE PLANNER’S ROLE IN BUY-SELL AGREEMENTS**

*Featuring Chris Mercer (moderator), L. Paul Hood, Jr., Esq., and John H. Brown, Esq.*

100 minutes » Noon – 1:40pm CST

**Thursday, JUNE 14, 2007**

**HIGHLIGHTS:**

- Features two of the most respected planners in the nation – L. Paul Hood, Jr., Esq. is a nationally-known estate planning attorney and John H. Brown, Esq., is president of Business Enterprise Institute (BEI), the only single source of education, marketing support, and exit planning design for advisors of business owners.
- Understand the defining elements that should be present in every buy-sell agreement
- The challenges faced by planners when crafting buy-sell agreements for clients
- Learn how to approach your clients to review their buy-sell agreements – a business opportunity for you and a real service for them
- Plenty of real-life examples of buy-sell agreements that went well and those that didn’t
- How to review a buy-sell agreement from a valuation perspective specifically for planners

This session focuses on helping planners help their clients – and in turn, potentially build their own practice.

As a well-respected attorney commented to us upon the publication of our book:

“Buy-sell agreements have always plagued me. You write them and they never come out the way you think they should.…

Attorneys and other planners work diligently with shareholders/investors to craft solid buy-sell agreements. However, this often comes at the end of a transaction process when the shareholders/investors think that all is done and they should be able to get down to business. They typically do not want to incur further legal costs and are ready to move on, so they give the buy-sell agreement little thought because, as is so often said “There will never be a problem, anyway.” Famous last words!

A life insurance professional told us a story that after hearing one of our recent presentations on buy-sell agreements, he decided to approach four of his clients to talk about their buy-sell agreements. Because he focused on this niche and had the information we provided in the speech, he was able to review each client’s buy-sell agreement and offered real value to his clients by finding areas that could potentially become problems.
PART 3: BUY-SELL AGREEMENTS: OPPORTUNITIES & CHALLENGES FOR BUSINESS
APPRAISERS
Featuring Chris Mercer (moderator), Roger Grabowski, ASA and Jim Hitchner, CPA/ABV, ASA
100 minutes » Noon – 1:40pm CST
Thursday, JULY 19, 2007

Highlights:
- Features three of the biggest names in business valuation
- The role of the business appraiser
- Multiple appraiser vs. single appraiser process agreements
- How to become involved in the drafting stage of buy-sell agreements
- Identify the main areas of dispute when things go wrong and the client ends up in litigation
- Learn how to approach your clients to review their buy-sell agreements – a business opportunity for you and a real service for them
- Plenty of real-life examples of buy-sell agreement engagements

The “words on the pages” of your or your client’s buy-sell agreement probably do not say what you think they say. Nevertheless, know this: If there is ever a dispute over your buy-sell agreement, chances are that certain “words on the pages” will not be interpreted by a business owner or even their attorney. They will be interpreted by one or more business appraisers. As such, it is vital for business appraisers to be knowledgeable. Also, without solid advice from a reputable appraiser, the words may be interpreted by a judge or jury in an expensive and time-consuming trial.

As Rand Curtiss, FIBA, MCBA, ASA, ASA noted in a review of the book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* “Appraisers who apply [the] lessons [of the book] will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.”

This session focuses on helping appraisers become facilitators of business valuation dispute resolutions along with offering real-world guidance from three professionals who have been in the trenches.

~~~~~~~~~~~~~~~~~~~~~~~~~~~~

WHY YOU SHOULD ATTEND?
Attend the teleseminar series to learn about buy-sell agreements from a business and valuation perspective, and to learn how to avoid or to fix potential problems with your and/or your client’s buy-sell agreements before they have to be implemented. If you are a professional advisor to business owners, learn how to help your clients which is a real business opportunity for you and a real service to them.

Chris will be speaking directly from my 30+ years of experience as a business appraiser and businessman about the problems, issues, advantages, and disadvantages of different types of buy-sell agreements. The panelists will be contributing their years and depth of experience.

WHO SHOULD ATTEND?
Anyone with or associated with businesses having buy-sell agreements to govern the process and price of future transactions in stock. This includes business owners, officers and directors, their attorneys, their accountants, life insurance professionals, wealth planners, and other professional advisors, including their business appraisers.

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To take advantage of the discount package pricing:
Before May 24, 2007, call BV Resources at (503) 291-7963 or send an e-mail to customerservice@bvresources.com indicating that you would like to register and they will contact you!

For more information, contact Barbara Price at priceb@mercercapital.com or 901.685.2120

Time is running out! Sign up today for information you won’t find anywhere else!
Visit Mercer Capital’s website or BV Resources website for other information!
Released in January 2007, “Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?” has quickly become a valuable tool for attorneys, business advisors and business owners who recognize the importance of buy-sell agreements. Don’t take our word for it. Below are just some of the published reviews of “Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?.”

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...Buy-Sell Agreements offers a comprehensive buy-sell audit checklist that alone makes it worthy of purchase, serious use and study...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 is a no-brainer addition to the library of every one who works with or who drafts buy-sell agreements.

L. Paul Hood, ESQ.
at www.leimbergservices.com

In the teacher’s manual to our Business Associations case book, my friend, colleague and coauthor Bill Klein posits that “any lawyer who advises people entering into a business venture and who fails to urge the adoption of a buy-sell agreement is guilty of malpractice.” Z. Christopher Mercer’s new book Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions offers a tremendously useful guide to these remarkably important contracts. In it, he provides guidance for business people and their financial advisors to use in assessing the need for a buy-sell agreement and, if one is appropriate, deciding on key terms. It will also be very useful to counsel drafting buy-sell provisions, as it offers drafting checklists and samples of how various issues can be treated. I recommend it very highly.

Stephen Bainbridge
William D. Warren Professor of Law, UCLA Published on ProfessorBainbridge.com

Mr. Mercer has done a great job of addressing the reasons business owners might want to have a buy-sell agreement and the business factors these business owners should consider in the agreement...Overall, Mr. Mercer provides valuation practitioners, business consultants, and business owners with a very useful handbook for preparing, reviewing and interpreting buy-sell agreements.

Rand M. Curtiss, FIBA, MCBA, ASA, ASA
President, Loveman-Curtiss, Inc.
Chair of the American Business Appraisers National Network Published on IBA Discussions Blog at www.go-iba.org/blog

In this eminently well-written, concise, and non-technical book, Chris lays out the fundamental parameters and processes that must be considered to minimize problems...Appraisers who read this book and apply its lessons will be able to position themselves in the marketplace as not just valuation specialists but in the wider role of facilitators of business valuation dispute resolutions, a much more productive role for us.

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David A. Ellner, CPA/ABV
The Financial Valuation Group Published in the AICPA ABV e-Alert Volume 9, Issue 2, February/March 2007

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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 - 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
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