Do You Know that Your Buy-Sell Agreement Will Work As Expected?

Buy-sell agreements are not merely legal documents to be signed and forgotten. How they operate when triggered can have huge consequences for a business owner, his or her family, and the business. Are you sure that you know what will happen when your agreement is triggered? If not, this book is for you. It provides critical information and insight you won’t find anywhere else — information that can save you and/or your heirs money, as well as possibly control of your business.

Chris Mercer is a nationally known business valuation expert who has over 30 years of experience working with business owners on buy-sell agreement issues. In this book, he shares the lessons he has learned with one goal: You can know your buy-sell agreement will work without triggering it.

“In a straightforward and easily understood style, this book describes what owners need to do today to prevent unintended and perhaps financially ruinous consequences tomorrow. Chris Mercer’s newest book is destined to be a standard for business owners.”

John Brown
President, Business Executives International

“In direct and non-technical terms, Mercer thoughtfully explores the pros and cons of competing approaches, and unflinchingly expresses his specific recommendations. Anyone who owns or advises a privately owned business needs to read this book.”

Jared Kaplan
Senior Counsel, McDermott Will & Emery

“Having advised clients on buy-sell agreements for more than 30 years, I’ve seen the devastating consequences of poor planning. Mercer’s book is the best treatise on this topic and is a must read for any attorney, advisor, or business owner working on buy-sell agreements.”

Kelly Finnell, J.D, CLU, AIF®, Executive Financial Services, Inc.
An Overview
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?”

Sam: “Sounds good to me. See you then.”
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.

- Require agreement at a point in time
- Define the conditions that “trigger” the buy-sell provisions
- Relate to transactions that will or may occur at future points in time
- 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

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do your clients have a buy-sell agreement?</td>
<td>If so, what type of agreement is it?</td>
</tr>
<tr>
<td>Do they know what the buy-sell agreement says?</td>
<td>There are six defining elements that must be in every process agreement if the valuation process and, therefore, the agreement, will work</td>
</tr>
<tr>
<td>How is the buy-sell agreement funded?</td>
<td>How life insurance proceeds are treated can make a big difference in the valuation of the company</td>
</tr>
</tbody>
</table>
Do You or Your Clients Have a Buy-Sell Agreement?
How Do Buy-Sell Agreements Come Into Existence?

## Potential Opposing Shareholder Characteristics That Make Discussing Buy-Sell Agreements Difficult

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Shareholder 1</th>
<th>Shareholder 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td>Younger</td>
<td>Older</td>
</tr>
<tr>
<td>Ownership</td>
<td>Noncontrolling</td>
<td>Controlling</td>
</tr>
<tr>
<td>Involvement</td>
<td>Active</td>
<td>Inactive</td>
</tr>
<tr>
<td>Personal Outlook</td>
<td>Optimistic</td>
<td>Pessimistic</td>
</tr>
<tr>
<td>Investment Type</td>
<td>Sweat Equity</td>
<td>Real Money</td>
</tr>
<tr>
<td>Investment Amount</td>
<td>Smaller</td>
<td>Larger to Much Larger</td>
</tr>
<tr>
<td>Personal Guaranties</td>
<td>None</td>
<td>Substantial</td>
</tr>
</tbody>
</table>
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

» The owners agreed on a price.
» That price is likely years out of date.
» There are three possibilities regarding the price 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.

_The owners haven’t agreed on a way to update the price._

REALITIES Seldom DISCUSSED

» If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price.
» If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit.
» The other owner(s) are making just the opposite bets.

_Why should the owners take a chance that they’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

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!

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

» Update it annually – so simple but rarely ever done
$11 Million or $178 Thousand?


» New Jersey Appellate Court upheld “book value” in buy-sell agreement

» The Partnership owned substantial assets and Claudia’s estate argued that the true value was $11,526,162; however, the Appellate Court, citing the language in the buy-sell agreement, upheld the amount of $177,809

» From partnership agreement: “... Each of the Partners has determined that the full and true value of the Partnership is equal to its net worth plus the sum of $50,000. The term ‘net worth’ has been determined to be net book value as shown on the most recent Partnership financial statement...”

» *Estate of Claudia L. Cohen* should be a wake-up call to every business owner who has a buy-sell agreement with a formula or fixed price pricing mechanism
Formula Agreements

DESCRIPTION

» The owners 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.

The owners haven’t agreed on ways to make necessary/appropriate adjustments.

REALITIES Seldom DISCUSSED

» If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price.
» If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit.
» The other owner(s) are making just the opposite bets.

Why should the owners take a chance that they’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

EXAMPLE

» 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

» The owners agreed to let business appraisers set the price for the 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 each owner thought they agreed to.
  ▪ It might not be reasonable and what each owner thought they agreed to.

No one will know until the end of a lengthy & uncertain process what the outcome will be.

REALITIES SE LD OM DISCUSSED

» Each owner is 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

» Every buy-sell agreement should be:

<table>
<thead>
<tr>
<th>UNDERSTANDABLE</th>
<th>PREDICTABLE</th>
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<tr>
<td>LIKELY TO ACHIEVE REASONABLE RESOLUTIONS</td>
<td>HELPFUL IN THE WEALTH MANAGEMENT PROCESS</td>
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</table>
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 DETERMINER

THIRD APPRAISER AS JUDGE

THIRD APPRAISER AS MEDIATOR
Multiple Appraiser Agreements
## Multiple Appraiser Agreements

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<tr>
<td>1. Price not determined now</td>
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<tr>
<td>2. Potential for dissatisfaction with the process for all parties</td>
<td>x</td>
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<td>3. Danger of advocacy</td>
<td>x</td>
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<td>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</td>
<td>x</td>
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<tr>
<td>7. Expensive</td>
<td>x</td>
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<td>8. Time-consuming</td>
<td>x</td>
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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
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

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Having your business or a client’s business appraised every year sounds good, but we know it won’t happen.

What now?
Do You Know What Your or Your Client’s Buy-Sell Agreement Says?

From a business perspective?

From a valuation perspective?
The Six Defining Elements of Process Buy-Sell Agreements

<table>
<thead>
<tr>
<th>Standard of Value</th>
<th>Qualifications of Appraisers</th>
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<tr>
<td>Level of Value</td>
<td>Appraisal Standards</td>
</tr>
<tr>
<td>The “As Of” Date</td>
<td>Funding Mechanism</td>
</tr>
</tbody>
</table>
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 and on...
Defining Element #2
Level of Value

- Price we hope to get if we sell the company together
- Price the rest of us can reasonably pay if we have to buy out someone else
- “Fair market value of the (minority) interest”
Defining Element #2
Level of Value

Traditional

Controlling Interest Level
Control Premium ▲ ▼ Minority Discount

 Marketable Minority Level
(“As-If-Freely Traded”)

Nonmarketable Minority Level
(Illiquid Minority Interests)

Expanded, Modified

Strategic Control Value

Financial Control Value

Marketable Minority Level

Nonmarketable Minority Level

$140 Per Share

$100 Per Share

$60 Per Share
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
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
- NACVA Professional Standards
- CFA Institute Code of Ethics & Standards of Professional Conduct
# The Six Defining Elements of Process Buy-Sell Agreements

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How is Your or Your Client’s Buy-Sell Agreement Funded?
How Is Your or Your Client’s Buy-Sell Agreement Funded?

» The company will issue a promissory note...

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<th>BUYER-SELLER TENSIONS</th>
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</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Price</strong></td>
</tr>
<tr>
<td><strong>Buyer</strong> (Company)</td>
</tr>
<tr>
<td>Low</td>
</tr>
<tr>
<td><strong>Seller</strong> (Shareholder)</td>
</tr>
<tr>
<td>High</td>
</tr>
<tr>
<td><strong>Terms</strong></td>
</tr>
<tr>
<td><strong>Buyer</strong> (Company)</td>
</tr>
<tr>
<td>Lenient</td>
</tr>
<tr>
<td>Long Term</td>
</tr>
<tr>
<td>Deferred Payments</td>
</tr>
<tr>
<td>Low Interest Rate</td>
</tr>
<tr>
<td>No Security</td>
</tr>
<tr>
<td><strong>Seller</strong> (Shareholder)</td>
</tr>
<tr>
<td>Cash Now</td>
</tr>
<tr>
<td>Short Term</td>
</tr>
<tr>
<td>Rapid Payments</td>
</tr>
<tr>
<td>High Interest Rate</td>
</tr>
<tr>
<td>Full Security</td>
</tr>
</tbody>
</table>
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”
  (download from www.ChrisMercer.net)
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?
# Funding Mechanism

What about Life Insurance Treatment for Valuation Purposes?

<table>
<thead>
<tr>
<th>Proceeds are a Funding Vehicle</th>
<th>Company</th>
<th>Harry (Estate)</th>
<th>Sam</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Stock Ownership (Shares)</td>
<td>100.0</td>
<td>50.0</td>
<td>50.0</td>
</tr>
<tr>
<td>2 Stock Ownership (%)</td>
<td>100.0%</td>
<td>50.0%</td>
<td>50.0%</td>
</tr>
<tr>
<td>3 Pre and Post Life Insurance Value ($m)</td>
<td><strong>$10,000.0</strong></td>
<td><strong>$5,000.0</strong></td>
<td><strong>$5,000.0</strong></td>
</tr>
<tr>
<td>4 Life Insurance Proceeds</td>
<td>$6,000.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Repurchase Liability</td>
<td>($5,000.0)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Post-Life-Insurance Value</td>
<td><strong>$11,000.0</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Repurchase Stock</td>
<td>($5,000.0)</td>
<td>$5,000.0</td>
<td></td>
</tr>
<tr>
<td>8 Retire / Give Up Stock</td>
<td>(50.0)</td>
<td>(50.0)</td>
<td></td>
</tr>
<tr>
<td>9 Remaining Stock</td>
<td>50.0</td>
<td>0.0</td>
<td>50.0</td>
</tr>
<tr>
<td>10 New Stock Ownership (%)</td>
<td>100.0%</td>
<td>0.0%</td>
<td>100.0%</td>
</tr>
<tr>
<td>11 Post-Life Insurance Value of Co.</td>
<td>$11,000.0</td>
<td>$0.0</td>
<td><strong>$11,000.0</strong></td>
</tr>
<tr>
<td>12 Post Life Insurance Proceeds</td>
<td><strong>$5,000.0</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13 Net Change in Value from Repurchase</td>
<td><strong>$1,000.0</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Funding Mechanism
What about Life Insurance Treatment for Valuation Purposes?

<table>
<thead>
<tr>
<th>Proceeds are a Corporate Asset</th>
<th>Company</th>
<th>Harry (Estate)</th>
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<tbody>
<tr>
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<td>$3,000.0</td>
<td>$3,000.0</td>
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<tr>
<td>5 Post-Life Insurance Value ($m)</td>
<td>$16,000.0</td>
<td>$8,000.0</td>
<td>$8,000.0</td>
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<td>6 Repurchase Liability</td>
<td>($8,000.0)</td>
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<td>14 Net Change in Value from Repurchase</td>
<td>($2,000.0)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Types of Buy-Sell Agreements

» Fixed-price agreements - Update it

» Formula agreements – Calculate price yearly

» Process agreements
Review

The Six Defining Elements of Process Buy-Sell Agreements

<table>
<thead>
<tr>
<th>Standard of Value</th>
<th>Qualifications of Appraisers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of Value</td>
<td>Appraisal Standards</td>
</tr>
<tr>
<td>The “As Of” Date</td>
<td>Funding Mechanism</td>
</tr>
</tbody>
</table>
Multiple Appraiser Agreements

Review

Appraiser 3 is the Tie-Breaker
- Average with other two (gives credence to outliers)
- Average with the closer of Appraisal 1 and Appraisal 2
- The conclusions of Appraisal 1 and Appraisal 2 may establish upper and lower bounds for final price
Single Appraiser Agreement

Select Now and Value Now
Resources