



THE BUY-SELL AGREEMENT

# AUDIT CHECKLIST

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# **The Buy-Sell Agreement Audit Checklist**

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Published by Peabody Publishing, LP  
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# The Buy-Sell Agreement Audit Checklist

Audits are performed annually by certified public accountants for many thousands of companies each year. There are, in fact, expectations on the part of lenders, suppliers, customers, boards of directors and, perhaps, managements that companies will have an annual audit.

The concept of a financial audit is obviously well-known. We are introducing the parallel concept of the *Buy-Sell Agreement Audit* in this book.

The purpose of the *Buy-Sell Agreement Audit* is to enable a business owner(s), with the assistance of accountants, attorneys, business consultants, and appraisers, as necessary and appropriate, to express the opinion that his company's buy-sell agreement(s) fairly reflect the wishes and desires of the owners subject to it, in accordance with good business practices and common sense. All the shareholders and the company itself rely on this "audit" in their personal and corporate planning.

Unlike a traditional audit performed by a CPA which is backward-looking, the *Buy-Sell Agreement Audit* is forward-looking and addresses questions like the following:

- Is there a reasonable probability that the agreement will operate to effectuate a reasonable transaction when trigger events occur?
- Are all shareholders who should be subject to the agreement parties to it?
- Do the shareholders who are parties to the agreement understand how the agreement will operate to determine prices and terms for future transactions?
- Has the agreement been reviewed by legal counsel to ensure compliance with applicable laws and statutes?
- Are the defining elements of value clearly specified?
- Will the pricing mechanism provide a reasonable value if and when trigger events occur in the future?
- Is the funding mechanism in place and workable?

Because you may be in uncharted territory with the *Buy-Sell Agreement Audit*, I recommend that you meet with your accountant, other shareholders, corporate attorney, corporate business consultant, and financial planner, if appropriate, to review the buy-sell agreement. This team will enable you to discuss the business and legal aspects of your agreement in detail.

In addition, you should obtain competent advice regarding valuation aspects of the agreement. The valuation expert should be able to identify issues related to the expected operation of the agreement from a valuation viewpoint and make suggestions to modify the text to correct identified issues.

## The Buy-Sell Agreement Audit Checklist

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This checklist has been prepared to assist shareholders, corporate officers and their advisors in negotiating business and valuation issues relating to buy-sell agreements. The checklist is not a substitute for competent legal advice or for the advice of other professionals regarding taxation, estate planning, and other areas of shareholder or corporate concern.

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>NATURE, SIZE AND OWNERSHIP OF ENTITY</b></p> <p>1. Parties to consider in discussions about the buy-sell agreement</p> <ul style="list-style-type: none"> <li>▪ The company</li> <li>▪ Employee shareholders</li> <li>▪ Non-employee shareholders                             <ul style="list-style-type: none"> <li>» Active</li> <li>» Passive</li> </ul> </li> <li>▪ Remaining shareholders who may not be subject to the agreement</li> </ul> <p>2. Is the entity an S corporation? [It may be appropriate to restrict stock ownership to eligible classes of shareholders.]</p> <p>3. Are there multiple classes of stock or ownership?</p> <ul style="list-style-type: none"> <li>▪ Are all classes of ownership subject to the agreement?</li> <li>▪ If the agreement is applicable to only a certain class or classes of stock, what is the impact on other classes of ownership?</li> </ul> <p>4. Are there two or only a few shareholders?</p> <ul style="list-style-type: none"> <li>▪ Should all shareholders be subject to the buy-sell agreement?</li> <li>▪ What happens or should happen if shares subject to the agreement are transferred?                             <ul style="list-style-type: none"> <li>» If within family units, are they required to remain subject to the buy-sell agreement?</li> <li>» If not within family units, are they required to remain subject to the buy-sell agreement?</li> </ul> </li> </ul> <p>[A cross-purchase agreement may be appropriate, where the shareholders can purchase life insurance to acquire the shares of deceased shareholders.]</p>	✓	

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ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>If there are numerous shareholders, or if there are other reasons, it may be appropriate to have the company act as the purchaser for required buy-sell transactions.</p> <p>If the entity is of large value, even with a small number of shareholders, it may be appropriate to have the entity act as purchaser for required buy-sell transactions.]</p> <p>5. Are there groups of shareholders where it is important to maintain relative ownership between groups? [Family groups may desire to have provisions to maintain relative family ownership, but to have freedom to transfer shares within the group. There may be a control group. It may be necessary to have provisions to ensure that this group maintains control in the event of buy-sell transactions.]</p> <p>6. Are there older shareholders in the group of owners? [Life insurance may not be available. It may be necessary to allow for purchase of their shares with a term note and to have agreement for this up front. If there are older shareholders, they will likely retire or die relatively sooner. Consider provisions to account for these eventualities.]</p> <p>7. Are there shareholders who will be employees and others who will be passive owners, even if on the board?</p> <ul style="list-style-type: none"> <li>▪ What distinctions should be made between employee owners and passive owners in the buy-sell agreement?</li> <li>▪ If a passive owner dies, should employee owners be allowed to purchase all or a portion of the shares directly, if they are capable? [If so, they can increase their relative ownership if this is desirable.] <ul style="list-style-type: none"> <li>» Should the employee owner purchases be pro rata to all employee owners, or is it desirable to have one or more particular employee owners make the purchases?</li> <li>» Should the company assist with such transactions?</li> </ul> </li> </ul>	✓	

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ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<ul style="list-style-type: none"> <li>» If employee owners cannot make the transactions, should passive shareholders have the option to purchase the shares before the company acquires them?</li> <li>» With such purchases, individually or cumulatively over time, should there be provisions to maintain control of the company in any particular fashion?</li> </ul> <p>8. Are there state laws that will impact the ability of the company to redeem shares?</p> <p>[If so, counsel will have to advise how to draft the agreement to ensure maximum flexibility for the company and minimum likelihood for problems with insolvency as result of operation of the buy-sell agreement.</p> <p>Counsel will also have to draft provisions to protect the company in the event that insolvency becomes an issue as result of buy-sell transactions.]</p> <p>9. Are there restrictions under loan agreements that could be triggered by buy-sell transactions?</p> <p>[Such restrictions need to be anticipated, and provisions drafted to ensure compliance with the agreements and maximum flexibility to engage in buy-sell transactions.</p> <p>The lender(s) may have to approve these provisions in the buy-sell agreement.]</p>	✓	

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<p>10. Will there be a right of first refusal agreement (ROFR), either as a separate agreement or to be incorporated as part of the buy-sell agreement? [ROFRs may be appropriate if there is a desire to ensure approval of any new/additional shareholders]</p> <ul style="list-style-type: none"> <li>▪ What will be the terms of the ROFR agreement? Some considerations include: <ul style="list-style-type: none"> <li>» Must there be a bona fide offer, in writing, from a buyer of proven financial capacity? [If so, the right of first refusal may provide the ability for the company to purchase the shares on the same terms and conditions as in the bona fide offer.]</li> <li>» When such an offer is presented to the company, how long will the company have to consider the offer? (30 days? 60 days? Longer?)</li> <li>» If the company does not purchase the shares, will the shares be offered to the remaining shareholders for their purchase? <ul style="list-style-type: none"> <li>◇ In any particular order of ownership?</li> <li>◇ Pro rata to their ownership percentages?</li> <li>◇ How long with the shareholders have to make their decision? (30 days? 60 days? Longer?)</li> </ul> </li> <li>» If the shareholders do not purchase some or all of the offered shares, will the company have a “last look” to purchase the shares? <ul style="list-style-type: none"> <li>◇ If so, how long will the company have to make its decision?</li> </ul> </li> <li>» If neither the company nor the shareholders purchase the offered shares, will the purchaser of the shares be required to become a party to the ROFR?</li> </ul> </li> </ul>	<p>✓</p>	

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ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>TRIGGER EVENTS FOR CONSIDERATION</b></p> <p>1. <i>Quits</i>. Is quitting employment a trigger event for employee shareholders?</p> <ul style="list-style-type: none"> <li>▪ Will the agreement make a distinction between employee owners who quit to seek unrelated employment and those who quit and enter into competition with the company?</li> <li>▪ Should there be a penalty in valuation for those who compete within a specified period of time? (3 months? 6 months? One year?)               <ul style="list-style-type: none"> <li>» Penalty in valuation if competition begins immediately?</li> <li>» Withholding of a portion of proceeds for the specified period of time?</li> </ul> </li> <li>▪ Should the terms of repurchase be more lenient for the company in the event that an employee shareholder quits?</li> </ul> <p>2. <i>Fired</i>. Is being fired a trigger event for employee shareholders?</p> <ul style="list-style-type: none"> <li>▪ Will the agreement make a distinction between employee owners who are terminated for cause relative to those terminated not for cause?</li> <li>▪ Should there be a penalty in valuation for those who are terminated for cause?               <ul style="list-style-type: none"> <li>» What should be the magnitude of the penalty relative to the buy-sell agreement price?</li> <li>» If a percentage, should that percentage be impacted by the amount the employee owner has invested in his or her shares?</li> <li>» Should this percentage penalty vary with length of employment?</li> </ul> </li> <li>▪ Should the terms of repurchase be made more lenient for the company in the event that an employee shareholder is terminated?               <ul style="list-style-type: none"> <li>» If for cause, how so?</li> <li>» If not for cause, how so?</li> </ul> </li> </ul>	✓	

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<p>3. <i>Retires.</i> Is retirement a trigger event for employee shareholders?</p> <ul style="list-style-type: none"> <li>▪ Should the retiree be allowed to elect not to sell shares upon retirement, but otherwise remain subject to the agreement?</li> <li>▪ Should retirement be a mandatory trigger event?</li> </ul> <p>4. <i>Disabled.</i> Is disability a trigger event for employee shareholders?</p> <ul style="list-style-type: none"> <li>▪ What is the definition of disability for purposes of the agreement (period of time unable to work)?</li> <li>▪ Is disability of the employee-shareholder a mandatory trigger event?               <ul style="list-style-type: none"> <li>» Can the company, at its election, defer the purchase from a disabled shareholder? If so, for how long?</li> <li>» Can the shareholder elect to defer the purchase? If so, for how long?</li> </ul> </li> </ul> <p>5. <i>Dies.</i> Is the death of a shareholder a trigger event for the buy-sell agreement?</p> <ul style="list-style-type: none"> <li>▪ Is the buy-sell agreement price binding for estate tax purposes?</li> <li>▪ Is the buy-sell agreement funded by life insurance on the life of all shareholders? Or key shareholders?</li> </ul> <p>6. <i>Divorce.</i> If a party divorces and the value of his or her ownership is required to be split in order to settle the marital estate, should it be mandatory that the shares (or sufficient shares such that the party can retain ownership of the remainder) be repurchased by the company or other shareholder(s) in order to prevent ownership from being shifted to the ex-spouse?</p> <p>7. <i>Default.</i> This can be another name for situations involving personal bankruptcy and other involuntary transfers. The corporation and remaining shareholders will want to protect against having a bankrupt owner's shares falling into unfriendly hands in the bankruptcy process.</p>	✓	

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<p>8. <i>Disqualification.</i> This can be an important factor in businesses requiring licensing or regulatory approval. For example, if an owner is rendered disqualified to sell insurance or securities by state regulators, the other shareholders may desire that such disqualification be considered a trigger event for the buy-sell agreement.</p> <p>9. <i>Disaffection.</i> This may seem a stretch, but sometimes owner-employees quit in place and need to be discharged.</p> <p>10. <i>Disagreement.</i> Interestingly, when I ask groups of people what the most common triggers for buy-sell agreements are, they almost always place divorce and disagreement (or deadlock) as first and second. However, many buy-sell agreements do not address the potential issue of disagreement or deadlock. Should yours?</p> <p>11. <i>Disclosure.</i> The shareholders' agreement may need to address the need to maintain confidentiality of competitive information and intellectual property. This is important at all times, of course, but even more so in the event that a shareholder departs, for whatever reason.</p> <p>12. <i>Dispute resolution.</i> The parties to an agreement may want to provide for specific procedures in the event that otherwise irresolvable disputes arise. The parties may agree, for example, that certain disputes are to be resolved through binding arbitration, as well as the procedures for setting up and paying for the arbitration process.</p> <p>13. <i>Dilution.</i> When corporations sell or issue additional shares, the ownership percentages of existing shareholders may be diluted. The shareholders may want to agree in their buy-sell agreement on procedures to protect against their being diluted by the issuance of new shares. Such provisions would prevent a share issuance without notice and would provide the affirmative opportunity to participate in the issuance pro rata to their ownership.</p>	✓	

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<p>14. <i>Dividends.</i> It may be appropriate to agree on dividend policy, particularly in early or growth stages of a company’s life, or when the company has debt outstanding. If agreement is not reached in the formative stages of a business, then dividend policy will be determined by the controlling shareholder or group of shareholders that exercises control.</p> <p>15. <i>Distributions.</i> If the company is an S corporation or other tax pass-through entity, it is a good idea to document an agreement to make distributions to shareholders, at a minimum, for their pro rata share of personal taxes generated by income at the entity level.</p> <p>16. <i>Drag-along rights.</i> A controlling shareholder may desire to have what are called “drag-along” rights. If, for example, she obtains an offer for her shares representing 75% of the stock, she may wish to be able to force (by agreement, of course) the remaining 25% of the shares to sell with her. This might occur when a buyer would purchase not less than 100% of the shares.</p> <ul style="list-style-type: none"> <li>▪ <i>Tag-along rights.</i> The corollaries to drag-along rights are known as “tag-along” rights. With a tag-along provision, the minority shareholders can force (by agreement, of course) the majority shareholder to arrange for the sale of their shares at the same time and for the same price and terms as the controlling shareholder receives. This would prevent a controlling shareholder from selling only a control block, leaving the remaining shareholders in a minority position with a new and unknown owner.</li> </ul> <p>17. <i>Double entities.</i> Many owners of companies desire to separate the ownership of real property from the operating company. The purposes for this separation can be to protect the property legally, to provide a separate entity for estate planning purposes, to isolate financing arrangements, and many others. If there is parallel ownership between operating company and a real estate entity, it may be appropriate to have parallel terms in their respective buy-sell agreements.</p>	✓	

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<p>18. <i>Differential pricing.</i> Sometimes owners agree to differential pricing for purposes of their buy-sell agreements depending upon circumstances of the triggering event (or departure). Assume there is a price for purposes of the agreement determined by appraisal or the “Purchase Price.” The following are certainly not recommendations, but are illustrative of what might be agreed to by the owners:</p> <ul style="list-style-type: none"> <li>▪ <i>Death.</i> 100% of the Purchase Price.</li> <li>▪ <i>Retirement.</i> 100% of the Purchase Price.</li> <li>▪ <i>Terminated without cause.</i> 90% (or 100%) of the Purchase Price.</li> <li>▪ <i>Terminated with cause.</i> 80% of the Purchase Price.</li> <li>▪ <i>Quit or terminated and competing with company.</i> 75% of the Purchase Price.</li> </ul> <p>19. <i>“Don’t compete” agreements.</i> The shareholders may have noncompete agreements in the ordinary course of business. However, the buy-sell agreement could require that a noncompete agreement be signed reasonable as to length and geography) in the event of a purchase of shares pursuant to the agreement. Noncompete agreements are of sufficient importance to need additional discussion below.</p> <p>20. <i>Donate.</i> The buy-sell agreement may specify under what circumstances stock can be given to spouses, children, charities, etc.</p> <p>21. <i>Distributions after a trigger event.</i> What happens to dividends or distributions during the period of time when a buy-sell agreement is triggered and when the purchase transaction is completed? This question is important when disagreements arise, and many months or years go by before there is resolution.</p>	✓	

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<p><b>FIXED PRICE AGREEMENTS</b></p> <ol style="list-style-type: none"> <li>1. Will the agreement be a fixed price agreement? If so, how will the price be set initially? <ul style="list-style-type: none"> <li>▪ What will be the amount for the valuation of the company or per share?</li> <li>▪ What process will be utilized to set the price?</li> </ul> </li> <li>2. How will the price be updated? <ul style="list-style-type: none"> <li>▪ Will there be an agreement to update the price annually?</li> <li>▪ What process will be utilized to establish the new price each year?</li> </ul> </li> <li>3. What will happen in the event that the price is not updated for one or more years and then there is a trigger event? <ul style="list-style-type: none"> <li>▪ Will there be a requirement that the price be updated to a current price? [strongly advised]</li> <li>▪ What are the steps in updating the price? <ul style="list-style-type: none"> <li>» Will the parties have an opportunity to agree on a current price? How long will that period last?</li> <li>» What happens if the parties cannot reach agreement? Will the agreement provide for a valuation process to establish the new price?</li> </ul> </li> </ul> <p>[If a valuation process is called for, see Chapters 16 and 17 for things to consider in specifying the updating process.</p> <p>If you are going to the trouble to specify a process to use when the fixed price is out of date, why not just go with a valuation process and eliminate the fixed price?]</p> </li> </ol>	✓	

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<p><b>FORMULA AGREEMENTS</b></p> <ol style="list-style-type: none"> <li>1. Will the agreement be a formula agreement? How will the formula be established?</li> <li>2. Will all the terms be specifically defined?</li> <li>3. Will the formula be specified algebraically?</li> <li>4. Will all adjustments to financial performance indicators (income, expense, balance sheet) called for by the formula be specified?</li> <li>5. Will a calculation of the formula be included as part of the agreement?</li> <li>6. Will a recalculation of the formula be required each year?               <ul style="list-style-type: none"> <li>▪ Who will perform the recalculation?</li> <li>▪ Will the recalculation become the current price for purposes of the agreement?                   <ul style="list-style-type: none"> <li>» What happens if the recalculation indicates problems, such as a valuation that is significantly different from prior calculations?</li> <li>» What if additional adjustments are required to the formula?</li> <li>» What if the formula result cannot be adjusted to reach a reasonable result?</li> </ul> </li> </ul> </li> <li>7. Will there be a provision for an appraisal process in the event of disputes regarding the formula result if a trigger event occurs?</li> </ol>	✓	

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<p><b>THE DEFINING ELEMENTS OF VALUATION PROCESS AGREEMENTS</b></p> <p>There are defining elements that must be specified clearly if a process buy-sell agreement will work as expected. Each should be the subject of specific negotiation and agreement when a process buy-sell agreement is initiated or reviewed.</p> <p>1. <i>Standard of Value.</i> What is the standard of value for the required appraisal to determine price?</p> <ul style="list-style-type: none"> <li>▪ <i>Fair Market Value.</i> This standard is the most frequently used standard of value for buy-sell agreements. It is a “willing buyer, willing seller” standard of value. [If fair market value is the concluded standard of value, it is a good idea to either incorporate the precise definition into the agreement or to provide a specific reference to the desired definition in the agreement. For example: <ul style="list-style-type: none"> <li>» Definition per Revenue Ruling 59-60 found at page _____</li> <li>» Definition per <i>ASA Business Valuation Standards</i> found at page ____ ]</li> </ul> </li> <li>▪ <i>Fair Value.</i> This standard of value appears in numerous buy-sell agreements. When it is used without further definition, it can give rise to confusion. <ul style="list-style-type: none"> <li>» Is <i>statutory fair value</i> in the state of incorporation of the company the desired standard of value? [If so, the agreement should specify the appropriate statute for reference. If the statute does not define fair value, consider the agreement referring future appraisers to then-current judicial interpretations of fair value in the state, and specify a law firm to interpret the meaning of fair value for appraiser(s) in a manner they can translate into operative valuation approaches and methods. Consider specifying in the agreement that all appraisers providing appraisals pursuant to the agreement will use the same definition of fair value determined just above as the standard of value for their appraisals.]</li> </ul> </li> </ul>	✓	

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<p>» Is <i>accounting fair value</i> is the desired standard of value? [If so, the agreement should specify the appropriate accounting rules or regulations that define the kind of value that is meant by fair value.</p> <p>Consider specifying in the agreement that all appraisers providing appraisals pursuant to the agreement will use the same rules and regulations as the basis for their determinations of statutory fair value.]</p> <p>▪ <i>Investment Value</i>. This standard suggests a value to a unique buyer or type of buyer.</p> <p>» If the agreement specifies investment value as the appropriate standard of value:</p> <ul style="list-style-type: none"> <li>◇ There should be a definition of what investment value means.</li> <li>◇ The specific buyer or the specific type of buyer should be defined.</li> <li>◇ Consider specifying in the agreement that all appraisers providing appraisals pursuant to the agreement will use the same definition of investment value and the same specified buyer(s) in their appraisals.</li> </ul> <p>▪ <i>Going Concern Value</i>. Often, parties desire to specify that the valuation shall be of the company as a “going concern.” Specifications like “going concern value” or “value of the company as a going concern” are not, however, adequate to specify a workable standard of value.</p> <p>[If it is the desire of the parties that the valuation be specified as a going concern value (as opposed to, for example, a liquidation value) this modifier should be included with another selected standard of value (see above).</p> <p>Note that the standard of value of fair market value of a business presumes that the business is a going concern unless the analyst determines that a liquidation value would yield a higher resulting valuation (see USPAP).]</p>	✓	

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<ul style="list-style-type: none"> <li> <ul style="list-style-type: none"> <li>▪ <i>Other Standards.</i> If some other standard of value than those above is selected, make certain that the standard is clearly defined and that all parties understand it. In addition, make certain that business appraisers are able to make a similar interpretation.</li> </ul> </li> <li>2. <i>Level of Value.</i> What will be the level of value specified for purposes of the appraisal? [This specification is particularly critical and relates to whether the buy-sell price will represent a pro rata share of the value of the enterprise, or the value of a particular, perhaps minority, interest of the enterprise. We suggest reading Chapter 14 before discussing this specification for your buy-sell agreement.]           <ul style="list-style-type: none"> <li>▪ <i>Strategic Control.</i> Is the appropriate level of value for the agreement that of “strategic control?” [This level reflects the value of the enterprise considering strategic or synergistic benefits available to certain buyers, but not generally available to the company or to its shareholders.  If this level of value is deemed appropriate, the agreement should probably specify that no discounts related to lack of marketability or lack of liquidity be considered by the appraisers. There is no market evidence of such discounts and such discounts are not considered by qualified buyers of companies.]</li> <li>▪ <i>Financial Control / Marketable Minority.</i> Is the appropriate level that of “financial control,” which is also considered synonymous with the “marketable minority” level of value? [This level of value reflects the value of the enterprise based on normalized earnings of the enterprise as it operates, with existing ownership and management. In other words, value at this level would not include the benefit of expected synergies for synergistic or strategic purchasers of the business.</li> </ul> </li> </ul>	✓	

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<ul style="list-style-type: none"> <li> <p>▪ <i>Nonmarketable Minority</i>. Is the appropriate level of value for the agreement that of “nonmarketable minority?”</p> <p>[This level of value reflects the value of a minority interest in the company, taking into account its lack of marketability.</p> <p>If this level of value is deemed appropriate, the agreement should specify that the appraiser(s) should consider minority interest and marketability discounts, to the extent appropriate in the valuation of the interest.]</p> </li> <li> <p>▪ General Levels of Value Issues.</p> <p>[We recommend that buy-sell agreements specify the selected level of value. We also recommend that agreements reference a “levels of value” chart indicating the selected level of value, such as the chart below, reproduced for ease of reference. The agreement might also reference the text discussing the levels of value surrounding the chart.]</p> </li> </ul> <div style="text-align: center; margin-top: 20px;"> <p><b>The Levels of Value</b></p> </div>	<p>✓</p>	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>3. <i>The “as of” Date.</i></p> <p>[The “as of” or “effective date” is the date as of which available information pertaining to a valuation should be considered by appraisers. It should be specified. Values of companies change over time based on in such things as the national economy, interest rates or regulations, the industries in which the companies operate, regional or area economic activity, as well as changes within companies themselves. In the operation of process buy-sell agreements, it is necessary to fix the point in time at which appraisals are conducted and prices are determined. See Chapter 14.]</p> <p>Possible “as of” dates for consideration include:</p> <ul style="list-style-type: none"> <li>▪ <i>The exact date of the trigger event.</i> <ul style="list-style-type: none"> <li>» This may be the most understandable and agreeable date in many instances, but others may be considered appropriate by the parties.</li> </ul> </li> <li>▪ <i>Date determined by availability of financial statements.</i> <ul style="list-style-type: none"> <li>» The date of the monthly financial statements immediately preceding the trigger event (which might be published after the trigger event).</li> <li>» The date of the quarterly financial statements immediately preceding the trigger event.</li> <li>» The date of the financial statements for the month during which the trigger event occurs.</li> <li>» The date of the quarterly financial statements for the quarter during which the trigger event occurs.</li> </ul> </li> <li>▪ <i>Date determined by the appraisal process.</i> <ul style="list-style-type: none"> <li>» The date the initial appraiser(s) is (are) selected and hired.</li> <li>» The date that the appraisal report(s) is (are) submitted by the appraisers. Note that any subsequent appraiser(s) would have to use this same date.</li> </ul> </li> <li>▪ <i>Other date, as agreed upon by the parties.</i></li> </ul>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>4. <i>Appraiser Qualifications.</i> Appraisers render appraisal opinions, but most appraisers work for appraisal firms. The issue of qualifications can, therefore, relate both to qualifications of firms and individual appraisers.</p> <ul style="list-style-type: none"> <li>▪ Appraisal firms can be considered based on a number of criteria, including but not limited to:           <ul style="list-style-type: none"> <li>» Size</li> <li>» Longevity</li> <li>» Scope of business</li> <li>» “Convenience” factors               <ul style="list-style-type: none"> <li>◇ <i>Location.</i> With today’s transportation facilities and communications abilities, location may not be much more than a psychological factor for many appraisal processes.</li> <li>◇ <i>Price.</i> Appraisal costs (prices) are not a subject for mention in buy-sell agreements; however, price is often a consideration in the selection of appraisers, even when it should not be. Keep in mind that cheaper is not necessarily the best factor on which to base a decision for products or professional services (less expensive, other things all being equal may be a factor, but not absolute cost alone). Alternatively, more expensive does not necessarily mean better. When looking for an appraisal firm, look for the best combination of quality of service, reputation, and price.</li> </ul> </li> </ul> </li> <li>▪ Appraisers can be selected based on a number of objective criteria, including:           <ul style="list-style-type: none"> <li>» Education</li> <li>» Credentials &amp; compliance with professional standards</li> <li>» Valuation training &amp; experience</li> <li>» Industry experience</li> <li>» Publications</li> <li>» Expert testimony experience</li> <li>» Public speaking and/or writing on valuation issues</li> <li>» Other considerations relevant to the parties</li> </ul> </li> </ul>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>5. <i>Appraisal Standards.</i> The agreement should specify which appraisal standards should be followed by all appraisers providing appraisals pursuant to the buy-sell agreement. [It is critical that all appraisers follow the same, or at least similar, appraisal standards. It is even more critical that all appraisers attest in their reports that they have conducted their appraisals in accordance with applicable (to your agreement) business valuation standards. Chapter 14 discusses the <i>Uniform Standards of Professional Appraisal Practice (USPAP)</i>, the <i>ASA Business Valuation Standards</i>, and the <i>AICPA Statement on Standards (SSVS) No. 1</i> and mentions other relevant business valuation standards.]</p> <ul style="list-style-type: none"> <li>▪ <i>Uniform Standards of Professional Appraisal Practice (USPAP).</i> USPAP Standards Rules 3 relates to appraisal reviews. SR 9 and SR 10 relate to the development and reporting, respectively, of business appraisals.</li> <li>▪ <i>ASA Business Valuation Standards.</i> These standards are required to be followed by all appraisers who are members of the American Society of Appraisers. In addition, members of the American Society of Appraisers are required to follow USPAP in their appraisals.</li> <li>▪ <i>AICPA Statement on Standards for Valuation Services (SSVS) No. 1.</i> The AICPA published these standards as guidance for CPAs who provide business valuation services.</li> <li>▪ Other relevant business appraisal standards. See Chapter 14 for references to these standards.</li> </ul> <p>6. <i>Funding Mechanism.</i> As stated in Chapters 13 and 15, the funding mechanism is not generally necessary to define the valuation, but it is so important to the operation of buy-sell agreements that it is mentioned specifically in this “audit.” [The primary funding mechanisms in buy-sell agreements are life insurance (in the event of the death of a shareholder), corporate assets, external borrowings, and selling shareholder notes. Combinations of the above are also possible.]</p>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>Considerations related to the funding mechanism include the following:</p> <ul style="list-style-type: none"> <li>▪ <i>Life insurance.</i> <ul style="list-style-type: none"> <li>» Will the agreement be funded, in whole or in part, by life insurance?           <ul style="list-style-type: none"> <li>◇ Will the insurance be whole life insurance or term insurance?</li> <li>◇ What happens if one or more shareholders are uninsurable or not insurable at reasonable cost?</li> </ul> </li> <li>» <i>Valuation issue.</i> Will life insurance proceeds (net of applicable corporate taxes) be considered by the appraisers as a corporate asset in their appraisals, or should it be considered to be a funding mechanism only, and not be additive to value)? [See Chapter 15 for a discussion of valuation issues related to life insurance.]</li> </ul> </li> <li>▪ <i>Corporate assets (or “sinking fund”).</i> There may be sufficient corporate assets to fund particular required redemptions.           <ul style="list-style-type: none"> <li>» Should the available corporate assets be considered in the valuation as an excess asset and included in the valuation for purposes of the buy-sell agreement?</li> <li>» If there are not sufficient corporate assets to finance a repurchase, there may be sufficient assets to support external borrowings.</li> </ul> </li> <li>▪ <i>Selling shareholder notes.</i> Many agreements call for financing buy-sell agreement transactions through the issuance of corporate notes.             [If this is the funding mechanism decided upon for an agreement, the following table provides an overview of considerations for inclusion in the agreement regarding the structure of shareholder notes. See Figure 6 in Chapter 13.]</li> </ul>	✓	

# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: MULTIPLE APPRAISER OPTIONS</b></p> <p>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 prices. For more information on each multiple appraiser process, see Chapter 16.</p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p style="text-align: center;"><b>Third Appraiser as Reconciler</b></p> <pre> graph TD     TE([Trigger Event]) --&gt; C[Company]     TE --&gt; SS[Selling Shareholder]     C -- selects --&gt; A1[Appraiser 1]     SS -- selects --&gt; A2[Appraiser 2]     A1 --&gt; AP1[Appraisal 1]     A2 --&gt; AP2[Appraisal 2]     AP1 --&gt; D([Within ___%])     AP2 --&gt; D     D -- YES --&gt; P[P = Average]     D -- NO --&gt; A3[Appraiser 3]     A3 --&gt; AP3[Appraisal 3]     AP3 --&gt; PR[PRICE]                     </pre> <p><b>Appraiser 3 is the Reconciler</b></p> <ul style="list-style-type: none"> <li>» Average with other two conclusions (gives credence to outliers)</li> <li>» Average with the closer of Appraisal 1 and Appraisal 2</li> <li>» The conclusions of Appraisal 1 and 2 may establish upper and lower bounds for final price</li> </ul> <p style="font-size: small; text-align: right;">© Mercer Capital 2010 www.buysellagreementsonline.com</p> </div>	<p>___ days to get started</p> <p>___ days to get select</p> <p>___ days to provide draft appraisals</p> <p>___ days to review drafts &amp; finalize</p> <p>___ if appropriate, days to review draft &amp; finalize</p>	

# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: MULTIPLE APPRAISER OPTIONS (Continued)</b></p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p style="text-align: center;"><b>Third Appraiser as Determiner</b></p> <pre> graph TD     TE([Trigger Event]) --&gt; C[Company]     TE --&gt; SS[Selling Shareholder]     C -- selects --&gt; A1[Appraiser 1]     SS -- selects --&gt; A2[Appraiser 2]     A1 --&gt; MA([Mutually Agree])     A2 --&gt; MA     MA --&gt; A3[Appraiser 3]     A3 --&gt; R[ ]     R --&gt; P[PRICE]             </pre> <p style="margin-top: 10px;"><b>Appraiser 3 is the Determiner</b> » The appraisal provided by Appraiser 3 determines the price</p> <p style="font-size: small; text-align: right;">© Mercer Capital 2010 www.buysellagreementsonline.com</p> </div>	✓	

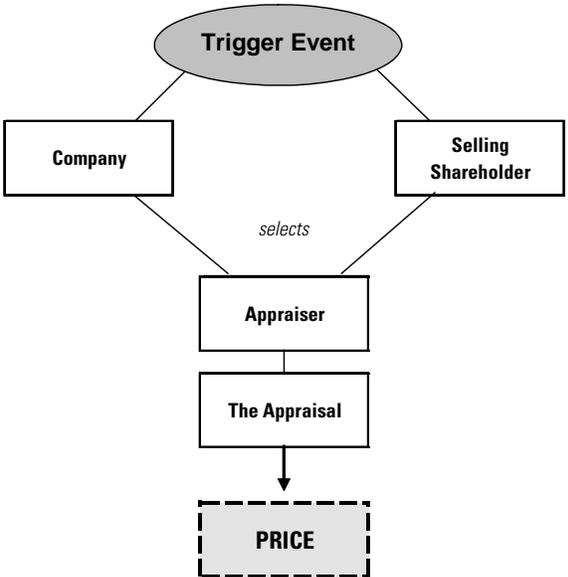
# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: MULTIPLE APPRAISER OPTIONS (Continued)</b></p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p style="text-align: center;"><b>Third Appraiser as Judge</b></p> <pre> graph TD     TE([Trigger Event]) --&gt; C[Company]     TE --&gt; SS[Selling Shareholder]     C -- selects --&gt; A1[Appraiser 1]     SS -- selects --&gt; A2[Appraiser 2]     A1 --&gt; AP1[Appraisal 1]     A2 --&gt; AP2[Appraisal 2]     AP1 --&gt; D([Within ___%])     AP2 --&gt; D     D -- YES P = Average --&gt; A3[Appraiser 3]     D -- NO Appraiser 1 and Appraiser 2 select --&gt; A3     A3 --&gt; P[PRICE]     style P stroke-dasharray: 5 5     </pre> <p style="font-size: small; margin-top: 10px;"> <b>Appraiser 3 is the Judge</b>              » Appraiser 3 selects which of the first two appraisals he or she believes to be more correct/reasonable, and this selection becomes the price         </p> <p style="text-align: right; font-size: x-small; margin-top: 10px;">             © Mercer Capital 2010              www.buysellagreementsonline.com         </p> </div>	✓	

# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: SINGLE APPRAISER OPTIONS</b></p> <p>Single appraiser agreements call for the selection of one appraiser who provides an appraisal for purposes of the agreement – the conclusion of which becomes the price. For more information, see Chapter 17. <u>Single Appraiser, Select Now and Value Now is the recommended process for most closely held and family businesses.</u></p> <div style="border: 1px solid black; padding: 10px; margin: 10px 0;"> <p style="text-align: center;"><b>Single Appraiser Select Now and Value Now</b></p> <pre> graph TD     C[Company] -- selects --&gt; A[Appraiser]     S[Selling Shareholder] -- selects --&gt; A     A --&gt; AP[The Appraisal]     AP --&gt; P1[PRICE]     P1 -.-&gt; PR1[Possible Reappraisal]     PR1 -.-&gt; P2[PRICE]     P2 --&gt; TE([Trigger Event])     TE -.-&gt; PR2[Possible Reappraisal]     PR2 -.-&gt; P3[PRICE]             </pre> <p style="text-align: right; font-size: small;">© Mercer Capital 2010 www.buysellagreementsonline.com</p> </div>	✓	

# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: SINGLE APPRAISER OPTIONS (Continued)</b></p> <div style="border: 1px solid black; padding: 10px; margin: 10px auto; width: 80%; text-align: center;"> <p><b>Single Appraiser Select and Value at Trigger Event</b></p>  <pre> graph TD     TE([Trigger Event]) --- C[Company]     TE --- SS[Selling Shareholder]     C -- selects --&gt; A[Appraiser]     SS -- selects --&gt; A     A --&gt; AP[The Appraisal]     AP --&gt; P[PRICE]             </pre> <p style="font-size: small; margin-top: 10px;">© Mercer Capital 2010 www.buysellagreementsonline.com</p> </div>	✓	

# The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS BUY-SELL AGREEMENTS: SINGLE APPRAISER OPTIONS (Continued)</b></p> <div style="border: 1px solid black; padding: 10px; margin: 10px auto; width: 80%; text-align: center;"> <p><b>Single Appraiser Select Now and Value at Trigger Event</b></p> <pre> graph TD     Company[Company] --- Selects(selects) --- Appraiser[Appraiser]     Shareholder[Selling Shareholder] --- Selects --- Appraiser     Appraiser --&gt; TriggerEvent((Trigger Event))     TriggerEvent --&gt; Appraisal[The Appraisal]     Appraisal --&gt; Price[PRICE]             </pre> <p style="font-size: small; margin-top: 10px;">© Mercer Capital 2010 www.buysellagreementsonline.com</p> </div>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>FINANCIAL STATEMENTS TO BE USED</b></p> <p>Once the “as of” date for the appraisal is selected, the appraisers must decide which financial statements should be used in the appraisal. See the discussion in Chapter 18.</p> <ol style="list-style-type: none"> <li>1. <i>Trailing 12-months ending the fiscal quarter-end immediately prior to the “as of” date.</i> [This choice is fairly common and necessary for companies that do not prepare monthly financial statements in the level of detail available for quarters.]</li> <li>2. <i>Trailing 12-months ending the month-end immediately prior to the “as of” date.</i> [This can also be a good choice, if the quality of the monthly financials is good.]</li> <li>3. <i>If the “as of” date is close to the fiscal year-end.</i> [It may be desirable to agree to use the year-end financial statements, either internally prepared or audited, if available. Waiting for the audit results can delay the valuation process, but the additional clarity and certainty provided by the year-end statements (adjusted for end-of-year adjustments) and/or the audit may offset the inconvenience.]</li> </ol>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>PROCESS TIMETABLES</b></p> <p>Each stage of the appraisal process takes time. Agreement on the basic timelines is a good idea. Note that one or more of the following stages may not be applicable to the process, whether multiple appraiser or single appraiser, that is agreed upon.</p> <ol style="list-style-type: none"> <li>1. <i>Time to get started:</i> ____ days. [Allow some time to get an appraisal process underway. Depending on the trigger event, a relatively shorter or longer start-up may be indicated.]</li> <li>2. <i>Time to select appraiser(s):</i> ____ days. [Particularly for shareholders who may never have been involved with an appraisal process, it can take considerable time to identify, talk with, and to select an appraiser. The company may have more experience, but it can still take time.] <ul style="list-style-type: none"> <li>▪ <i>Independence.</i> [In the event of a multiple appraiser process, it may be a good idea to preclude appraisers who have previously worked for the company, or at least, to require acceptance of such an appraiser by the side not selecting him or her.]</li> </ul> </li> <li>3. <i>Time to prepare appraisals:</i> ____ days. The major steps in an appraisal process are outlined below to help establish an appropriate timeline for your particular process: <ul style="list-style-type: none"> <li>▪ <i>Engagement letter phase.</i> [Once selected, the company (for a single appraiser process) or the company and the shareholder, will need to enter into engagement agreements with the appraiser(s).]</li> <li>▪ <i>Information gathering phase:</i> ____ days. [Each selected appraiser will provide an information checklist to the company. It will take some time for the company to respond to these requests.] <ul style="list-style-type: none"> <li>» <i>Assurance of completeness.</i> [The company should provide all information requested (by either or both appraisers) to both appraisers. It is important that all appraisers have access to the same information base. This rule applies to initial information requests as well as all subsequent questions raised by any appraiser.]</li> </ul> </li> </ul> </li> </ol>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<ul style="list-style-type: none"> <li>▪ <i>Due diligence visits:</i> ____ days. [The appraiser(s) will almost always visit the company. It is a good idea to schedule the visits simultaneously. By following this procedure, you will be assured that both appraisers hear the same information from the same representatives of management. There is the added benefit that neither side can use the visit as a reason for delay.]               <ul style="list-style-type: none"> <li>» <i>Discussions with shareholder or his representatives.</i> [In many cases, a selling shareholder will desire to have the opportunity to talk with the appraiser(s). Consider whether this is desirable for your particular agreement.]</li> <li>» <i>Subsequent questions.</i> [Quite often, appraisers have post-visit questions for management. You may specify that they e-mail a designated management representative with any questions. Management can then respond by e-mail to both appraisers. Note that this procedure keeps pressure on all parties to maintain the momentum of the process.]</li> </ul> </li> <li>▪ <i>Initial Drafting phase:</i> ____ days. [It takes time for the appraiser(s) to draft their reports. 30 days from the date of the visit is a good target time for drafting. This would have to be extended, of course, if management were slow in responding to subsequent questions.]</li> <li>▪ <i>Initial Draft review and finalization phase:</i> ____ days. [You may desire to allow some time, perhaps a week or two, for review of draft reports and for the appraisers to finalize their reports.]</li> <li>▪ <i>Process completion check.</i> [If the two appraisals are within ____% of each other (you pick), then the price for the buy-sell agreement might be the average of the two appraisals. If the two conclusions are apart by more than ____% (you pick), the second phase of the process will begin.]</li> <li>▪ <i>Specifying the base for calculating the desired percentage of difference.</i> [To avoid confusion, specify one or the other of the two appraisals, perhaps the lower of the two, as the base to determine whether the percentage difference test is met.]</li> </ul>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>4. <i>Time to select the third appraiser:</i> _____ days. [It will take some time for the first two appraisers to identify and agree upon the selection of the third appraiser.]</p> <ul style="list-style-type: none"> <li>▪ <i>Specify what happens if the first two appraisers cannot agree on the third appraiser.</i> [If agreement cannot be reached, there has to be a mechanism for resolving the selection. One possibility would be to name a specific person or institution (like a bank trust department) in the agreement that would, in this event, be called upon to name the third appraiser. An arbitrator could also be selected at this point for the sole purpose of identifying and naming the third (neutral) appraiser.]</li> <li>▪ <i>Specify whether the third appraiser will have access to the appraisal reports prepared by the first two appraisers as well as to the appraisers themselves</i> (preferably together).</li> </ul> <p>5. <i>Time to prepare the third appraisal:</i> _____ days. [The third appraiser must go through his processes, including data gathering, visiting with management, and drafting the report.]</p> <ul style="list-style-type: none"> <li>▪ The agreement should specify whether the third appraiser is to provide a draft report for review by the parties or whether the report should be issued in final form, without review by the parties.</li> <li>▪ The third appraisal should at this point be definitive of value, depending on the agreement of the parties: <ul style="list-style-type: none"> <li>» Average of the third appraisal with the closest of the first two appraisals, or</li> <li>» Average of the third appraisal with both of the first two appraisals, or</li> <li>» Setting the first two appraisals as the upper and lower bound for the final price, or</li> <li>» The third appraisal's conclusion determines the price, or</li> <li>» Other, as the parties agree.</li> </ul> </li> </ul>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>WHO BEARS THE COST OF THE APPRAISAL(S)?</b></p> <p>1. <i>Company pays for appraisals.</i> [The parties can agree that the company will pay for the cost of all appraisals in the process.]</p> <ul style="list-style-type: none"> <li>▪ <i>Agreed upon budgets.</i> [The company and the selling shareholder should have similar budgets for the appraisal process.]</li> </ul> <p>2. <i>Parties pay their own respective appraisal costs.</i> [Some agreements call for the company to retain and pay for its appraiser and for the selling shareholder to retain and pay for its appraiser. If a third appraisal is required, those agreements often call for its cost to be shared by the parties. For reasons discussed in Chapter 15, this may not be reasonable for selling shareholders, particularly those with relatively small (in dollar value) positions.]</p> <ul style="list-style-type: none"> <li>▪ <i>Transaction costs.</i> [When the company is ultimately sold, there will be transaction costs, including some or all of the following: legal fees, accounting fees, consulting fees, and investment banking or brokerage fees.]</li> <li>▪ <i>Transaction fee.</i> [The parties could agree on a transaction fee of ___% of the value based on the conclusion of the appraisal process for the interest under consideration. This would represent a transaction fee that places all shareholders who sell on the same fee-adjusted basis.]</li> <li>▪ <i>Legal fees.</i> [The agreement should specify who pays legal or other professional fees in the event that there is litigation during the appraisal process.]</li> </ul>	✓	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p>3. <i>What rights does the triggering of the buy-sell agreement create?</i> [When the buy-sell agreement is triggered, an appraisal process is set into motion (for process agreements). Many buy-sell agreements consider that the selling shareholder owns stock until it is purchased. It is possible for the shares to be converted into a right to receive the value determined by the appraisal process.]</p> <ul style="list-style-type: none"> <li>▪ <i>Continuing ownership interest.</i> [There are a number of potential issues for consideration if the shares represent a continuing interest in the company.]</li> <li>▪ <i>Interest.</i> [The parties should agree on whether the value of the shares will bear interest from the trigger date until the price is determined. If interest is to be paid, the interest rate should be determined or defined in relationship to a known index rate.]</li> <li>▪ <i>Vote.</i> Are the shares entitled to vote following the trigger event, but prior to their purchase?</li> <li>▪ <i>Dividends of distributions.</i> Is the company bound to maintain its historical distribution policies between the trigger date and final resolution?</li> <li>▪ <i>Tax pass-through payments.</i> Is the company required to make an additional payment upon purchase of the shares to account for the shares' pro rata portion of applicable state and federal income taxes accruing from the trigger event until the purchase?</li> <li>▪ <i>Right to receive value as of the "as of" date.</i> [If the shares turn into a right to receive value, the shareholder would, in effect, cease to be a shareholder upon the occurrence of a trigger event. This would be analogous to the rights of a dissenting shareholder who perfects the right to dissent to a corporate transaction giving rise to the right to dissent.] <ul style="list-style-type: none"> <li>» <i>Interest.</i> [If the shares convert to a right to receive value, interest should, in all likelihood, be paid between the "as of" date and the end of the appraisal process. If interest is to be paid, the interest rate should be determined or defined in relationship to a known index rate.]</li> </ul> </li> </ul>	<p>✓</p>	

## The Buy-Sell Agreement Audit Checklist

ITEMS TO CONSIDER WHEN DRAFTING OR REVIEWING A BUY-SELL AGREEMENT	✓	COMMENTS
<p><b>TAX PASS-THROUGH ENTITY APPRAISAL ISSUES</b></p> <p>There are a number of issues related to the treatment of S corporations in the valuation process. Many appraisers consider S corporations and other tax pass-through entities to be C corporation equivalent in value <i>at the enterprise level of equity</i>. Others believe that it is appropriate to consider a “premium” in value related to the “additional value” of an S corporation relative to a C corporation.</p> <ol style="list-style-type: none"> <li>1. <i>Have an appraiser explain the various positions to you.</i> [If all the parties are not familiar with the various arguments related to S corporation valuation, have a qualified appraiser explain the differences to you.]</li> <li>2. <i>State the preferred valuation method for the agreement.</i> [Based on the appraiser’s explanations, the parties should decide, for purposes of the agreement, how the issue of S corporation status (or other pass-through entity) should be treated for purposes of valuation.] <ul style="list-style-type: none"> <li>▪ <i>As-if-C corporation.</i> [The tax pass-through entity is to be valued as if it were a C corporation at the enterprise level (whether marketable minority, financial control, or strategic control is the desired level of value).]</li> <li>▪ <i>S corporation benefits.</i> [The tax pass-through entity is to be valued in such a way to provide a valuation premium for the future benefit of expected total tax savings from being a tax pass-through entity.]</li> </ul> </li> </ol>	✓	

## Basic Considerations for Shareholder Notes in Buy-Sell Agreements

Potential Areas for Agreement	Comment	Company Perspectives	Selling Shareholder Perspectives
<b>Term of Note</b>	Typical terms range from two years on the low side to as many as ten years.	Longer terms tend to be preferable to assure flexibility and ability to pay with least impact on the business.	Shorter terms tend to be preferable in order to complete transaction and eliminate credit exposure to the company.
<b>Form of Note</b>	The form of the note can range from interest-only, to amortizing over the term with equal payments, to equal payments of principal each year (or quarter or month), together with interest.	Interest-only provides the most flexibility to companies and defers payment as long as possible.	Amortizing notes - equal stream of payments  Equal payments of principal each period - declining stream of payments  Interest-only is riskiest and defers payment of principal to maturity.  If credit exposure is not an issue, longer deferral of principal payments extends payment of capital gains with installment sale treatment of the note.
<b>Down Payment</b>	The down payment can range from nothing down, to a set percentage of the total price at closing, to requiring that the first payment of an amortizing note be paid at closing.	Low down payments provide the greatest flexibility to companies.	Larger down payments provide current liquidity for selling shareholders and minimize future risk of credit exposure to the company.
<b>Payment Schedule</b>	Payment schedules can range from monthly to quarterly to annually.	Monthly payments are generally considered to be too frequent by most companies. Annual payments provide the greatest flexibility.	Sellers often prefer monthly payments for predictability, but will often agree on quarterly payments.
<b>Interest Rate: Level</b>	The interest rate on the loan is an important element and requires careful consideration. The manner in which the interest rate is set should be clearly stated in terms that will be clear in the future.	Companies tend to desire a relatively low interest rate to minimize cash flow requirements.	Sellers need to have a reasonable (market) rate to assure a risk-adjusted return on the note while awaiting repayment of principal.  Below market rates reduce the present value of the purchase price.
<b>Interest Rate: Floating or Fixed</b>	Depends on company and shareholder tolerance to interest rate exposure during term of notes. With a floating rate and a regular amortization, the amortization schedule must be recalculated as rates change. If the rate is based on the <i>Wall Street Journal</i> prime rate as of, say, the trigger date, the agreement must be clear if the rate is fixed at that level or repriced periodically. Unclear language creates big problems.	Many companies will tend to desire to fix the interest rate to eliminate exposure to rising rates over the term of notes.	Sellers need to consider the risk of interest rate exposure with floating rates relative to the consistency assured by fixed rate notes.

## Basic Considerations for Shareholder Notes in Buy-Sell Agreements

Potential Areas for Agreement	Comment	Company Perspectives	Selling Shareholder Perspectives
<b>Priority in Company's Capital Structure</b>	Must specify position in capital structure. If this element is not specified, it will likely assure that shareholder notes are effectively subordinated debt, i.e., subordinated to all other lenders and other creditors.	Companies tend to want notes to be unsecured and at the bottom of the capital structure. A shareholder note without other protections or security is favorable financing and tantamount to subordinated debt.	Many agreements give no thought of subordination to other creditors. If a seller note is effectively subordinated to all other creditors, then the interest rate should reflect its relative risk in relationship to other borrowings. The effect of an inadequate interest rate relative to risk is to devalue the note relative to its par value. Sellers may desire that future incremental financings be subordinated to their notes or else company will need to pre-pay.
<b>Security</b>	The question for consideration is whether the shareholder note will be secured in any fashion by the general assets of the company, by specific assets owned by the company, or by stock in the company.	Companies tend to prefer that shareholder notes not be secured. Having them unsecured provides maximum flexibility for future financings.	Sellers will want to have security for their notes. At the very least, the shares that have been sold can be the security. Since remaining shareholders benefit from the company's purchase of shares under the agreement, a portion of their shares could be held as collateral. Certainly, shareholders desire to be assured that future financings of the company will be subordinated to their debt.
<b>Prepayment: Right or Obligation</b>	Prepayment can be an issue under a number of circumstances and is one that should be covered in buy-sell agreements.	A company may desire the right to prepay a note to assure flexibility regarding cash flow and future financings. Companies prefer that there be no prepayment penalty.	Prepayment can be beneficial to sellers in that they achieve liquidity earlier than planned. However, if the prepayment terminates a note with an attractive interest rate (relatively high) and the rate cannot be replaced in the markets, prepayment may be unfavorable. Sellers will want mandatory prepayment if the company is sold or engages in a substantial recapitalization that could jeopardize a note's creditworthiness.
<b>Events of Default / Rights of Holder / Ability of Company to Cure</b>	Surprisingly, many buy-sell agreements do not discuss events of default regarding shareholder notes at all.	If events of default, such as the failure to make a payment, are considered, the company will want the right to cure the default within a short period of time.	In the event of default not timely cured, sellers may want the ability to accelerate the note such that it is due in full.
<b>Other Terms per Counsel</b>	As recommended and agreed to by owners and the company.		

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## **BUY-SELL AGREEMENTS**

for Closely Held and Family Business Owners

Z. Christopher Mercer, ASA, CFA, ABAR

Foreword by Tom Deans, Ph.D.  
Author of *Every Family's Business*

# **BUY-SELL AGREEMENTS**

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by **Z. Christopher Mercer, ASA, CFA, ABAR**

Buy-sell agreements are among the most common yet least understood business agreements, and many are destined to fail to operate like the owners expect. Many, in fact, are ticking time bombs, just waiting for a trigger event to explode. If you are a business owner or are an advisor to business owners, this book is designed to provide a roadmap for business owners to develop or improve your buy-sell agreement.

### **ABOUT THE AUTHOR**

Chris Mercer is a nationally known business valuation expert, writer, and speaker. As an acknowledged expert in his field, Chris has occupied a front-row seat in courtrooms and boardrooms in buy-sell agreement disputes. This unique vantage point informs his understanding of buy-sell agreements and how they should work from business and valuation perspectives.

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