

# I Don't Buy It

---

## The Effect of Buy-Sell Agreements in Divorce

**Z. Christopher Mercer, FASA, CFA, ABAR**

MERCER CAPITAL

901.685.2120 | [mercerc@mercercapital.com](mailto:mercerc@mercercapital.com)

[www.MercerCapital.com](http://www.MercerCapital.com)

[www.ChrisMercer.net](http://www.ChrisMercer.net)

2016 AICPA/AAML National Conference on Divorce

May 20, 2016

# What are the basics of buy-sell agreements that impact a company's valuation for divorce?



# Comments from Participants About Buy-Sell Agreements

*Thank you Miles Mason*

*Thank you Barry Sziklay*

What the heck is a  
buy-sell agreement, anyhow?

# And What Are They Supposed to Do?

- Require agreement at a point in time
- Relate to transactions that will or may occur at future points in time
- Define the conditions that “trigger” the buy-sell provision
- Determine the price(s) and terms 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?**

# What is the Purpose of a Divorce “Trigger” in a Buy-Sell Agreement?

- **Protect the Company in the event an owner is divorced**
- **Protect the other owners in the event an owner is divorced**
- **Prevent shares from being distributed to the non-owner spouse in an equitable distribution**
  - Provides for the right of the Company the other owners to purchase the shares prior to their being distributed to the non-owner spouse
  - Should provide the price available to the divorcing owner in the event that some or all of the divorcing owner’s shares must be sold to satisfy the divorce

*Story*

# Three Questions to Ask

**Does your client have a buy-sell agreement?**

If so, what type of agreement is it?

**Do you know what the buy-sell agreement says?**

There are six defining elements that must be in every process agreement if you want the valuation process and, therefore, the agreement, to work

**How is the buy-sell agreement funded?**

How life insurance proceeds are treated can make a big difference in the valuation of the company



# How Do Buy-Sell Agreements Come Into Existence?

## POTENTIAL OPPOSING SHAREHOLDER CHARACTERISTICS THAT MAKE DISCUSSING BUY-SELL AGREEMENTS DIFFICULT

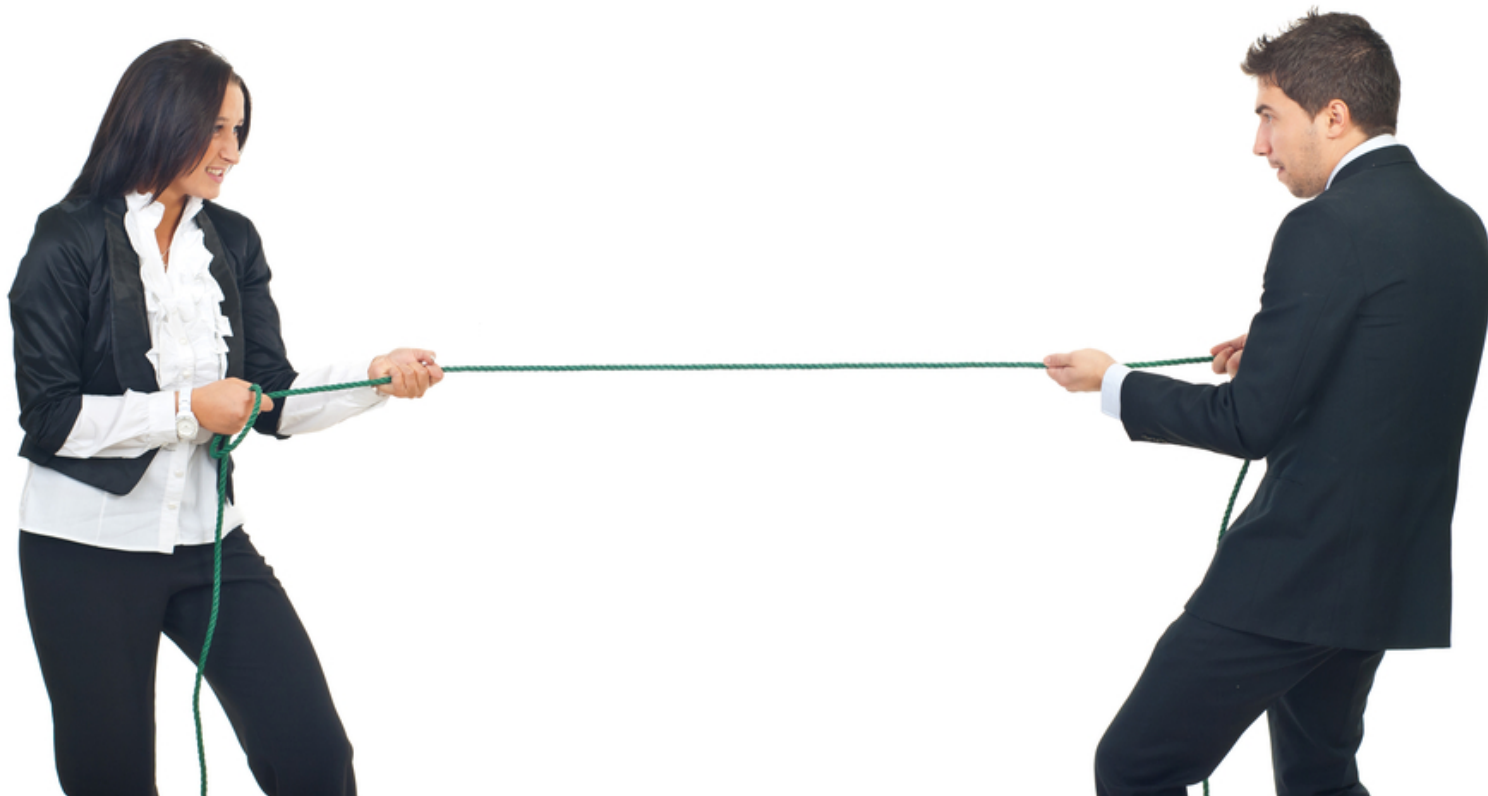
Characteristic	Shareholder 1	Shareholder 2
Age	Younger	Older
Ownership	Noncontrolling	Controlling
Involvement	Active	Inactive
Personal Outlook	Optimistic	Pessimistic
Investment Type	Sweat Equity	Real Money
Investment Amount	Smaller	Larger to Much Larger
Personal Guaranties	None	Substantial

*Not easy, but necessary*

**My Advice to Business Owners:  
Get Agreement. Now.**

**Just Do It**

## What Happens if There is a Trigger Event and There is Not a Good Buy-Sell Agreement in Place?



# Types of Buy-Sell Agreements

## ■ Based on how price is determined

- Cross-purchase agreements
- 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***

# 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

# Fixed-Price Agreements

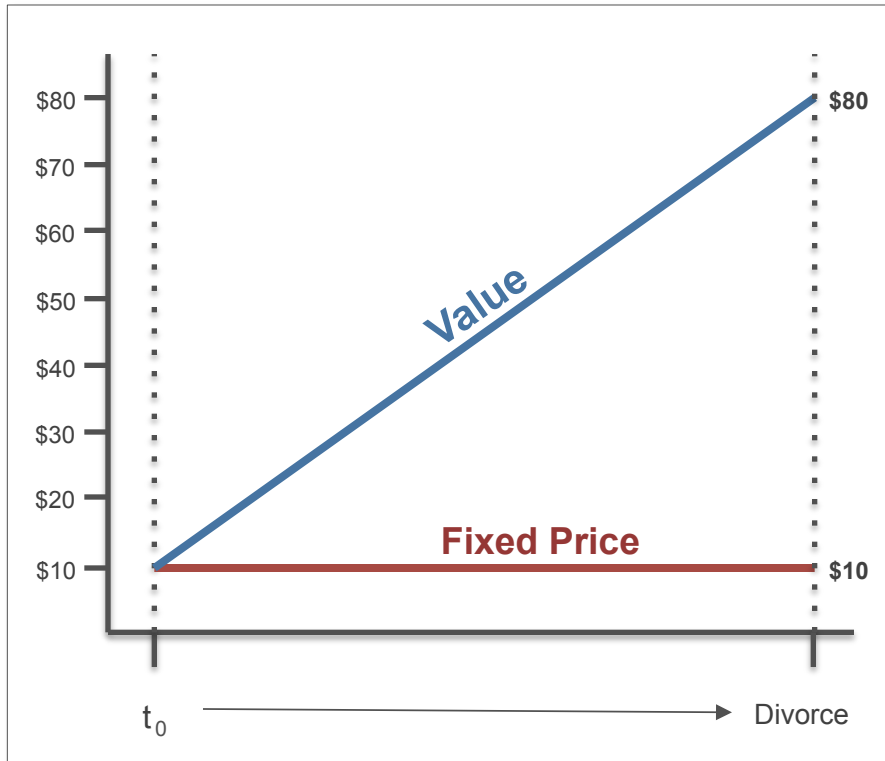


Chart 1

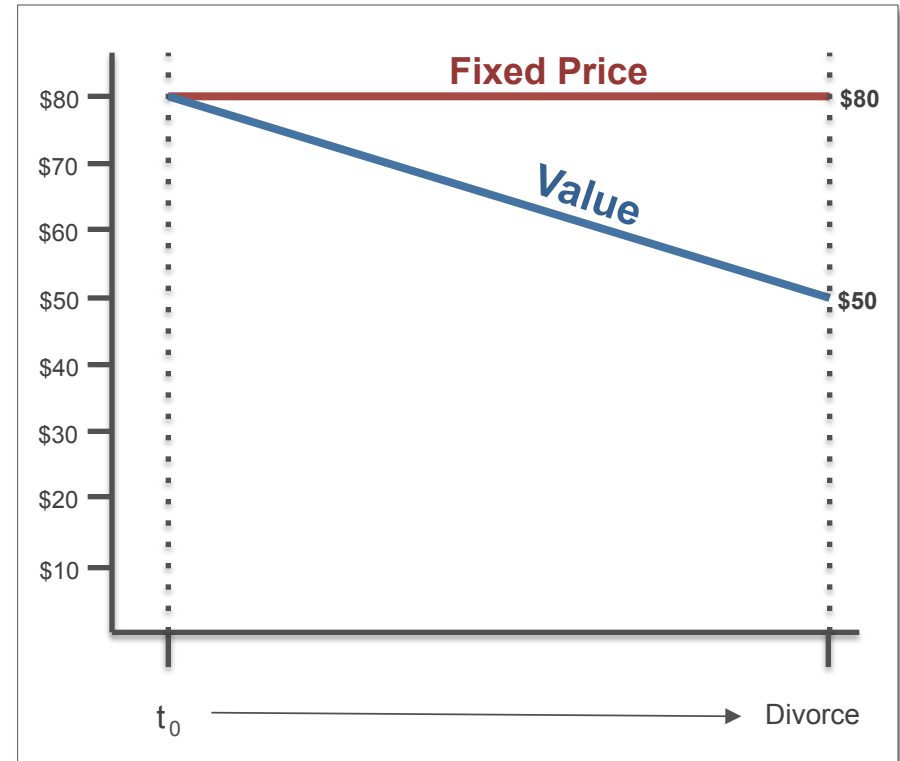


Chart 2

*Story*

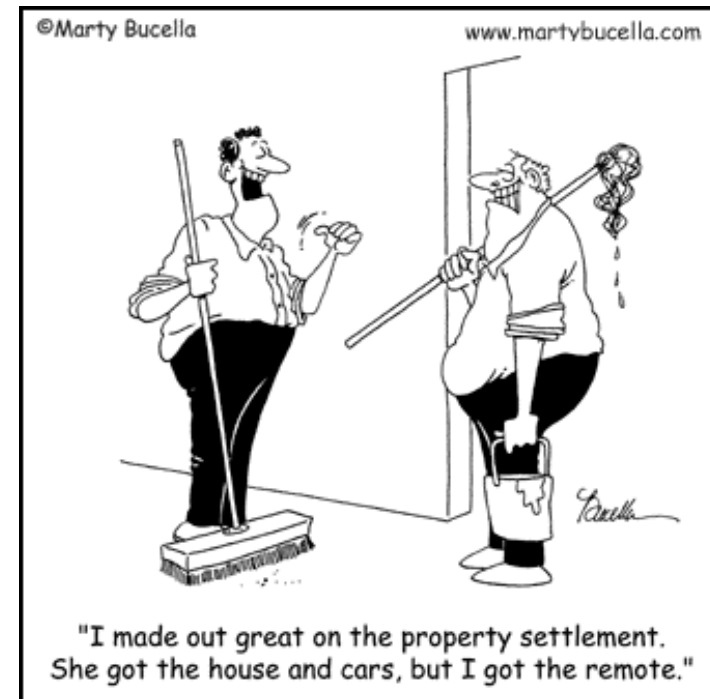
**Is a fixed price in a buy-sell agreement binding in the event of a divorce such that it sets the price at which a divorcing owner's shares might be purchased?**



**"My divorce didn't turn out so good.  
I got custody of my lawyer's teenage children."**



Is that fixed price  
binding for  
establishing the (fair  
market or other) value  
of a divorcing owner's  
shares in the event  
there is no need to sell  
them for equitable  
distribution purposes?



# 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.***

# 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**

In the real world, how often do non-owner spouses sign buy-sell agreements?



**"Hey, we're not talking divorce.  
We're talking leveraged buyout."**

# Process Buy-Sell Agreements

## DESCRIPTION

- The owners agree 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***

# 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:

**UNDERSTANDABLE**

**PREDICTABLE**

**LIKELY TO ACHIEVE  
REASONABLE RESOLUTIONS**

**HELPFUL IN THE WEALTH  
MANAGEMENT PROCESS**

**(and in Divorce)**

# 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**

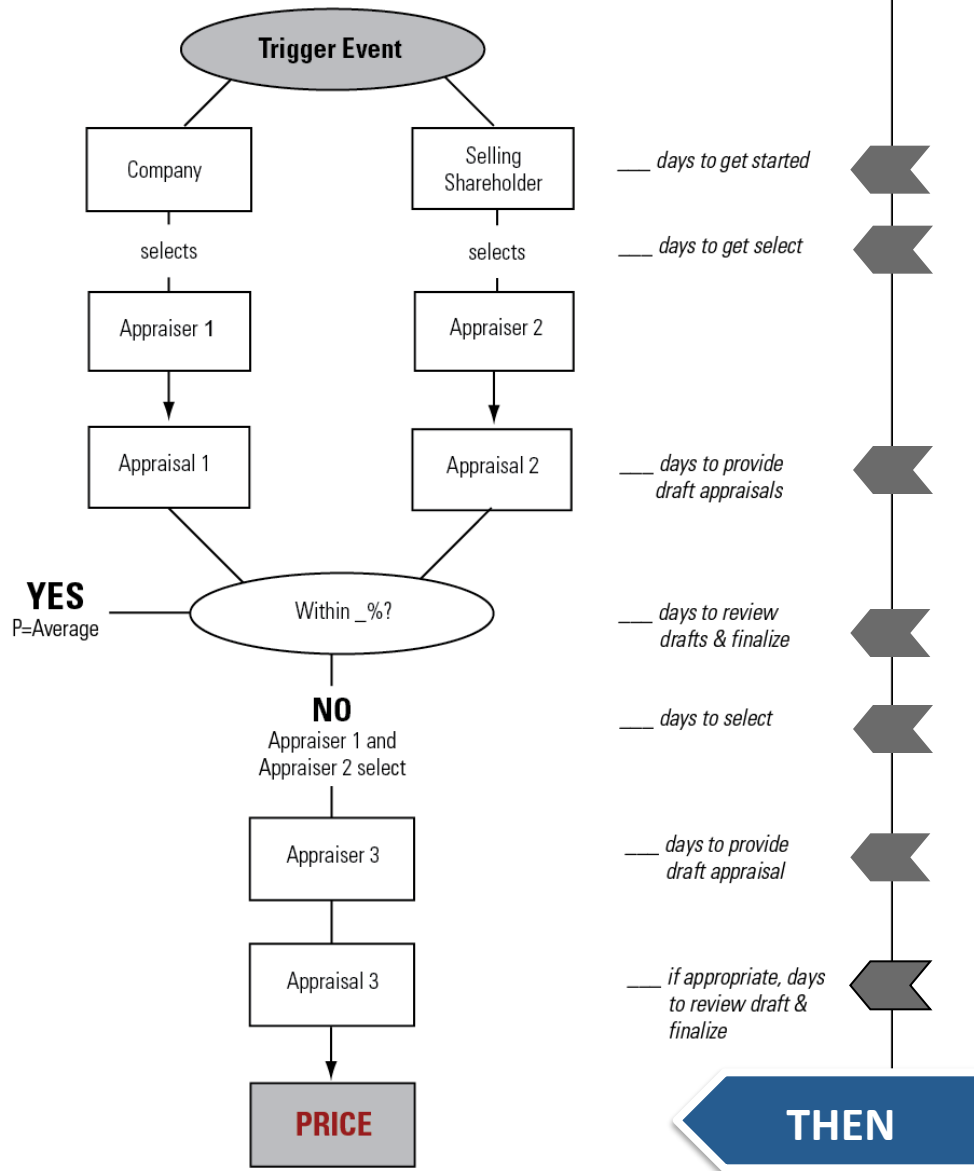
THIRD APPRAISER AS **JUDGE**

THIRD APPRAISER AS **DETERMINER**

THIRD APPRAISER AS **MEDIATOR**



## MULTIPLE APPRAISER PROCESS AGREEMENTS



# Multiple Appraiser Agreements

## Third Appraiser as Reconciler

**Why don't I like  
multiple appraiser  
buy-sell  
agreements?**

**Let me  
count the  
ways!**

# Multiple Appraiser Agreements

DISADVANTAGES		MULTIPLE APPRAISERS
1.	Price not determined now	X
2.	Potential for dissatisfaction with the process for all parties	X
3.	Danger of advocacy	X
4.	Uncertainty over what will happen when a trigger event occurs	X
5.	Uncertainty over final price if the process is invoked	X
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	X
7.	Expensive	X
8.	Time-consuming	X
9.	Distracting for management	X
10.	Potentially devastating for affected shareholders and their families	X

# What Can Happen if Divorce is a Triggering Event for a Minority Interest Owner?

## ■ If the valuation process calls for a multiple appraiser process:

- Company retains an appraiser
- Divorcing owner retains an appraiser (time, angst, expense)
- Maybe a third appraiser is called for if the initial two are far apart
- The divorcing owner and the Company are in conflict
- The divorcing spouse and his/her spouse are in conflict

**The judge will be enormously confused!**

For businesses with less than \$10 million in annual revenue, how typical/frequent are there buy-sell agreements?

Is the answer different for businesses with more than \$10 million in annual revenue?



*"I understand it's a Category 5 divorce."*

# 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**

# **My Key Recommendation (before divorce)**

## **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.



Describe the “Big A..  
Problem” buy-sell  
agreements can solve  
in divorce?



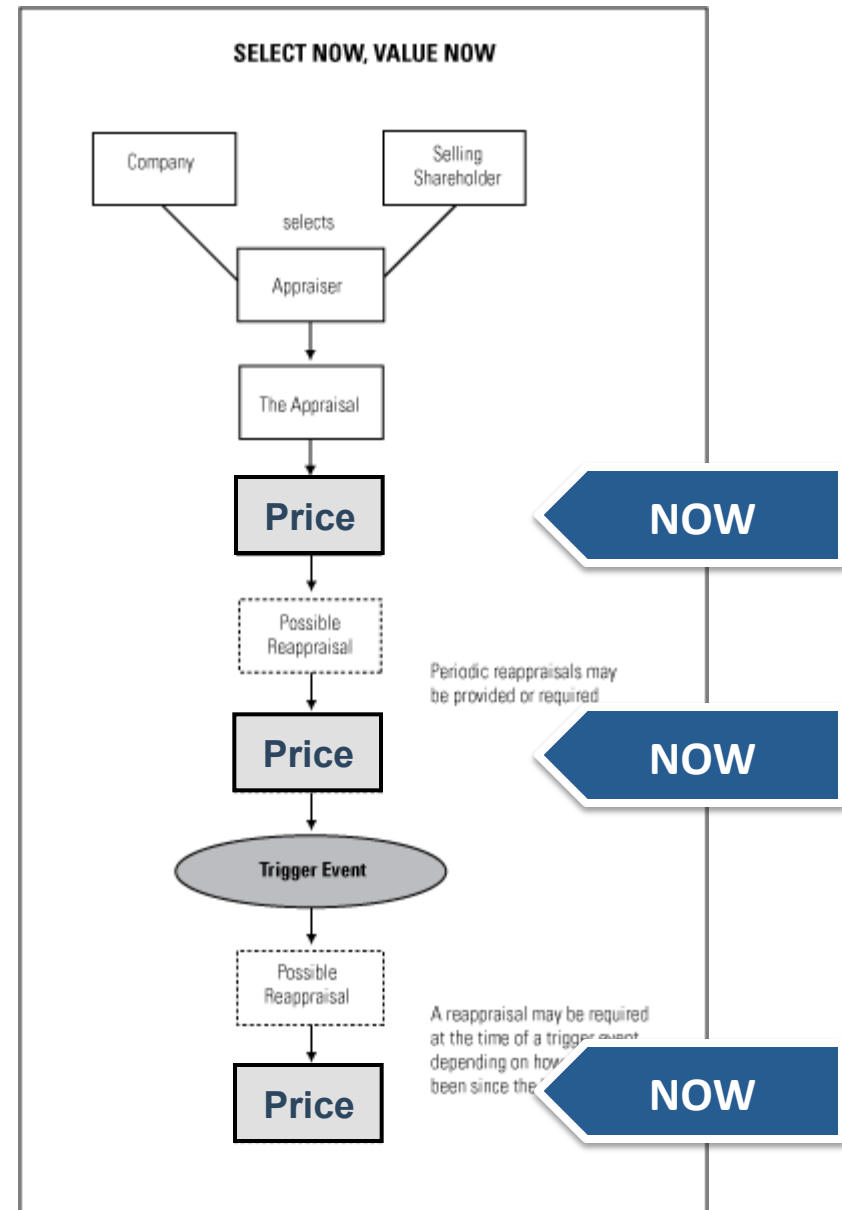
*"Just another of our many disagreements. He wants a no-fault divorce, whereas I would prefer to have the bastard crucified."*

CN  
COLLECTION

## RECOMMENDATION

# Single Appraiser Agreement Select Now, Value Now

Story



# 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

*Manage Expectations*

# Multiple Appraiser vs. Single Appraiser, Select Now and Value Now

DISADVANTAGES		MULTIPLE APPRAISER	SINGLE APPRAISER Select Now and Value Now
1.	Price not determined now	x	
2.	Potential for dissatisfaction with the process for all parties	x	Minimized
3.	Danger of advocacy	x	Minimized
4.	Uncertainty over what will happen when a trigger event occurs	x	Minimized
5.	Uncertainty over final price if the process is invoked	x	Minimized
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	x	Minimized
7.	Expensive	x	
8.	Time-consuming	x	
9.	Distracting for management	x	
10.	Potentially devastating for affected shareholders and their families	x	

# Single-Appraiser Process in Divorce

- If the selected appraiser values for purposes of divorce, the appraisal should have credibility with the Court
- If divorce is not a trigger event, the Company could allow the divorcing couple to jointly retain the selected appraiser
- Difficult for non-owner spouse's counsel to bring in a shill appraiser to advocate an unreasonable value if there is an ongoing valuation process in place at a company

Why might having your client's company put a single appraiser valuation process in place be a good idea for purposes of its buy-sell agreement?



*"For a divorce case, that went smoothly."*

# IRC Section §2704

- IRS is about to issue new IRC Section 2704 regulations which will impact the provisions of LLC operating agreements and partnership agreements
- This upcoming guidance could materially affect valuation discounts associated with partnership and LLC operating agreements
- That, in turn, would require that buy-sell agreements for those entities be reviewed to avoid ending up with an unexpected tax bill



**The Six  
Defining Elements  
of Process  
Buy-Sell  
Agreements  
Are Agreed to by  
the Owners**

**Standard of Value**

---

**Level of Value**

---

**The “As Of” Date**

---

**Qualifications of Appraisers**

---

**Appraisal Standards**

---

**Funding Mechanism**

# Defining Element #1: Standard of Value

## ■ Normally fair market value

- Willing buyer, willing seller
- Arm's length standard – most often found in buy-sell agreements
- ....but buyers of what?

## ■ Fair value

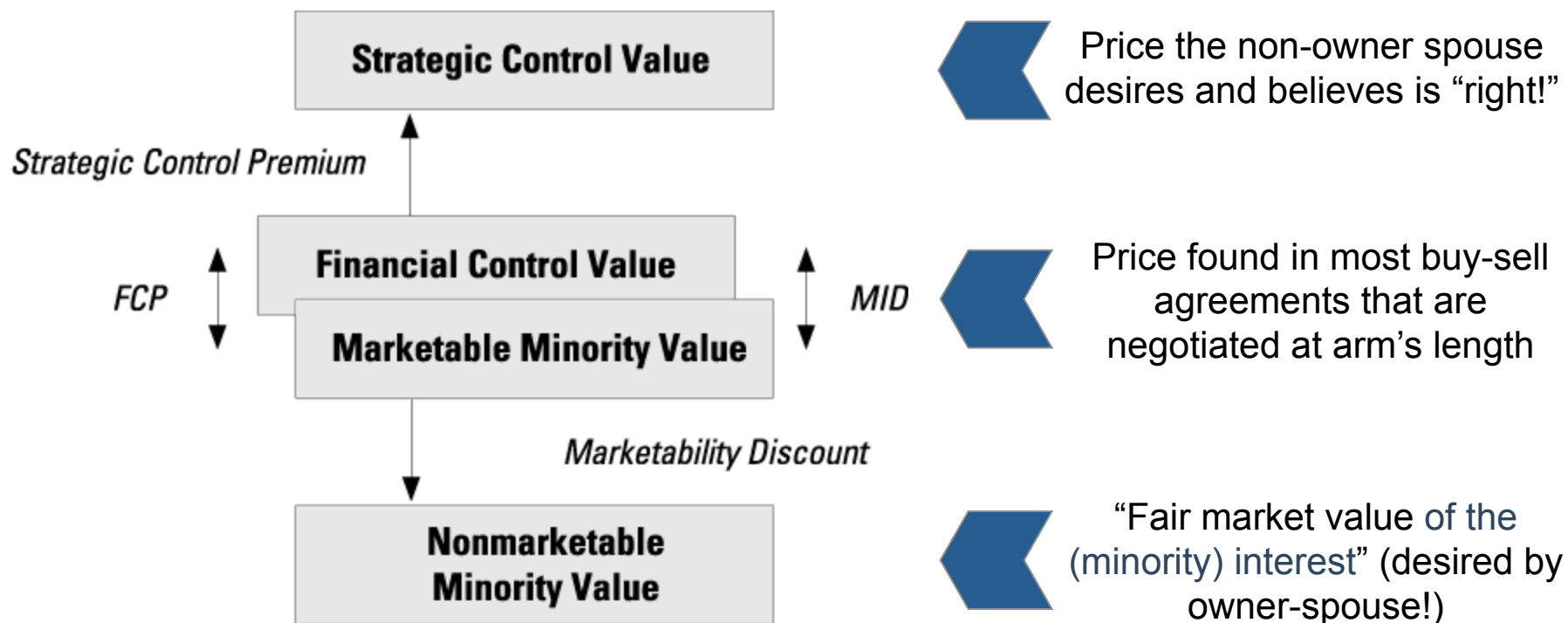
- Defined under state law
- A defined term, of sorts, under accounting rules

## ■ Investment value

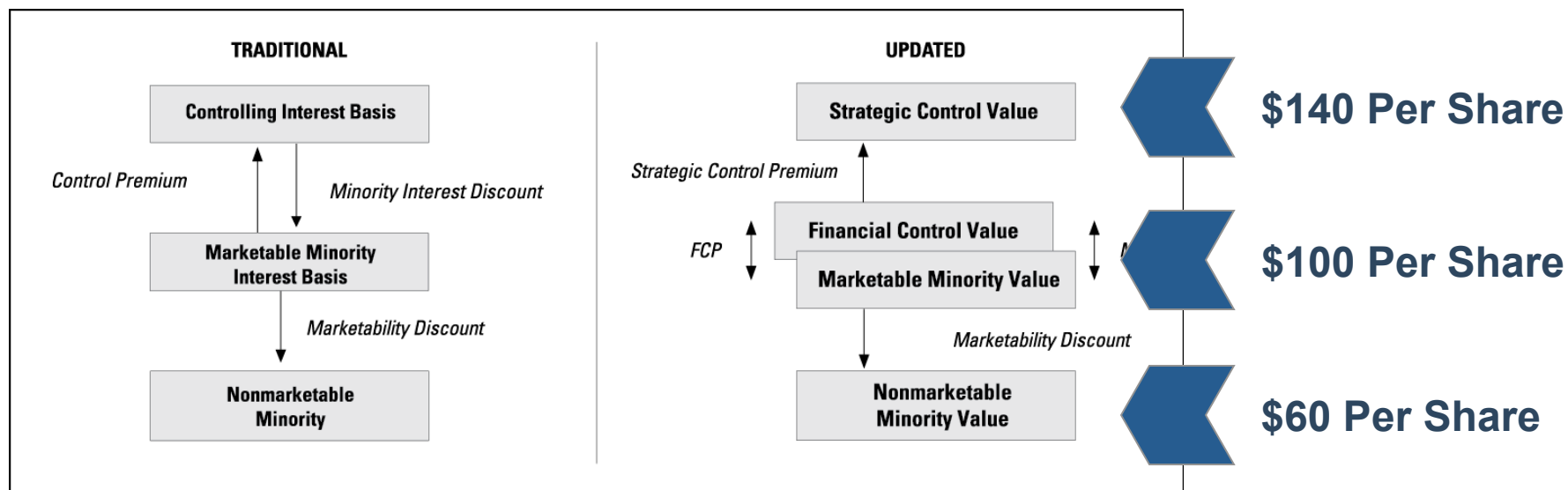
- From the perspective of whom?

## ■ “The Value,” “Going Concern Value,” and on and on and on...

# Defining Element #2: Level of Value



# Defining Element #2: Level of Value



*What is a judge to do?*

*Story*

# 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

## ■ The “as of” date can make a difference

- Date of marriage
- Date(s) owner-spouse received gifts of stock from parents
  - Buy-sell agreement likely won’t help here
- Date of separation
- Date of divorce trial

## ■ The buy-sell agreement could be binding if there is a current valuation in place at the time of separation or trial

# Defining Element #4: Qualifications of Appraisers

## INDIVIDUAL

- Education
- Valuation training
- Appraisal experience
- Industry experience
- Continuing education
- Publishing
- Credentials

## FIRM

- Size
- Longevity
- Specialization

Describe the business owner who really needs a buy-sell agreement as part of divorce planning but doesn't have one?

What are his/her demographics?

How is the best way to sell a client on paying for a buy/sell agreement?

What are we talking about in terms of cost?



*"Frankly, we didn't think we had another divorce left in us."*

# 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**
- **Institute of Business Appraisers Business Valuation Standards and Rules of Professional Conduct**
- **NACVA Professional Standards**
- **CFA Institute Code of Ethics & Standards of Professional Conduct**

***What happens when one or both appraisers have no standards?***



# How is Your Client's Company's Buy-Sell Agreement Funded?

**Learning about this may provide insight  
into the value placed on the company and its interests by the owners**

# 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**

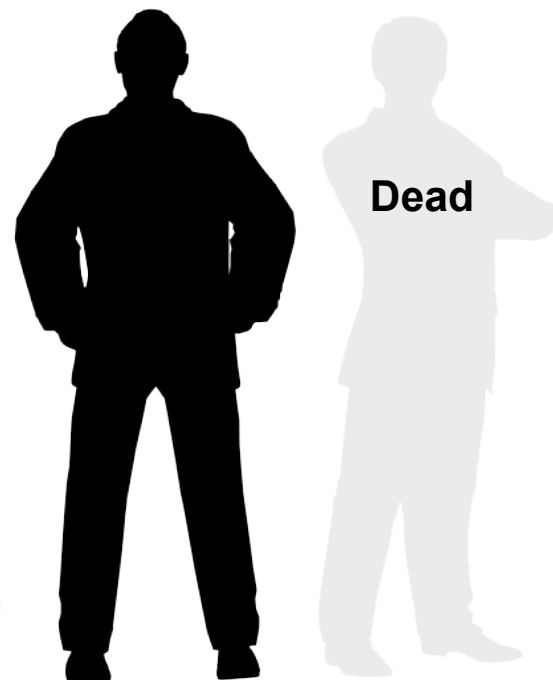
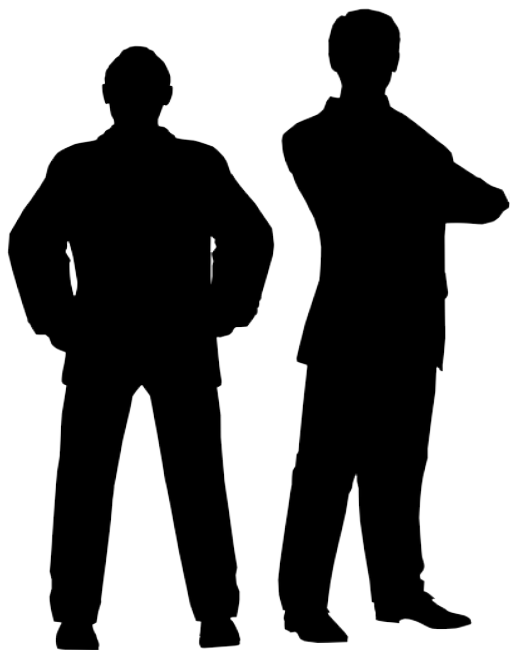
---

or

---

**Corporate Asset**

# True Story: Life Insurance



**What Happens Now?**

# What about Life Insurance Treatment for Valuation Purposes?

		Harry (Estate)	Sam
<b>Proceeds are a Funding Vehicle</b>	<b>Company</b>		
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre and Post Life Insurance Value (\$m)	<b>\$10,000.0</b>	<b>\$5,000.0</b>	<b>\$5,000.0</b>
4 Life Insurance Proceeds	\$6,000.0		
5 Repurchase Liability	(\$5,000.0)		
6 Post-Life-Insurance Value	<b>\$11,000.0</b>		
7 Repurchase Stock	(\$5,000.0)	\$5,000.0	
8 Retire / Give Up Stock	(50.0)	(50.0)	
9 Remaining Stock	50.0	0.0	50.0
10 New Stock Ownership (%)	100.0%	0.0%	100.0%
11 Post-Life Insurance Value of Co.	\$11,000.0	\$0.0	<b>\$11,000.0</b>
12 Post Life Insurance Proceeds		<b>\$5,000.0</b>	
13 Net Change in Value from Repurchase	<b>\$1,000.0</b>		

# What about Life Insurance Treatment for Valuation Purposes?

	Company	Harry (Estate)	Sam
<b>Proceeds are a Corporate Asset</b>			
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre-Life Insurance Value (\$m)	<b>\$10,000.0</b>	<b>\$5,000.0</b>	<b>\$5,000.0</b>
4 Life Insurance Proceeds (\$m)	\$6,000.0	\$3,000.0	\$3,000.0
5 Post-Life Insurance Value (\$m)	\$16,000.0	<b>\$8,000.0</b>	\$8,000.0
6 Repurchase Liability	(\$8,000.0)		
7 Post-Life-Insurance Value	<b>\$8,000.0</b>		
8 Repurchase Stock	(\$8,000.0)	\$8,000.0	
9 Retire / Give Up Stock	(50.0)	(50.0)	
10 Remaining Stock	50.0	0.0	50.0
11 New Stock Ownership (%)	100.0%	0.0%	100.0%
12 Post-Life Insurance Value of Co.	\$8,000.0	\$0.0	<b>\$8,000.0</b>
13 Post Life Insurance Proceeds		<b>\$8,000.0</b>	
14 Net Change in Value from Repurchase	<b>(\$2,000.0)</b>		

Assume a spouse seeking divorce planning/asset protection services should be considering a buy-sell agreement, to whom should we be referring this type of work?

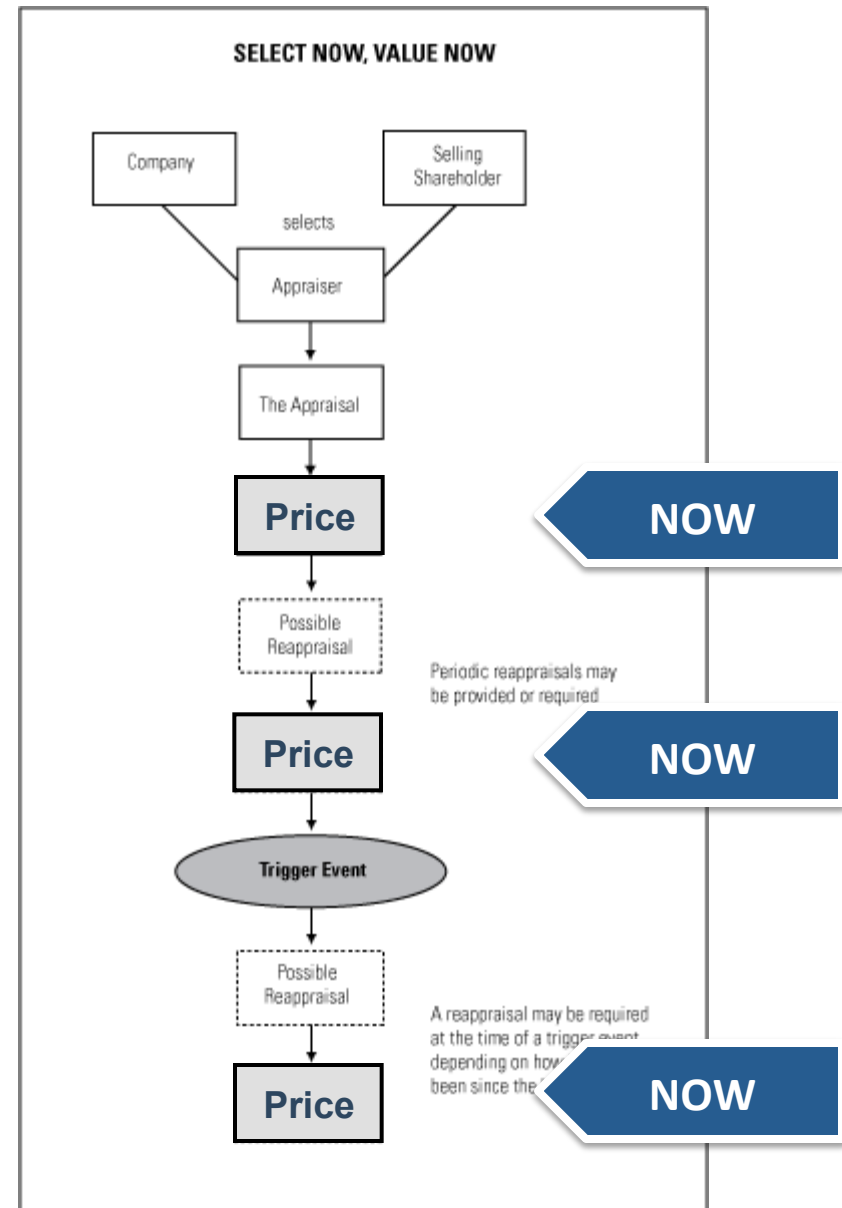


*"Dear, I'd like to roll our marriage over into an amicable divorce."*

## RECOMMENDATION

# Single Appraiser Agreement Select Now, Value Now

Don't forget this idea if you have an opportunity to influence a client to create or to modify a buy-sell agreement



# So your client's company (or the spouse's company) has a buy-sell agreement. What should you do?

- Obtain a copy
- Read it (or have a colleague read it) with my comments in mind
- Get a qualified business appraiser to read it as well addressing what it says
  - From a valuation perspective
  - From a business perspective



# Review Tools

Receive a complimentary copy of Mercer Capital's *Buy-Sell Agreement Review Checklist* by subscribing to my blog.

If you subscribe within the next two weeks, you will receive a complimentary copy of the e-book *Buy-Sell Agreements for Closely Held and Family Business Owners*



**Chris Mercer**  
Useful Business Valuation Information & Insights for Attorneys

---

FRIDAY, MAY 13, 2016

**10 Ideas for Attorneys to Help Unlock Their Clients' Private Company Wealth**

Comment 5 Tweet Share 12



I was in Boston to speak at the 2016 Spring Symposium for the American Bar Association Section of Real Property, Trust and Estate Law where I had the pleasure as a non-lawyer to share a session with Edward F. Koren, JD, leader of the Private Wealth Services Group of Holland & Knight. Our session title was "Unlocking Private Company Wealth: Give me Liberty (and Plenty of Cash)". The session was based on my book, *Unlocking Private Company Wealth*, and our joint experiences over many years. This post provides some of the concepts we shared in the presentation.

Categories: Management & Ownership Transition, Private Wealth Management [Continue reading »](#)

---

THURSDAY, MAY 5, 2016

**What Matters Most for RIA Buy-Sell Agreements? In Our Experience...**

ChrisMercer.net

Search my blog...

**Free Resource**

SUBSCRIBE TO RECEIVE  
**Buy-Sell Agreement Review Checklist**

Subscribe to receive posts via email and the complimentary resource The Buy-Sell Agreement Review Checklist.

\* indicates required

Email Address

First Name

Last Name

**Subscribe**

Privacy Guarantee: I will never share your email address with anyone else.



Review Checklist



E-Book

# Reviewing a Buy-Sell Agreement - 1

## ■ General issues that can impact value

- Agreement status
- Type of agreement
- Parties to the agreement
- Right of first refusal
- Life insurance
- **Are there two values for the agreement?**
- Status of stock after trigger event
- Binding or not? If so, when

Buy-Sell Agreement  
Review Checklist

Page 1

# Reviewing a Buy-Sell Agreement - 2

## ■ Fixed price agreements

- How is the price set?
- How is the price updated?
- What happens if agreement is not updated for 1 or more years after trigger event?
- Is there a provision for a valuation process?
- Is there life insurance & is the use of proceeds specified?
- Other

Buy-Sell Agreement  
Review Checklist

Page 4

# Reviewing a Buy-Sell Agreement - 3

## ■ Formula agreement

- Is formula specified in the agreement?
- Are all definitions of terms clear?
- Is there an example calculation attached to the agreement?
- What about potential adjustments to the calculations?
- Is the formula routinely recalculated by the Company?
- Who performed the last calculation?
- Calculate the formula yourself, using current information (if available)
- Would valuation adjustments be appropriate in the current valuation that would cause an appraised value to be different from the formula calculation?
- Does the agreement specify an alternative pricing resolution in the event there are disputes over the calculated formula price?
- Is there life insurance and is the use of proceeds specified?
- Other?

Buy-Sell Agreement  
Review Checklist

Page 5

# Reviewing a Buy-Sell Agreement - 4

## ■ Valuation process agreements

- Multiple appraiser valuation process agreements
  - Third appraiser as Reconciler, Determiner, or Judge
- Single appraiser valuation process agreements
  - **Single Appraiser : Select Now, Value Now**
  - Single Appraiser : Select Now, Value at Trigger Event
  - Single Appraiser : Select and Value at Trigger Event

Buy-Sell Agreement  
Review Checklist

Pages 6 - 9

## ■ Outline the process

# Reviewing a Buy-Sell Agreement - 5

## ■ Review the valuation sections for six factors that define the kind of value the appraiser(s) will determine

### Buy-Sell Agreement Review Checklist

Page 7

- *What is the **standard of value** (fair market value, fair value, etc.)?*
  - Is the standard defined precisely? If not, you might suggest a definition from Revenue Ruling 59-60 or the business valuation standards that you follow
- *What is the **level of value**?*
  - Is the value called for the value of *the interest* or the *pro rata share of the value of the enterprise*?
  - Is the language confusing regarding the use (or not) of valuation discounts and premiums? (If so, suggest referencing this book or another valuation text because it is often better to refer to a book than for attorneys to attempt to draft valuation language)

Assume I represent the non-business owner spouse in a divorce.

What red flags should I look for when determining if a buy-sell is simply a divorce planning/asset protection tool that is engineered to leave the non-owner spouse penniless?

Turning the question around, are there any signs that the buy-sell agreement is fair, just, and reasonable under the circumstances?



*"I'm having my wedding ring melted down into a bullet."*

# Questions?

**Z. Christopher Mercer, FASA, CFA, ABAR**

**Mercer Capital**

901.685.2120

[mercerc@mercercapital.com](mailto:mercerc@mercercapital.com)

[www.MercerCapital.com](http://www.MercerCapital.com)

[www.ChrisMercer.net](http://www.ChrisMercer.net)

[www.Linkedin.com/li/zchristophermercerc](http://www.Linkedin.com/li/zchristophermercerc)

Receive a complimentary copy of the *Buy-Sell Agreement Review Checklist* by subscribing to ChrisMercer.net.

Also receive a complimentary copy of the e-book *Buy-Sell Agreements for Closely Held and Family Business Owners* if you subscribe within next two weeks.



Review Checklist



E-Book