Unlocking The Vault

How to Transition Your Business in Seven Steps

John G. Griffin | SSG Companies

Unlocking the Vault...How to Transition Your Business

By

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Introduction to Seven Steps to Business Transition Planning

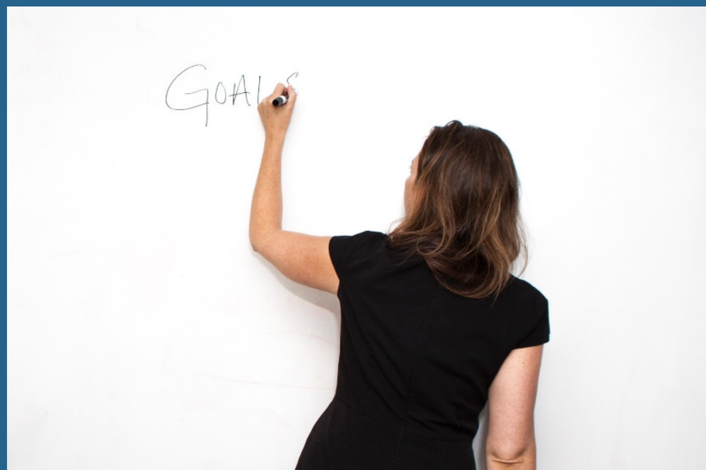
A process is like a recipe. It will give you dependable results if you use it. The same is true with the Business Transition process that has been honed over time and provides a means of establishing clear goals with achievable results, which have worked over time. The process is fairly simple. It involves seven steps that either identify the objectives to be met or determine how to achieve those objectives.

Here we have encapsulated the steps in the business transition process that have proven to provide predicable results.

Our Seven-Step Approach

1. **Setting the Business Transition Objective:** This is what is to be accomplished, as part of the overall business transition
2. **Defining Your Business Transition Team:** Family, management team or an outside third party or a combination are all groups considered. This may be one of the most important determining factors which will guide the transition effort
3. **Determining the Value of Your Business:** Once the business owner determines who will be parties to the transition, a determination can be made as to what is the value of the business
4. **Enhancing the Value of Your Business:** During the process of evaluating the business, areas that can be used to enhance the value of the business are often identified
5. **Evaluating Business Transfer Pros & Cons:** In some cases, the parties to the transaction – even that of a third party sale – will not be able to borrow or raise enough capital to complete the transaction, and ask the owner to finance a portion of the purchase price
6. **Contingency Planning:** The adage goes – if anything can go wrong, it will! Obviously a business transition plan has a lot of moving parts which depend upon a lot of things going right, but things can and do change over time, so it is vital to take those things into account throughout the process
7. **Wealth Transfer:** As is the case with every Business Transition, it will be necessary to take some steps to protect the accumulated wealth built by the business. To ensure our clients' receive significant tax savings, our approach includes a comprehensive wealth transfer planning session prior to the transition.

Step One - Setting the Business Transition Objective



In this chapter you will define:

- **Who do you want to sell to?**
- **When do you want to sell?**
- **How much do you want from your business?**

Your exit strategy starts with clear objectives.

If you don't know where you would like to go, then it is hard to chart a course to get you to the most optimal results from your business transition. This first step of defining your transition goals and objectives will allow you, as well as your transition team, to tell get crystal clear on what you would like to see happen with your business.

Setting Business Transition Objectives

The motivation behind every Business Transition is unique to each business owner – some decide to work until age 65 and retire, some desire a slower lifestyle to make room for other things, and some simply want to extract the value that they have built up in their business.

As with any major life event,
having enough time in order to get your Business Transition plan in place to be able to execute it when and how you desire is the primary objective.

Then, when you determine the timeframe, it is important to determine how much after-tax income that you would like to receive from the transition of your business. We have utilized after-tax income because every transition plan has its own particular tax cost and you want to make certain that you have enough income from the sale.

For example, one time we were working with the business owner who had his business set up as a C Corporation and someone had come along and made him a very large offer. Unfortunately, since this offer is in the form of buying the assets of the company, he would have to recapture income due to depreciation recapture and pay income taxes at two levels – corporately and individually – the overall tax cost of the offer would cost him 65% of the sales price in income taxes! While he did not take that offer, he did it then go about restructuring his business so that he could maximize his after-tax income.

But, it is important to determine what is the minimum amount of after-tax income that you would be willing to settle on, so that you understand what it will take in terms of the sales price – after taxes.

After that, you will need to determine who will be the parties to the business transition? Do you want to retain the business within your family? If so, how are you going to deal with active and inactive siblings in the business? Or, do you have a management team that is adding greatly to the value of the business that you would like to benefit? And if so, how are you going to transition the business to a management team that may or may not have the capital to make the transition? Or, do you want to sell your business to an outside third party? Are you willing to make a sale of your business to someone you may not know right now in hopes of providing you a much larger payday? Or, would you like to see a method by which you can extract some capital from your business on a tax free basis and utilize one of the three options above? All of these are available to you and you will need to determine who the parties to the bank business transition will be.

What do you think your business is worth? What is your valuation objective? For example, if you'd like to retain your business within your family, you probably don't want the highest valuation that you could achieve on your business in order to minimize the transfer tax. If your transition plan involves a management team, they may not be able to finance your business in full value and that you might end up holding a good deal of sellers notes that may or may not be worth anything at all over time. Or, you may be selling to an outside third party and you would like to ensure the sale of the business in such a way that you would benefit the most on an after-tax basis.

All of those considerations must come into play as you determine what the value of your business will be and what parties will participate in the business transition plan.

Ten Reasons That Businesses Change Ownership

For most closely held business owners, the process of transition is indeed a painful one, having to part with one's baby and to face the change that inevitably must come once that happens. How we hate change! Yet, there are definite times that we need to prepare for and determine just how it will affect our businesses. Here are ten reasons why businesses change hands:

1. A primary owner dies unexpectedly.

That's it. It happens, and control passes. The owner isn't thinking about transitioning the ownership of his or her business, but death happens. We might ask a few questions here. To whom did ownership pass? Is there a buy-sell agreement that will dictate the pricing and terms of the ownership sale? Is life insurance in place to fund the purchase of this owner's shares? Were there appropriate plans in place to assure a smooth transition, not only of ownership, but of management, as well? These are things to think about while we are still alive. Otherwise, our families, fellow owners, key employees and others are left to sort things out under often unfavorable and difficult circumstances.

2. A key employee leaves.

This employee's departure could trigger the necessity to sell the entire business under unfavorable circumstances. This might be particularly true if this key person takes important contacts, critical energy, and/or leadership that keep things going and growing. A couple of questions to ask include: Does your business have such an employee or employees? Are they owners of your business subject to buy-sell agreements and/or employee agreements, if appropriate?

3. The owner gets "tired" and decides to sell.

This is an unbelievably frequent reason why business ownership transfers occur. You may think that this circumstance might only happen with really small businesses, and not a larger business. Not so. If you as a business owner wait until you are "tired," you are already on the downside of the value curve. Tired owners almost unavoidably transmit their "tiredness" to employees and customers in many subtle ways. In the process, their businesses may lose the vital force that is critical for ongoing growth and success.

4. Unexpected offers come along.

Occasionally, business owners receive unexpected offers to purchase the businesses. When this occurs for a particular owner, s/he sometimes will sell to the surprise bidder or else decide then to put the company "in play" and sell to another, higher bidder. We might ask a few questions. Was the business ready to be marketed? Was the owner ready for a transaction with his or her personal planning in place? Was the stock of the business distributed to family or other employees such that *others could benefit appropriately? Just because someone comes along with a good price, even an outrageous price, does not mean that you are ready for ownership transition and sale.*

…Why Businesses Change Ownership

5. Business reversals happen.

Perhaps a company fails to adapt to changing markets, competition arises from unexpected quarters, or an accident or bad luck generates substantial losses. Sometimes the affected business never recovers and forced sales result. This is obviously not a desirable outcome.

6. The primary owner divorces.

Marital dissolutions where closely held or family businesses are substantial marital assets occur with increasing frequency. Wild card divorce judgments can create settlement terms that are so onerous that a business needs to be sold to settle the marital estate. Emotional changes resulting from the divorce can also create the necessity or the desire to sell the business.

7. Life-changing experiences occur.

Business owners sometimes encounter life-changing experiences such as heart attacks, cancer, or close calls with death in accidents. We all experience the death of parents, spouses, and friends. Such events can trigger significant changes in the desire to own and to manage a business. The emotional of physical shock of such experiences sometimes fosters a strong desire to "do things differently with the rest of my life." Business transfers can be the eventual results of these or other life-changing experiences.

8. Gift and estate tax planning.

Owners of many successful, closely held and family businesses engage in gift and estate tax planning as a normal means of ownership transfer. Interestingly, the absence of proper gift and estate tax planning can precipitate the forced sale of a business if an owner's estate lacks the liquidity to handle estate taxes, or if a failure to plan for orderly and qualified management succession cripples the business when the owner is no longer there. See reason number one above and think about your own estate tax planning.

9. The second (or third) generation is not up for the task.

There is substantial research indicating that most businesses do not survive to a second generation of family ownership.

10. Normal lifetime planning dictates timing.

Finally, for this list, businesses sell as a result of normal lifetime planning by their owners. These owners plan for and execute the sales of their businesses on their own timetable and terms. Numerous transfer mechanisms are employed in such transfers, including management buyouts (MBOs), Employee Stock Ownership Plans (ESOPs), leveraged recapitalizations, and other corporate finance techniques that are used to facilitate ownership transfer, in addition to outright sales. Quite often, such transfers occur over time while ownership and management are transferred in orderly fashion.

Step Two - Defining Your Business Transition Team

Appropriate Team Members

- **Family Members**
- **Management Team**
- **CPA**
- **Insurance Professionals**
- **Attorney**
- **Investment Advisor**

An effective business transition relies on a strong team.

As you transition out of your business or downsize your role, you will need to rely on key specialists and subject matter experts, which is why our *Seven Step Business Transition Process*, starts with defining the most appropriate participants for the transition process.

Choosing Who Your Transition Team

One of the most important questions that you will answer as you begin the process of *Business Transition* will be: Who will participate in the business transition?

As part of our seven-step process, *we will evaluate who will participate in the transition process and what issues will need to be resolved to make it successful.*

For the most part, the potential participants to a business transition will include:

- Family Members;
- The Management Team; and
- Outside third party;

Of course, there are always variations upon these themes**.** Many times, we have utilized an ESOP as the means of conveying a business to a family member while benefiting the rest of the family who would be inactive in the business. Or, we have used an ESOP as the means of transferring the business to the management team. Or, we have used ESOP as a stalking horse to ratchet up the value of the business for a potential third-party buyer.

Whatever the case, it is important to go through the process of determining who are to be participants in the business transition process. For the business owner who has family who are interested in the business, the decision seems to the simple. They would like to retain the business in their family so that their family will continue to enjoy the benefits of the business that they built. But, there are also some problems need to be dealt with whenever this choice is made. What do you do about inactive siblings who will never participate in the family business?

Then, we have had experience with business owners who have no family who will participate in the business in the next generation but they would like to get their business to a key management team who has helped build the business over time. For the management team, it is the opportunity of a lifetime. Most of them have dreamed about owning their own business only to be thwarted by not having enough capital in order to be able to purchase a business of that nature. A transition plan that contemplates transferring the business to a management team can provide a great upside to both the business owner and to the management team. However, there are some downsides to the transaction is well. How will the management team finance the purchase?

Then, almost every business owner dreams of having a third party buyer come in and offer them unbelievable price for their business. And, if that is the route that you choose take, it can be very beneficial to you and your family. We've seen many business owners who have sold their businesses to third-party buyers and it is been a wonderful opportunity for everyone concerned. But sales to outside third party buyers must be considered carefully. If you think that you can simply put a price out there and have an outside buyer take it, then you are sadly mistaken. The purchase of your business needs to be structured in the best possible manner in order to avoid having taxes take the great majority of the purchase price.

Step Three - Determining The Business Value

Emotional value matters , but your ability to successfully exit your business hinges on the price you can reasonably expect to receive for it in the marketplace.

In this chapter, you'll take steps to understand the key drivers in determining real business value and the direction of your overall business transition plan. The value for any business, or any asset for that matter, has a wide range in value, and is determined by a number of variables.

What is the Value of your Business?

While on the subject of the value of your business, what is the value of your business? Most business owners have some idea as to what the value of their business is or at least know what they would be willing to take to part with the business. And, in high markets and low markets, they have some idea as to what the value of their business is.

What do you estimate the value of your business,
what is the value that you hope to gain in the sale of your business,
and what is the minimum value that you will accept to even consider parting ways?

These are all very different, but very important figures when making the decision to transition out of your business, and based upon the parties to the transition plan, your value assumption will change. For example, when we are transferring a business to a family member, the most important aspect is typically being able to transfer that business at a low value to minimize the estate taxes on the transfer. But, that has got to be done within reason. If the IRS feels that you have transferred your business at a below market price, then they will come in and make their own determination as to what the value should have been and levy a gift tax on the transfer.

To that end, it is so important that you engage the services of a valuation firm, which can provide an objective, third-party evaluation, which can be used to transfer your business within your family. And, while we're on the subject of transferring your business to your family, the method by which you transfer the business becomes all-important as well. For instance, if you wait until your death to transfer your business, then the value of the business is going to be subject to speculation on the part of the IRS as to what its real value was. The value of the business will be filed on your form 706 or your estate tax return, they then have the ability to question that value and the tax that accompanied it. So, while it is important to get by with as low a value as you possibly can in order to transfer the business your family, it is also important to be able to substantiate that value. That is why it is so important to have a good valuation firm to stand by that appraisal.

What would the value of the business be if you were to sell it to a management team? And, let's assume that this management team has added to the value the business over time and are key participants in the ongoing value the business. Let's suppose that they have allowed you to devote your attention to other things than the business due to the fact that they've done a great job. What would you be willing to transfer your business at in terms of value? You see, there are mitigating factors that come into play as you begin to think about the overall value of your business.

And how about a sale to an outside third party? Would you like to get a big price for your business? Not so fast. What you want to do is to make a determination ahead of time as to what the after-tax value will be taking into account things such as the recaptured depreciation, the cost of selling assets versus stock, and the inability to continue to "live out of the business." What would it really take to replace all of the benefits that you are currently taking out of the business? All of those factors will have some bearing as to the overall value that you want to achieve with the sale to an outside third party.

In virtually every case, it is important to engage the services of an outside, qualified valuation firm that can provide you an overall valuation of your business while you determine what your objectives will be.

Step Four - Enhancing Your Business Value

Utilizing every tool and technique available to enhance the value of your business is a vital step for any successful business transition plan.

In this next chapter,
we'll examine a few universal drivers designed to add value to your bottom line.

Enhancing the Value of your Business

With any business, the value of the business is directly tied to the cash flow of the business. Very seldom will you see consideration given to businesses without a good cash flow. Some exceptions of this may be some of the technology startups, but for the most part, buyers like to see businesses that have built up good cash flow overtime.

What are areas that should be considered to enhance the cash flow of your business?

- **Nonessential Expenses**
  Are there any outsourced services that could be pulled in-house or cut completely? Have you taken a close look at your workforce and eliminated nonessential positions or dealt with underperforming personnel?

- **Cross-Selling Opportunities**
  It is not uncommon for long-standing successful companies to focus mainly on what's been working, but often times, cross-selling and topline revenue generating opportunities are simply overlooked.

- **Facility Improvements**
  Improving the overall appearance of your business space can work wonders. As with many purchase decisions, most of us are influenced by the appearance of what we see. For some, an upgraded or higher-end business facility conveys an image of success.

- **Reduce Debt**
  Paying down debt and not overburdening the business with high debt levels is a very important aspect of enhancing business value.

While there are many areas to consider, the bottom line is that buyers are looking for businesses that can sustain earnings over a long period of time, which is why our process is to thoroughly review business financials and talk about how you can leverage and enhances net profits, as well as the importance of documenting the sustainability of earnings. It is important to have multiyear substantial statements, which reflect how you have been able to maintain your earnings over time.

Additionally, implementing a strategy to grow the company is very important. Many business owners will plateau out as they get to a certain level and will not continue to grow their company. The old adage is that if you're not growing the business then you are shrinking the business. I think it is true. You are either growing or shrinking. It is hard to simply maintain a business without attempting to grow that business over time. Just the loss of customers in over time will cause your business to reduce in size without replacing those customers. Having a plan to grow the business and to continue to grow it over a long period of time is a very important aspect of your business transition process.

Finally, build a strong management team and groom a successor within that management team. Even if you do not think that you will transition the business to a management team, it is very important to the value of a business that there be a good strong management team in place that can carry on the business regardless of what happens to the owner. By having a management team in place, you are saying to potential buyers that you are building something of permanent value and that your management team is a portion of the value of the business that they are buying.

Step Five – Evaluating Business Transfer Pros & Cons

There are numerous questions and issues to consider when thinking about selling or transferring your family business to outsiders or to your children.

In this next chapter, we'll help you look at each unique transition objective, and take steps to better understand the benefits, and as well as any pitfalls, so that you can make informed decisions as you move forward.

Business Transitions to Family Members

With many family-owned closely held businesses and it is the desire of the business owner to maintain control of the business within his own family. It brings about great pride when you're able to pass along the business that is been developed by predecessor generations and still maintains its value. Very few family-owned businesses make it to the third generation. But, there are a number of issues which must be taken into consideration when you're contemplating the transition of your business and maintaining control of it within your family.

While many business owners dream of leaving a solid legacy that provides equal value for every member of the next generation, the realty is that it is very difficult to cede the control of a family business with multiple siblings.

For starters, there is the problem of siblings who are active and inactive in the business. You will find children in the next generation who have no interest in the family business and do not wish to participate in it at all. Then, you will have those who want to participate in the business but have no ability to run it. Because of that, it brings about in a dilemma, which must be solved in transitioning the business within the family.

In most family-owned businesses, the income that the family members receive from the business does not come by virtue of holding stock in the business – it comes in terms of salaries and bonuses which are made to stockholders who are actively involved in the operation of the business on a day-to-day basis. Those stockholders who are inactive in the business oftentimes do not participate in the same manner as active participants. An inactive stockholder may wish that most of the net profits of the business were paid out in the form of dividends. For the active stockholders, however, they would like to see profits plowed back into the business in order to grow it and make more profits. It often creates issues between active and inactive stockholders, which is why it is extremely important to determine which family members will participate in the family-owned business in advance.

Ensuring a clear line of management control that will exist in the next generation is another vital step in the business transition process.

We have mentioned one of the pitfalls in a business transition involving family members when the inactive children receive stock ownership in the business, but that is not the only problem. In addition, it is important to have a clear line of management control that will exist in the next generation. Like most businesses, it is heavily dependent upon management and management leadership going forward. You must carefully select the management leadership, which will continue into next generation. All of your family members may not be good management material. Without a good management team, the business will not continue to be valuable and profitable to the family as a whole.

What About Estate and Gift Taxes?

Due to the fact that the transfer of the business within the family oftentimes creates estate and gift tax issues, it is important that the parents embark upon an estate plan that will reduce the amount of taxes that would be levied against the transfer, and to provide the necessary liquidity in order to make it happen. We will deal with this in much more detail in a later chapter, but this is the particular elephant in the room which must be dealt with after all of the other issues have been dealt with.

Another important consideration is how can you transfer the business without being on the hook for owner financing?

Sometimes, one generation will sell their stock to the next generation in order to avoid the fights that can occur between siblings. Sometimes they sell the stock at what seems to be a below market value. We caution you against doing this since it could be construed to be a taxable gift by the IRS.

On the other hand, many times the next-generation buyer does not have the capital in order to purchase the business without some owner financing on the part of the first generation. How can you remove the issue of owner financing in the process?

How can you take the parents off of loan guaranties? In any good business transition plan within family members, this needs to be dealt with over some years in order to remove the guarantees that the first generation has with any bank financing that will be ongoing, and remove the owner financing that might take place in the time of transition. By having a long-term transition plan, this can be avoided fairly easily.

We utilize a unique process that we call *The Wealth Plan* to guide us in the choices that each and every high net worth individual and business owner needs to make concerning their business. Are you facing a large estate tax to get your business to your children? There are strategies that will allow you to avoid that taxation.

Matter of fact, there are only three places where your assets can go:

- Your family
- The Internal Revenue Service
- Your Favorite Charity

If you take the time to plan ahead, you get to choose who gets what! You can reduce the tax bill to zero, if you want! It is your choice!

What If Not All of Your Children Want to be in the Business?

For most successful entrepreneurs' children, one of their greatest desires is to see their children involved in their businesses. The business which is been such a vital part of the founder's life is often viewed by him or her as the perfect place for each and every one of their children, but what do you do if some of your children do not want to go into the business?

It can be a disaster if you attempt to force your children into a business with a vocation that they do not desire. So, how do you handle a situation where only one of your children desires to go into the family business?

First, if there is only one child who desires to go into the business, then it will be important for the son or daughter, assuming they are able, to be in management control of the business once you are no longer involved. If that child is the only active participant in the business, he does not need to be hashing out details of why there are no distributions from the business at present due to the fact that capital is being retained in order to expand the business. No, the successor who is involved in the business needs to be placed solidly in control of the management of the business.

Second, due to the fact that the business that the entrepreneur has started makes up such a large portion of his estate, it is very difficult to treat each of the qualified heirs equitably or give them equal portion of the entrepreneur's estate given the fact that the business might make up 70 to 80 percent of the total estate. And from my experience, most parents would like to treat their children in an equitable fashion delivering equal amounts of value to each, but how can you give the business to the successor who is involved in the business, while being equitably to the other siblings?

From the standpoint of the business, you can place the inheritor of the business in management control by granting him or her voting class stock or a general partnership interest, which provides management control or management interests if it is a limited liability company. For the most part, by bifurcating the voting structure of the various interests or stock in business, you can have the involved sibling in management control while the others participate in the equity of the business.

Another important consideration is how to take into account the fact that if each of the children have an interest in the business, they may expect to receive an income, which could present issues if the business struggles or require profits to be reinvested in order sustain. While employed family members receive a salary, inactive beneficiaries only receive distributions from after expense profits, which could lead to dissension in the ranks.

There are also times when the particular circumstances of each individual child should be taken into account. If there is a child who is incapable of handling the management of their money in a fashion that would be deep-rooted, then that child can be taken care of in a separate fashion. There times when children have drug and alcohol habits, which can only be exacerbated if, they would receive a large inheritance that they can use on their habit. Then, there times when one of the children will have no children themselves, and the entrepreneur will not wish to pass a portion of their interest to the spouse's family. Each of those situations can be planned around and allow the entrepreneur to create a business transition plan that will protect against losing the goose that is laying the golden eggs and at the same time protecting the legacy of their children and grandchildren.

How do you Deal with Inactive Siblings?

It is often a difficult conversation for parents to have with their children to determine that certain siblings may not participate in the family business. Never mind the fact that some of those children do not wish to participate in the business, the fact that they feel let down can create problems within the family. After all, you will still see them at Thanksgiving and Christmas, and you want to make certain that this is handled delicately.

It is important to deliver a sincere message to family members that although your business is a family business, it is a business, and should be treated as such.

As is the case in all businesses, promotion comes from demonstrating an ability to perform the functions necessary to sustain and grow the business. In other words, you don't get a job or a management position in a business simply because you are a family member. You must demonstrate the ability to perform in that function. If it is clearly understood among family members that only those who have paid their dues and have demonstrated an active role in managing the business will participate in the business, you won't have the psychological problems of oftentimes develop in families where it is assumed by children that they will participate in the business in some fashion regardless of whether or not they want or desire to participate in business.

It is also important to have a clear understanding between the husband and wife that the business will move into the hands of those who are capable of running it. Without a clear understanding of that nature, there can be great disagreements between spouses in terms of which children will participate in the business going forward. And that is not good for family relations either!

But, there are the other issues, which deal with the monetary compensation that each child may receive regardless of whether or not they're involved in the business. Most parents would like to see their children participate equally in the value of their inheritance. And, it is important that you differentiate between the value that they receive in their inheritance and control of the business which may have created some of that value.

If inactive stockholders are going to receive stock in the business, then that stock needs to be nonvoting stock so that they do not participate in the management decisions of the business except in extreme cases. Certainly, they can receive some nonvoting stock which clearly gives them an equity value in the business but they will trust the voting management team with the development of that value.

Additionally, you can provide the next generation an inheritance that comes from other assets such as investments that have been accumulated, real estate that has been developed, and life insurance, which is been purchased, on the life of parents. In all of those cases, the value of those assets can provide an alternative means of providing that next-generation inheritance which will equalize the inheritance.

It is important to develop a successor within your own family if you intend to retain the ownership of your business within your family. If there is not a successor – someone who can lead the company into the next generation – then you need to rethink the transition plan that you have for the business. It is often difficult for a next-generation inheritor of a closely held family business to inspire leadership within the management team if they have not demonstrated the capability of being a successor manager. It is important that this successor manager be developed some years ahead of the transition so that there is a clear line of demarcation, which occurs as you move forward in your transition plan.

Transition to a Management Group

Your management team has been an indispensable part of the success of your business. Many of them started some years back when the business did not have the resources to be able to compensate them in the manner that you would have liked, but they were extremely loyal and provided the business with a great amount of leadership over the years.

Transitioning your business to the current management team allows you the option to continue building upon your work and vision through the same hard work and leadership that has supported your efforts over the years, while providing a handsome reward for their long years of work and loyalty.

Let's examine some of the alternatives that you have when developing a transition plan for your management team. For starters, you can simply sell your stock on an after-tax basis to your management team utilizing some sort of financing option. You may even develop a sweetheart stock price that they can take advantage of or take into account the fact that they helped to build the company. As a seller, the sale of your stock would be a capital gains item and would give you the lowest possible taxable event for a transaction of this nature.

Most buyers of businesses, however, do not want to purchase the stock of the business, but may like to purchase the assets of the business. This is an attractive approach for several reasons.

- When you purchase the business asset, you are able to reset the depreciation schedules and for the buyer this becomes a very important item. Because they are purchasing the business with dollars that are after-tax, having some depreciation to offset some of that income becomes very important. So, most buyers will want to be able to reset the depreciation schedules.

- Most buyers do not want to purchase the contingent liabilities that go along with the purchase of the stock of the business. When a buyer purchases the stock of the business, he is also purchasing all of the potential contingent liabilities that it developed over years in the business. This can be disastrous if one of those contingent liabilities rears its ugly head after the purchase transacted. The buyer of the business is as liable as the former owner of the business would've been at that point because the liability belongs to the business. So, as you can see, it may not be as simple as you might have thought.

- The purchase of stock, you can utilize a non-qualified stock ownership plan called a *Management Stock Ownership Plan (MSOP)* which allows stock to be placed in what is essentially a deferred compensation plan which will be released to the management team upon achieving certain goals. This plan can be a tax advantaged method of transferring stock to a management team and at the same time retain those management team members. The stock does not become vested in the management team until they met the requirements and thus can be used as a tool to retain the key management people.

- An ESOP, in addition to an MSOP, can be utilized as a means of retiring the former owners**.** A combination MSOP/ESOP plan can provide you a means of selling your stock on a tax favored basis while at the same time providing a means of allowing the management team to come in and control of the company over time. In essence, the ESOP purchases the stock of the seller and the company will retire the debt that is incurred on the purchase on a tax-deductible basis by making contributions to the ESOP.

- A MSOP is used to transfer stock to the management team in over time as the stock is retained the management team gains equity in the business. This may be the most effective tool in transferring a business to a management team without negatively impacting either the buyer or seller.

One of the things, however, that we do not like to see seller clients do is to sell their stock to a management team with a significant amount of owner financing.

In fact, they will typically sell the stock on some sort of sweetheart arrangement and then will finance the purchase of that stock themselves and usually a low-interest loan and then wait for a number of years before they get their money.

Many times, they do not get their money. And, it is extremely difficult after you've been out of the business for five or more years to come back into the business when your note not been paid and you have to foreclose on your former management team. It is the worst of all worlds. So, if owner financing is used in any way in a management team, it needs to be used to judiciously with a lower percentage amount of the purchase price and in such manner that the seller is guaranteed a substantial amount of money out of the business which will guarantee his financial security during and after this transition.

The Sale to a Co-Owner

How do you develop a business transition plan with someone who has been your partner for a number of years? No doubt, your partner would be the most likely candidate to transition the business to but oftentimes it may be the most difficult transition that you will undertake. Remember, both of you have been working in the business for some time now. Both of you have added to the value the business over time and in almost every case the determining factor as to whether or not you will be able to transition the business revolves around the value of the business.

While there are many ways to arrive at the value of the business, for the most part, the sale between two co-owners is going to be the classic value of the business – what a willing buyer will pay a willing seller.

It will come down to the point of what your partner is willing to pay for the business. He should know it well. After all, it is one that he has been intimately involved in over the years. But, the deciding sales price will be the mutual price that the two of you will agree upon.

There are cases where you might bring in an outside valuation firm. Another negotiating tool would be to come up with a price that either of you would either buy or sell at. But, to achieve a good result, it has got to be a price that both of you can live with in the long term.

What are the triggering events of the sale? How will the funding of the buy sell agreement be arranged? All of these items are going to play into the discussion of the valuation of the business for the buy sell agreement.

Of course, the buyer is interested in the business at the lowest possible value to get the benefit of the upside in value over time. And then on the other hand, the seller of his interest in the business would like to get top dollar for his interest since he spent a large amount of his lifetime in developing the value of that business. So, how do you arrive at a value?

In many cases, co-owners will rely on an independent third-party valuation firm to come up with a value to their business as a going concern for the whole business, and then will they will have that same valuation firm value the interest of each of the co-owners.

Why do you do that? If one of the owners holds a majority share of the business and thus has management control, then his interest in the business is going to carry with it a premium on the overall valuation whereas the owner who holds a minority interest will be discounted for the lack of management control.

It is a fundamental which is used daily in the valuation of businesses. Discounts are often assessed for the lack of management control, lack of marketability, and lack of liquidity. And when discussing the value of a minority interest holder, those discounts need to be discussed amongst the co-owners. If there's not a clear understanding on the minority interest co-owner, then an argument can ensue and lead to a protracted battle in trying to develop a transition plan. As long as everyone has or is in agreement as manner in which the valuation is determined, then the each of the co-owners can arrive at a successful business transition plan.

The Funding Method Matters

It is extremely important for the co-owners to agree upon the method by which the business will be valued and each of their individual interest would be valuable, but it is also extremely important that there be an agreement as to the method that the transition plan will be funded.

For example, a number of years ago I was working with a firm that instituted a buy sell agreement amongst the equal shareholders that if anyone decided to withdraw from the partnership that the partnership would pay them off in a relatively short period of time. They had based the sales price of each partner's interest in the business coincided roughly with a market value the business.

The problem was the fact that one of the partners decided to withdraw from the business rather unexpectedly and was determined to enforce the specific sections of the agreement which stated that he and all his capital could be withdrawn out of the business at the market value over a relatively short period of time. The business was a capital-intensive business and required most of the capital in order to continue its business at the same level at which it was running. The problem was the fact that there was no definite plan for funding the buy sells agreement, only the vague reference to the fact that the partner could withdraw his capital.

The business ended up being able to withdraw enough cash and borrow enough money that they were able to make the payment to the departing partners, but it made it difficult for the next several years as the business had to replenish its capital to continue business at the same level as they once were.

One option would be that the business would begin to set back a sinking fund in anticipation that it would be utilized when a partner departed from the firm. This means that the business must take a disciplined approach to accumulating capital and having it readily available, assuming that the transition can occur at any time. And, depending on the type of business that the business is in, you can also serve as additional operating capital for funding purposes, financing purposes, etc. While businesses accumulate sizable amounts of cash, they oftentimes use those amounts of cash from time to time on acquisitions, capitalization of their own business, and distributions to stockholders. For the most part, this can be difficult.

In addition to this, the business can make arrangements to utilize the lines of credit and other critical resources in purchasing the interest of a co-owner. This, in effect, as the impact of impairing the company's credit lines and could affect business going forward. In addition to that, the business will have to pay back the funds on an after-tax basis did the fact that they will not have assets which can be written off in the course of the purchase. This makes the cash flow very difficult when attempting to do something to this nature.

Depending upon the terms of the buy sell agreement, the business can use forms of life insurance and disability insurance as a means to provide the funding for the agreement. For example, life insurance can be purchased on the lives of co-owners so that in the event of the death of one of those co-owners, the life insurance proceeds which of a tax-free are paid to the business and the buy sell agreement is completed. Permanent life insurance policies can also be used as a means of developing a fund of cash that can be available to consummate the transition.

In the same manner, key man disability insurance policies can be purchased on the co-owners so that it will provide a buyout amount in the event of the disability of one of the co-owners. What happens if one of you becomes disabled? Would the business be able to continue in the same fashion as it would have previously? Each of these should be considered carefully when constructing a business transition plan with co-owner.

But, eventually you have got to deal with the triggering event of retirement for co-owners simply wanting to get out of the business. What do you do in that event? We mentioned some of the alternatives above but not all of them are good. Most of them are heavily dependent upon using after-tax revenues in order to back the buyout. The leverage that is involved is the leverage that is provided by the bank which on the other hand also impairs the credit facility of the business.

One tool that we have utilized very successfully is an ESOP to be the buyer of departing stockholders.

The reason why an ESOP works so well is as follows:

- An ESOP can purchase the stock from the co-owner and either provide cash or cash and a note for the purchase;
- The ESOP through the sponsoring business can finance the purchase of the stock through a third-party bank;
- The payments made to the ESOP for the purchase of the stock of the repayment of the debt are done on a before tax basis all of the contributions being tax deductible to the ESOP;
- The remaining co-owner remains firmly in control of the business through the trustee arrangement of the ESOP;
- An ESOP can have the added effect of enhancing the profile of the employees of the business by making them owners of the business as well;

What we found over time, is that an ESOP will reduce the cost of a buyout of this nature by as much as 45% depending upon the state in which the business resides.

What are the Triggering Events of the Buy Sell Agreement

As we mentioned above, the death of a stockholder is a traumatic event not only for deceased stockholder's family but for the stockholders of the business. One of the triggering events of a buy sell agreement is typically the death of one of the stockholders. And oftentimes, this means that the business must come up with some of capital within a relatively short period of time in order to effect the purchase. A life insurance policy on the life of the stockholders the most natural solution for funding of this type and will provide an economical means of providing the funding.

What if one of the stockholders become disabled?

Another triggering event a buy sell agreement might be the disability of one of the stockholders. Most of the time in any business, the stockholders provide certain functions on behalf of the business, and if they are disabled, they are unable to provide those functions and someone else must do so. So, in most buy sell agreements, there is a triggering event which takes into account the disability of a co-owner and when the disability occurs, the triggering event calls for a buyout of the ownership interest of the stockholder who is disabled.

As we also mentioned above, there are designed disability insurance policies which are for this purpose which will provide a substantial portion of the buy sell amount. They can be utilized in a fashion that will provide most if not all of the funding in the event of disability, keeping the capital of the business intact.

What about retirement?

The most likely event to occur in most stockholders lies in the fact that they will retire at some point in time and many of them will like to be able to get out of the business that they are no longer active in. This means that the business needs a mechanism to be able to purchase the interest in the event of the retirement of the stockholder. We mentioned a number of funding mechanisms that can be utilized above and this needs to be considered fully as a transition plan is put into effect.

What if one of the Stockholders wants to quit?

One of the questions that often comes up is that one of the Stockholders may want to quit at some point in time and what do you do when that event occurs? Obviously, the selling Stockholder would like to get his money out of the business and get a price that he feels is adequate for his stock. But on the other side, the purchasing stockholder is often in a predicament as to how you come up with the capital in order to effect the purchase. Again, as you go through your planning stages, this is the point of discussion that is not neglected. Times change and circumstances cause things to change over time. If you did not take into account the fact that one of the Stockholders might decide to get out of the business before his retirement age, then you're making a big mistake and you will have a big hole in your Business Transition Planning.

Motivating Key Employees

Almost any business owner recognizes that the most valuable asset of his or her business is their key employees. Having key employees who take initiative, display leadership qualities, and are loyal to the overall vision of the owner of the business is invaluable. Every successful business enterprise, which begins as a one-man shop become successful through the efforts of key employees who have been attracted and retained by the business owner. Ask any entrepreneur who started as a sole proprietor and build his business into a large operation, and enabling knowledge that along the way there were certain key employees who took the business to the next level and allow them to focus on those parts of the operation and to enhance their marketing efforts in order to be able to grow.

Good key employees are the life-blood of any organization and any time that you see a successful organization you will find that there are some valuable key employees who are participating in the overall success of the organization.

Good key employees will always have a way of increasing the company's income stream by coming up with innovative ideas, supplementing those concepts that the business is already involved in, and plugging in for it's necessary in order to make it all work. That is usually where key employees come in. It is hard to put a value on good key employee until you've had the experience of a bad employee.

A bad key employee can keep you up at night worrying about the jobs that they are doing and how well or badly they are doing them. That anxiety usually carries over to the profit margins that the business is sustaining or not sustaining. The employees who do not have the success of the business on their minds oftentimes take away from the good things that the business is doing or could be doing.

Nevertheless, good key employees and a good management team provide potential buyers of the business a good reason to buy the business. In any business, there will be a certain amount of business that simply done due to the relationships of the business owner with the customers. However, when businesses develop systems and utilize their key employees to sustain those systems, it has the ability to expand their customer base and to allow them to grow sometimes exponentially.

When a potential buyer looks at the business, he looks at the sustainability of revenues, and good key employees for a good management team is a critical factor in maintaining sustainability of earnings.

As in almost every case, it is important that key employees and your management team have a good compensation plan. If you expect the business to throw off the profits, then you should expect to pay your management team who helps develop those profits. No doubt that a good salary is important to key employees, but a bonus plan that is specific not arbitrary is key to that overall compensation plan.

This bonus plan needs to be tied to specific performance standards. Those standards need to be understood by the group who will benefit by them and the bonus plan need not be too complicated or it will lose its effect. For example, if you have a bonus plan that is based on the net profits of a particular department, then make sure that the person who is responsible for that department can impact the net profits of that department. If the worker understands how they can enhance the net profit of their department, then what they will get the additional bonus that comes with it. If they do not, then the bonus becomes meaningless.

Given the individual employee does not have the ability to impact the net profits of an overall department because they do not control expenses but only sales, then sometimes the bonus plan needs to be based upon some gross revenue figure that they might have some input. In other words, the more business that the business does, then the better the bonus will be. The downside of a bonus plan of this nature is that you could have key employees adding revenue to the business that is not profitable. So, like with any other bonus plan, it needs to be monitored and adjusted as time goes by.

Additionally, the bonus needs to be substantial. If the reward is not large enough, it will not have its intended effect on the key employee. You would like to incentivize the employee to go the extra mile for the business to enhance its business and if the employee's bonus that comes from that effort is not substantial, then the employee will lose heart and it will be meaningless. Unfortunately, the bonus plan, which does not contain all of the factors above, becomes a discouragement to the employee.

What are you trying to accomplish by this bonus plan? You want to create a disincentive for the employee to leave. You have taken the time to train this key employee and invested the time and money necessary to get them to the point where they can do the job, now you would like to retain that key employee for the years ahead. You will find that investment in a good, key employee will provide continued dividends over the years this time goes by. So, you don't want them to go across the street for an additional little bit of money.

It is important that the employee have a deferred portion to his compensation plan. This can be achieved through a deferred compensation plan or a supplement retirement plan which must be earned to achieve. The business will provide the employee an additional sum of money, usually out a number of years, if they follow the guidelines of the plan. Otherwise, they forfeit the benefit.

We talked about cash compensation. A good salary and a cash bonus plan are very important to attracting and retaining good employees, but what about a MSOP? A Management Stock Ownership Plan can provide ownership to a key employee on a favorable basis, which is predicated on his continued efforts with the business. Many management stock ownership plans are set up as deferred compensation plans which are a form of nonqualified retirement plan which requires the employee to do work at a certain level in order to get the benefits from the plan.

The good thing about a Management Stock Ownership Plan is that its value is tied to the overall value of the business. In other words, the stock, which is in the MSOP and is the same stock which the owner has and as the business grows more valuable, then the stock in a Management Stock Ownership Plan grows more valuable as well.

This has the impact of putting the key employee on the same side of the table as the business owner. If the business owner wants to grow the business and make it more valuable, then the Management Stock Ownership Plan will examine the key employee to do likewise.

Can You Sell Your Business to an Outside Third Party?

We talk to business owners every day who "plan" to exit their companies via a sale to a third party because they believe that they'll get more cash up front (and more overall) than if they sell their companies to insiders (family members or employees). Consequently, they often take on far more risk when selling to a third party than to insiders.

- **Unless a business can be sold for all cash or if there's simply no time to implement a carefully designed sale to an insider, third-party sales are most often more risky**.
  Investment banker Kevin Short of Clayton Capital reminds owners that unless a company meets the following criteria, it is unlikely to sell to a third party—for substantially all cash:

  - ✓ Has more than $1 million (or even $2 million) in EBITDA;
  - ✓ Is in an attractive market sector;
  - ✓ Has strong fundamentals; and
  - ✓ Enjoys a unique competitive advantage.

- **Selling to a third party requires a third party wanting to buy.**
  In a difficult M&A market, being in an attractive market sector is more important than ever. For most companies, today's M&A market is decidedly cool if not stone cold; few companies meet the criteria above. The most realistic owners quickly realize that there simply are no third parties interested in their companies.

- **Waiting involves risk.**
  We suspect that some owners hold to the belief that there's little risk in waiting for a third party buyer because it provides an excuse to "avoid the hassle" of planning. "No risk?" we ask:

  - ✓ What if a qualified buyer doesn't show up?
  - ✓ What happens if or when you are ready to sell:
    - o The M&A market is dormant;
    - o Your industry niche has fallen out of favor; or
    - o Your business and/or the economy is in decline or worse?

- **Why subject your future financial security to these uncertainties?**
  Why not assume control of your exit—your life, really—by creating an exit strategy that allows you to:

  - ✓ Choose your buyer;
  - ✓ Name your sale price;
  - ✓ Control ownership until you are fully paid; and
  - ✓ Shift the burden of the company's future performance from your back to the buyer's?

The Objection to Insider Transfers

While sales to insiders require time and work on the owner's part, sales to third parties can require just as much work and be just as time consuming.

Once owners understand third party sales, they usually agree—especially if their companies are too small to attract qualified third party buyers—that transferring to insiders is a far better course than liquidation.

Let's talk about the most common objections to an insider transfer:

- Insiders do not have money to begin buying your company. That's true—today. But they can and will if:
- Your company has a good management team that desires ownership;
- Your company has good cash flow; and
- You have ample time before leaving to design a tax-sensitive transfer plan and to implement that plan.

Owners can often get as much cash (with no more risk) in an insider transfer as they can from a third party sale if they have time to work with their advisors to design and to implement a plan. If owners use time wisely, there's no reason that the insider transfer cannot yield as much cash as the third party sale.

What is our message? Don't overlook that insider sale that might be the answer to your business transition needs. While it may appear that your management team lacks the wherewithal to make a transition of this nature work, by proper planning you can mitigate those issues and provide yourself with a transition plan that may take the problems out of a third party sale.

Sale to an Outside Third Party

For most of us who have developed a business, there is a dream in the back of our minds that someone will come along and offer us an outrageous price for the business that we have built. Not only will we get a financial payday, but we will have a psychological payday is well. If a third-party buyer comes to purchase your business, they are saying that they recognize your achievements and the manner in which you put together your business. That can be pretty heady stuff!
But when you're considering the sale of your business to an outside third party buyer, it is important to understand what your goal is. What is your goal? You would like to maximize the net after-tax sales price to you and your family by structuring the agreements in such a way that will provide the most net dollars that you can get. And, possibly, you want to be able to take care of the management team that helped you get to where you are.

If your buyer is a publicly traded company, you may be able to work out a tax-free exchange, which will allow you to defer the taxable gain on your business until time you sell the securities that you received on the purchase.

However, that is often not the case. In fact, most buyers want to purchase your business for cash even though they have the currency of publicly traded stock, or they would like to purchase your business for a combination of cash and notes.

What if you were talking to an outside third party buyer who makes you an all cash offer? Are they buying your stock or are they buying the assets of the business? It is important to know. If they are buying your stock, then the transaction is a relatively simple one in which you'll pay capital gains tax on the gain that you have in the stock price. But, if they are purchasing the assets of your business – and most third-party buyers prefer to do this – then the taxable gain will not be much more difficult to determine. There will be depreciation to recapture. Possibly there will be amortization of good will to recapture. You may even find yourself at a point where you have to liquidate the company and pay an additional taxable liquidation if you are a C corporation! All of these things are important to know that you begin to discuss the sale of the business.

And what about the funding of the agreement? Hardly anyone thinks about the funding of a third-party purchase of a business because almost everyone assumes that the purchase will be done on all cash basis. But the great majority of third-party purchases are done with some combination of cash and seller notes, or there could be claw-back provisions based upon performance going forward, or some other tool that the purchaser is using in order to finance the purchase. That means that you as a seller are at risk after you sell your business!

It is one thing to retain a small interest in the business going forward and to have a non-compete agreement in which you maintain a management position in the business going forward. But it is quite another thing for you to seller finance the purchase which in effect leaves you at risk for a much longer period of time during which time you're losing control of the business and have no ability to correct it.

Negotiate the terms of the sale properly when selling to a third party buyer is key. The questions that you need to ask are as follows:

- Is the buyer a publicly traded company that can offer the stock for my company?
- Do I want to have stock in the company that is the buyer?
- Is the method that there purchasing my business giving me the most net after-tax bang for my buck?
- Am I having to owner finance any portion of the purchase price?
- What are my risks going forward upon the sale of my business?

As you evaluate the offers that you are receiving, ***you must not get too anxious*** about the whole process. Matter of fact, at times, it is better for you to have a surrogate that will deal with the potential buyer with whom you are dealing so that you have some time to process the offer and determine just how it will impact you. Don't rush into a sale until you have understood all parts of the purchase agreement!

Business Transition to an Outside Third Party
Valuation of the Business

When you're dealing with an outside third party buyer, one of the most important aspects of the whole business transition plan is to determine the value of your business. And, when you talk to most mid-level investment bankers (the ones that you would typically deal with), they will tell you that most buyers would like to purchase your business based upon your past financials rather than its potential future. But, don't get me wrong. The buyer will buy based upon potential, but he would like to buy it on its past performance. However, for the seller of the business who has spent time and has hopefully gotten the growth of the trajectory of the business to the point where much of the value the business lies in its future, that won't be acceptable.

As the seller, it is in your best interest to take advantage of some of that potential future value, as you have been instrumental in setting it up.

And, this is where a good narrative as to what you had been doing in your business over time to enhance its value comes in handy. *Nothing tells the story any better than the words of the business owner as to what his plans for the future are, how he arrived at the place where his business is at present, and where he plans to go in the future.* An outside third party buyer would want to hear that story so that they can evaluate the prospects of your business in the future.

Almost every business owner who is attempting to sell his business but outside third party would love to get an all cash offer for an outrageous price for his business. But most of the time, that outrageous price does not come without some negotiation on the part of the seller and his advisors. That is why we often enlist the help of a mid-level investment banker who is adept at negotiating a price for a business as well as having ready buyers who are looking for businesses all the time.

You can never really underestimate a mid-level investment banker can be helpful in a number of ways. First of all, this will not be his first time negotiating the sale of a business which might be the case for you. He will handle hundreds of transactions of this nature and understands the process that you go through as a seller of a business. In addition, there will be times that he will need to be the intermediary between you and the buyer so that *your anxiety over the sale does not take precedence over your desire to get a good price.* There have been many a time that a seller has wound up selling his business at a below market price simply because they were put in a position of anxiety which seemed to devour them. The investment banker will keep that from happening.

What are the types of funding? As we mentioned above, almost every seller of a business would like to get an all cash offer for an outrageous price. But most of the time, the outrageous price has got to be negotiated before it happens and then the terms of the offer are typically not all cash. Now, if your business is large enough for a company like Berkshire Hathaway to purchase the business this does not hold true. Their offers are typically all cash due to the fact that Warren Buffett does not like to dilute his Berkshire Hathaway stock by giving it away for another business. But most businesses are not in the category that they would be of interest Berkshire Hathaway.

The terms of the offer can come in all sorts of forms:

- By closing on a cash offer there would typically be some other form of written modification such as an escrow account that must be maintained until a certain period has passed
- At times a buyer will attempt to get the seller to take virtually all of the purchase price in the form of a note (most of these type of buyers are fishing without bait)
- Sometimes in dealing with public companies they will make an offer to give you stock in their company for your business, and you will have to evaluate the value of their company side by side to yours

Kevin Short, a mid-level investment banker whom we've worked with at Clayton Capital, offers a few valuable points in his book Sell Your Business for an Outrageous Price, which tells the story of a business owner who wanted to sell his business and got an outrageous cash offer very soon after putting the business on the market. Kevin could hardly believe the offer since it was a multiple of what they expected to be able to get! However, the buyer of the business was a special buyer. They were looking for businesses that they could put together and multiply the value of the purchased business as well as their existing business. Matter of fact, the buyer approached Kevin later and ask him if he had any other businesses like that for sale! Talk about a motivated buyer!

The value of the business is in the eye of the buyer.

There are times when a buyer will be a strategic buyer and will have an idea as to how he might be able to put this business with some existing businesses that he already has and to multiply the value of all the businesses over time. That would be a strategic buyer. They are attempting to achieve market share in a particular industry or they want to dominate a particular region of the country or some other reason, which makes them want to buy your business.

Then, there are buyers who are what we call aggregators.

They have a business plan based on the fact that they will be able to put together diverse businesses in a manner that will provide greater overall value if they are together rather than if they are apart. Many service companies have been purchased over the years when the buyers of those services found out the profit margins that their vendor was able to achieve and determined that they would like to incorporate those profit margins in their own businesses so they purchase those service businesses. They will aggregate a number of firms together and hopefully continue to achieve the same profit levels.

Then, you will have the one off buyer of a business who sees the opportunity of your business and wishes to buy it. Typically, these sorts of buyers do not have a process to go through when they're doing due diligence on the business and it is important that you have a process with which you will go through in the process of evaluating the buyer so that you don't waste a great deal of time money and effort in the fishing expedition that some of these buyers have you go on.

That is where the business transition process comes in handy. Most buyers of this nature can recognize the value of a particular business in a particular industry, but they may lack the financial resources to make an all cash offer. This is when it becomes very important that you not only determine the value of the business that you are selling but also that the terms of the sale are strictly negotiated so you do not wind up selling a business with a substantial amount of seller notes which you no longer will control and quite possibly may have to foreclose on at some point in the future.

Using an ESOP as a Business Transition Plan

Most business owners contemplate coming up with some sort of transition plan when they began to think about what they would like to do when they get ready to slow down. To most business owners, those decisions never come easy. However, the options as to how you might transition the business are few in number: you'll either maintain the business within your family, you will sell the business to your management team, or you will engage in a third-party buyer who will purchase your business.

> ***Most of the time, business owners have an idea as to the value of their company, but they don't have a clue as to how they might be able to market their company.***

We are talking about something different than the occasional business broker who contacts you about putting your business on the market and has no idea as to what kind of business that you're in or the value of your business. For the most part, those business brokers are attempting to get you to list your business with them so that they can in turn see if they might create a market for your business. No, we're talking about creating a market for your business that will be provide you the means of extracting your hard labor and years of experience from the business in the form of money – cold, hard cash.

One concept that we have used on numerous occasions very effectively is the combination of MSOPs and ESOPs. An ESOP has the benefit of being able to purchase a majority share of a business owners stock on a tax favored basis while at the same time being able to pay for that stock on a tax-deductible basis. For almost any other buyer, they would be purchasing the business with after-tax dollars that would be subject to the friction of income taxes before they were able to pay for the business. And, because of that friction, most buyers will attempt to negotiate the price of the business downward in order to take that into account.

But what if you could structure the purchase of your business so that you could avoid entering into an asset sale, which would cause you to have to recapture as ordinary income the depreciation that you've taken on your assets over time? Most outside third-party buyers would rather buy the assets of the business than they would the business itself. This is because they are trying to avoid the potential contingent liabilities that might be associated with the ownership of the business and any previous liability that might have been incurred, and they would like to reset the depreciation schedules on the assets that they purchased. But what if you could sell that very selfsame business that no more than a capital gains rate?

An ESOP allows a business owner to structure a substantial sale of his business in order to extract some of his capital from the business on a tax-favored basis. It can be structured on a tax-deferred basis if it is a C Corporation (Code Section 1042 exchange). At worst, if it is a S Corporation, the sale of the stock to the ESOP would be a capital gains sale with no ordinary income recapture. The difference can be significant!

At the same time, if you have a management team that you would like to see succeed you in the business, an MSOP can be set up in order to benefit those who are in the management group who you would like to see benefit from such a plan. Through stock grants and stock awarded under a deferred compensation plan, the management stock ownership plan can provide the management team a means of obtaining an interest in the business without having the mortgage the farm in order to get there. At the same time, it ties that selfsame management team to the business and provides additional value to you the business owner as you are making your transition.

But what if you would like to transition the business to your family? And ESOP can also be a useful tool in that endeavor. Most business owners today who have built up quality businesses have to deal with the gift and estate tax levy on the transfer of those businesses. One of the big issues upon transfer is the valuation that the Internal Revenue Service attempts to place on businesses of this nature and due to their illiquid nature, provides an impediment to the transfer the business to family members.

What if you could use an ESOP as a means of extracting the good a good portion of the capital of business on a tax favored basis while at the same time providing a means for your family the either purchase the remaining shares will work to do a combination of gift purchase of those shares? You could be avoiding only costly income taxes on the transfer but also devastating gift and estate taxes that would occur.

Maybe a combination MSOP/ESOP plan could be just the thing for you to extract the value from your business and transition it to the next generation.

Step Six – Contingency Planning

Dealing with the "WHAT IFS" is a crucial step in the Business Transition process. We never want to think about negative possibilities, but when it comes the details of transitioning your business, an ounce of prevention is worth a pound of cure.

This next chapter is all about defining the necessary steps needed to understand and prepare for future obstacles that are possible and unique to your individual exit strategy.

Contingency Planning during the Business Transition Process

What are the issues that keep you up at night or trouble you about the future of your business? Every business owner has a list of issues, which they know could cause them problems in the future should they occur. Now, we are not advocating staying up at night worrying about things that may or may not happen, but what are the real issues that face your business? Are your markets changing? Has your customer base changed significantly? Do you continue to have good relationships with your banks? Is your product line still up-to-date? What are the factors in your general industry which affect your business?

All of these are questions that you need to ask yourself as you contemplate a business transition because at any point in time a significant change in your business could affect the manner in which you transition your business.

What happens to your business in the event of your death or disability before you complete your transition plan?

Do you have a management team in place that will be able to step in and do the things that you're doing currently? Or, have you inhibited their ability to grow as managers and therefore they would be at a loss if you are not around to guide them? It is important to have a contingency plan in place when the business owner dies in the midst of putting together a transition plan or before the transition plan can be affected.

If you die at work or become disabled, what would be the impact on your banking relationships? Could the business survive the loss of this financial resource?

Suppose that you are dependent upon a bank in order to provide you the financing for your inventory or your accounts receivable as you continue to grow the business. What would you do if you lost that valuable resource? In addition, what would happen to the business if you were to lose one of your main lines of products or one of your manufacturers is no longer able to produce it? These are just some of the questions that you need to ask yourself as you go forward and determine where the potential losses could be your transition plan.

We've discussed this previously, but securing the continued services of your key employees through a written plan is extremely important as you wind your way through the process of developing a business transition plan. If you are contemplating a transition in your business, then your employees are most certain to find out that you are doing so. If they fear the loss of their jobs or a change in control that will affect them adversely, then they may begin to look elsewhere for a position that is suited to their skills. Losing key employees, particularly those who are on your management team, can be particularly difficult as you represent the strengths of your business to potential outside third-party buyers. So before you embark upon a business transition plan, it is important to secure the services of your key employees to a written employment agreement.

We discussed previously, however, what would happen if you were to lose certain key employees? Employees of the most valuable asset in a business and there's nowhere on the balance sheet that they appear. However, particularly in a sale to a third-party buyer, key employees will prove to be the doing or the undoing of the transition plan. If you have good key employees who are able to continue the management of the business regardless of whether or not you are there, then the business is indeed valuable to an outside third-party buyer. If in fact you have lost your key employees, then you've probably lost the most valuable asset in your business.

Step Seven – Wealth Transfer Planning

Providing Effective Wealth Transfer Planning

In reality, effective wealth transfer planning should be undertaken prior to engaging a business transition plan in order to take advantage of these strategies which will allow you to significantly reduce the tax liability that you will have an organized your wealth in a manner that will allow you to maintain management control of your wealth.

The areas that a good wealth transfer plan should cover are as follows:

- Determining where your wealth will go – your family, the IRS or to charity;
- Maintaining management control of your assets;
- Minimizing taxes by utilizing valuation discount tools;
- Affecting a freeze on the value of your assets and move any appreciation on those assets out of your taxable estate; and
- Providing for adequate liquidity for your estate on a cost effective basis.

All of these will be covered in greater detail separately as the discussion takes place concerning providing a business continuation plan for you to be able to extract the wealth that you have created in your business. SSG Companies has bene vitally involved in the wealth transfer arena for years, and is intimately acquainted with the strategies being used today to reduce and avoid gift and estate and income taxes on your accumulated wealth.

Business Value Drivers

With the help of a number of M&A professionals, we have identified nine value drivers common to all businesses.

1. Best-In-Class Management Team
2. Operating systems demonstrated to increase sustainability of cash flows
3. Diversified Customer Base
4. Proven Growth Strategy
5. Revenue that is recurring sustainable and resistant to "commoditization"
6. Good and improving cash flow
7. Demonstrated Scalability
8. Competitive Advantage
9. Financial Foresight and Controls

VALUE DRIVER 1: Best in Class Management Team

We have mentioned it over and over again, but we will mention it one more time. The most important asset that never is shown on your balance sheet is your management team. A good management team will aid the business owner, but a great management team will transform the business and make it very valuable. Many business owners attribute their success by hiring great people and letting them do their jobs.

VALUE DRIVER 2: Operating Systems That Improve Sustainability of Cash Flows

The establishment and documentation of standard business procedures and systems demonstrate to buyers that a business can maintain its profitability after the sale. The establishment and use of systems contribute to cash flow creation and increase its sustainability. This cannot be emphasized too much. When you document as to how and why you did what you did, the potential buyer will begin to understand just what makes your business tick, and it will provide a roadmap to those who work with you.

VALUE DRIVER 3: Diversified Customer Base

Buyers typically look for a customer base in which no single client accounts for more than 10 percent of total sales. A diversified customer base insulates a company from the loss of a major customer. For example, if a company's three top customers generate 60 percent of sales, a buyer would be concerned if one or more of them left upon learning that the owner had left company. To a lesser extent this may also be a concern to inside buyers if the biggest customers are loyal to the owner, rather than to the company or other employees.

VALUE DRIVER 4: Proven Growth Strategy

Even owners who expect to retire tomorrow should have a written plan describing future growth and how they will achieve that growth in the context of industry dynamics and demand for a company's products. A growth plan may include: development of new product lines or augmenting existing ones, market plans, growth through acquisition of other companies, expansion into new territories or increasing manufacturing capacity. A detailed and properly communicated growth plan helps to attract buyers especially if a company's previous plans have successfully attained their goals (and the owner can prove it.) A growth plan should break down each growth initiative into achievable, time-sensitive actions and assign responsibility to specific individuals.

VALUE DRIVER 5: Revenue that is recurring, sustainable and resistant to "commoditization"

Buyers love to acquire businesses that print money at the touch of a button. Is there a way for your clients' companies to create one or more recurring revenue streams? For example, if an owner sells a product, can she also offer a warranty or service contract for it at time of sale?

VALUE DRIVER 6: Good And Improving Cash Flow

Ultimately, all value drivers contribute to stable and predictable cash flow. You can help owners start to increase company cash flow by focusing on ways to operate the business more efficiently: increasing productivity and decreasing costs.

VALUE DRIVER 7: Demonstrated Scalability

Can a company improve its profit margins if it increased its revenue? Think about designing a computer app like Angry Birds. There is a fixed cost to design and test, but additional sales do not increase those costs. Yes, scalability is a bit more difficult if your client owns a hardware store, but not impossible: if the store enjoys high profitability and strong revenue growth, it likely has many of these value drivers in place, including a competitive advantage. If these value drivers can be replicated, an owner can scale this business by establishing new stores in different locations using the same value driver model. Think Walmart.

VALUE DRIVER 8: Competitive Advantage

To paraphrase Michael Porter of Harvard University's Business School, competitive advantage is the product or service that a company offers—either better or more cheaply—over time than does its competitors. A company's competitive advantage is the reason customers buy from one company instead of from its competitors. Many successful owners have not identified their competitive advantage. Helping them do so allows them to grow and protect it.

VALUE DRIVER 9: Financial Foresight and Controls

Effective financial controls protect company asset and support a seller's claim that a company is consistently profitable. This is an ownership responsibility.

Now Before You Embark on your Journey

Imagine that you are about to take the trip of a lifetime. You have charted all the places where you and your spouse would like to visit. You have written down every single thing that you would like to accomplish on this journey. Then, you have your travel agent work out the details of the trip of a lifetime. Why? Because he or she makes arrangements like this, every day of their lives, knowing what accommodations are to your liking and the level of comfort that you would like to have on your trip.

You might have spent a little more on your accommodations. You might have spent a little more on your side trips. But, you get back from your trip, thinking what a great trip it was. All because you have the right kind of assistance in making your journey. And, the dividends that a nice trip paid off with the spouse!

You are about to embark on a journey with the transition of your business. You have built this business as no one could have built it, and you have babied this business and stayed up at night taking care of this business and spent your whole adult life making sure that it got the care that it deserved. You sacrificed vacations, time with family, and a myriad of things that you might have wanted to do, but you had a business to run.

You will be making decisions about the most valuable asset that you have. Wouldn’t it be a good idea to enlist the advice of professionals who have done this type of work for years? Wouldn’t you want to get the benefit of the best ideas and concepts from those who are working daily to help other business owners like you to transition their businesses? At SSG Companies, we have been working with business owners for over thirty-five years, providing them with strategies and concepts that have proven to be valuable in transitioning their businesses. We would love to help you.