

The Role of the Financial Adviser In Helping Owners Leave Their Businesses in Style

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Most business owners do not have an Exit Plan in place nor do they know how to create one. To leave a business in style however, owners, with the help of their advisers, should undertake a seven-step exit planning process. From setting objectives and valuation to ensuring both business continuity and family security a comprehensive Exit Plan addresses every contingency and prepares for a smooth transfer to family members, employees, co-owners, or third parties.

The everyday battles facing business owners often seem, to them, a matter of life or death. Financial advisers all too frequently encounter such frazzled owners who simply do not have the time, or are not willing to take the time, to engage in an estate or business planning process.

Yet, surprisingly even the most battle-weary owner welcomes one type of planning: exit planning. These owners are receptive to planning advice if that advice helps them leave their businesses sooner rather than later and for more money rather than less. They listen to advisers who offer a workable, step-by-step plan designed to reach a successful exit. Most owners know that they cannot design this Exit Plan alone. They need assistance — both technical advice and

emotional support. But few owners realize that the choice of how and when — or whether — they leave their businesses is theirs alone.

What few financial advisers realize is that the departure of a business owner from his or her business, if properly planned and executed, offers tremendous opportunities to both the owner and the adviser.

There is no mystery to leaving a business in style. Exit planning is based on a simple premise. At some point, every owner leaves his or her business — voluntarily or otherwise. At that time, every owner wants to receive the maximum amount of money in order to accomplish personal, financial, income, and estate planning goals.

Owners begin thinking about the exit planning process when two streams of thought begin to converse. The first stream is the feeling that they want to do something besides go to work everyday: either they'd like to be someplace else, doing something else, or they simply no longer get the same kick out of doing what they do. The second stream is the general awareness that the owner is either approaching financial independence, or making significant strides toward reaching that goal, or can achieve financial independence through the sale of the business. When these two streams converse, thoughts flow inevitably towards exiting the business.

Ideally, when that happens, the Exit Plan should be in place, and the owner should be able to leave the business when he or she wants to. That, in a nutshell, is the purpose of exit planning: to leave on the business owner's terms and on schedule.

What exactly is an Exit Plan that allows a business owner to leave his or her business in style? How is one created? And, what role does the financial adviser play in creating the Exit Plan? Of course, exact plans vary but, properly crafted, each plan has several common elements. Business owners best grasp these elements, or steps, when framed as questions.

Step 1: Exit Objectives. Has the business owner determined his or her primary planning objectives in leaving the business such as:

- departure date?
- income needed to achieve financial security?
- selection of new owner?

Step 2: Valuation. Does the owner know how much the business is **worth**?

Step 3: Making the Business More Valuable. Does the owner know how to increase the value of his or her ownership interest?

Step 3: Sale to Third Party. Does the owner know the best way to sell the business to a third party which will max-

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imize cash and minimize tax liability?

Step 5: Transfer to Family, Employees, or Co-owner. Does the owner know how to transfer the business to family members, co-owners, or employees while paying the least possible taxes and enjoying maximum financial security?

Step 6: Business Continuity Upon Death or Disability. Has the owner implemented all necessary steps to insure that the business continues if he or she does not?

Step 7: Estate Plan. Has the owner provided for his or her family's security and continuity if the owner dies or becomes incapacitated?

Step 1: Setting Exit Objectives

Failing to set goals means that an owner will not be able to exit his or her business in style. Many owners do not set exit objectives precisely because it is emotionally too wrenching to separate themselves from a business they have created, nurtured, lived with, suffered with, brought to maturity, and in which they have totally immersed themselves. It is difficult, if not impossible, for any planning professional to engage an owner in the planning process until that owner is emotionally prepared to leave the business. Those who are emotionally ready to face leaving often do not know what to do or where to begin.

This is the point at which the need for clear, simple exit objectives is of paramount importance. There are three straightforward retirement goals that every owner must fix in his or her mind. Establishing these goals allows the owner to cut through a lot of muddled thinking that previously prevented him or her from moving forward. These objectives are as follows:

1. Determining the length of time the owner wants to work in the business before retiring or moving on:

2. Determining the annual after-tax income needed during retirement (in today's dollars); and

3. Determining who to transfer the business to:

- family,
- key employee(s),
- co-owner, or
- outside party.

No owner can effectively leave his or her business without setting each of these objectives. Yet, only a handful has carefully formulated these objectives in advance of the actual transfer of the business. Of course, determining these objectives is primarily the responsibility of the business owner. But the owner need not work alone.

The owner's financial adviser possesses the experience and computer capability to create a financial retirement model based on at least the following factors:

1. The owner's retirement income needs based on current lifestyle expenditures (forcing the owner to finally develop that personal budget he or she has been promising to create).
2. Inflation assumptions.
3. Value of current portfolio.
4. Investment growth assumptions on current and future investments.
5. Number of years to retirement.
6. Life expectancies of the business owner and his or her spouse.

As the financial adviser works through this model with the client, the owner will likely discover that his or her current investments are not sufficient to allow a financially secure retirement. More money and more investments need to be in place before the owner can leave the business in style. While the owner can personally accumulate excess money (along the way) prior to retirement, the bulk of the needed investment monies normally comes from the sale of the business.

The business owner's financial adviser should run a number of "what if" scenarios using different variables in

order to formulate realistic financial objectives for the client. The financial adviser's role as an empathetic and experienced adviser is of immense assistance to the client at this initial stage. First, develop a retirement income needs model based upon the client's current lifestyle. Based on this model, calculate how much money the client wants or needs when he or she leaves the business. This, in turn, determines how much cash the client needs to reap from the business — either over time (if he or she sells to children or employees) or at the time of sale (if he or she sells the business to an outside party). Only by going through this analysis can the financial adviser and the client empirically determine how much money the business owner needs to realize from the sale of the business. This information is vitally important if the exit planning process is to proceed on course.

The most important service that any adviser can offer is to listen, to offer suggestions about various alternatives, and then to identify and to quantify each goal. That is exactly what the adviser will be doing during this first step of the exit planning process.

Step 2: Valuing the Business

A universal ownership objective is to secure an income stream that the owner and his or her family will need to support their future lifestyle. Knowing the value of the business is critical if the owner is to undertake the planning necessary to successfully exit the business. Why?

1. The business is probably the owner's most valuable asset. The business generally comprises between 65 and 90 percent of the typical owner's total assets. Financial security depends on converting that asset to cash.

2. The owner and his or her advisers need to know the current value of the business so that it can be deter-

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mined if the owner's financial objective can be met at present through a conversion of value to cash; or, as is more likely, how much business value must grow in order to reach the owner's retirement objectives.

The need for an accurate and thorough valuation is evident. The bigger question of who will perform the valuation raises several possibilities.

1. **A business appraisal firm.** These firms employ highly trained valuation experts and typically charge between \$ 10,000 and \$35,000 to perform a valuation.

2. **Independent CPA firm/Certified Valuation Analyst.** The typical fee charged by these professionals is between \$2,500 and \$ 15,000.

3. **The business's regularly retained CPA firm.** The fee charged the business owner's CPA is often nominal: \$1,000 to \$5,000.

4. **Financial advisers.** There is another valuation resource available to owners: the financial adviser, his or her computer, and its valuation software. Many insurance companies provide a valuation service to their financial adviser affiliates. The valuation work is performed at the home office from information the adviser has obtained from the business owner/client. There is also a wealth of commercial valuation software available if the adviser chooses to perform the valuation analysis.

The traditional use of the valuation analysis (for planning purposes only) is to provide a business value for buy-sell purposes. This valuation service performed by an adviser or the adviser's company is a most valuable tool; its use should not be limited to buy and sell situations, but to every business client contemplating exiting his or her business. Of course, any valuation needed for gifting or sale purposes must be performed by a certified valuation expert.

It is a sound practice to have the

valuation report reviewed by the owner's CPA. The CPA firm typically offers its opinion of the company's value. For the business owner, this is the most cost-effective means of assembling, preparing and reviewing valuation information. It is a "poor man's" valuation report.

Using these types of appraisals is appropriate to determine business value for planning purposes and for transfers of business interests to "insiders," family members, employees, or co-owners. There is one caveat: If a buy and sell agreement is used to "fix" the value for estate tax purposes, the value must be the fair market value (FMV) at the time the agreement is entered into. If the business is to be sold to an outside party, the financial adviser should steer the client to a reputable transaction adviser, a business broker (if the business is likely worth less than \$1 or \$2 million), or an investment banker if the business is more valuable. These advisers are in a better position to properly assess the likely sale price of the business, for the sale price of a business considers the current marketplace and other factors not usually considered when using historically oriented valuation methods.

Step 3: Making the Business More Valuable

An inevitable by-product of a consistently well-run business is an ever-increasing value for that business. There are numerous actions an owner can and should take to maximize value. These include:

- maintaining and consistently increasing cash flow,
- creating and using efficient systems,
- documenting the sustainability of earnings, and
- Motivating and keeping key employees.

This step goes to the heart of a successful business and to the essence of the role of a business adviser: to help the client enhance the value of the business.

If the client's objectives include selling the business for cash to a third party, the financial adviser should suggest that he or she meet with the CPA to discuss the appropriate level of financial review recommended to document earning history. In most significant third-party sales, the buyer will insist on audited financials for the previous two to three years.

If the client's objective is to transfer the business to family or employees, audited financials are unnecessary. In fact, many decisions ordinarily based upon financial information (such as increasing revenue, net income, market-share, etc.) play second fiddle to minimizing risk and increasing security. A sale to a non-cash buyer means the financial adviser must minimize the client's exposure to business risk after he or she has left the business, while maximizing the ability of the business to pay off the client.

Motivating and keeping key employees is critical, whether the client sells to an outside party (who will pay more for a company with stable motivated management), or sells to an insider (who will run the business after the client leaves). Most investment bankers believe that the single most important factor, other than increasing cash flow, is giving rise to a higher business value through the existence of a stable, motivated management team that will remain in the business after the owner exits. It is often the case that the business's regular advisers have little experience in designing, implementing, and funding key-employee incentive plans. Hence, there is a need for the financial adviser to play a leading role with respect to this value-enhancing factor.

At this point the financial adviser

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should suggest several techniques to motivate and keep the client's key employees such as the following:

1. Stock (or equity) incentive-based plans including:

- Stock bonus
- Stock option
- Stock sale

2. Non-equity plans including:

- Cash bonus
- Nonqualified deferred compensation
- Phantom stock
- Stock appreciation rights (SAR Plan)
- Salary Continuation
- Death Benefit Only (DBO Plan,
- Split Dollar

financial adviser can provide assistance to the client with respect to these value-enhancing concepts by educating the client on the use of these concepts, involving the other advisers in the design and implementation of these concepts, serving as a catalyst to keep the exit planning process moving forward, and suggesting various types of funding tools to be used in conjunction with key employee benefit plans. Most financial advisers can also provide suggestions with respect to appropriate funding vehicles.

Step 4: Sale to a Third Party for Maximum Dollars

Owners sell to outside parties when their primary exit objective is to maximize the amount of cash in their pockets. The best way to obtain the maximum amount of money for a business is to expose it to a number of pre-selected qualified buyers using a sophisticated marketing and sale process.

The most effective marketing process is a four-phase strategy designed to create a competitive or *controlled auction*. The competitive auction is intended to bring multiple qualified

buyers to the negotiating table at the same time, all with the same information, and ready to make an offer for the company. This process enables the business owner to select the sale price, deal structure, and an on-going operating philosophy that is most attractive to him or her. The auction process also keeps the business owner in control of the sale process.

The controlled auction process is comprised of the following four phases:

Phase I. Pre-sale Planning

1. Establishing objectives,
2. Assembling an experienced team.
3. Performing pre-sale due diligence

Phase II. Marketing

1. Developing a buyer profile
2. Making a good first impression
3. Finding the buyer
4. Executing the confidentiality agreement
5. Buyer due diligence

Phase III. Negotiating

1. Maintaining momentum
2. Providing letter of intent
3. Final due diligence
4. Maintaining confidentiality

Phase IV. Documentation and Closing

1. Developing definitive purchase agreement
2. Closing

Inherent in this process is the need for experienced transaction financial advisers. The trusted adviser can play a key role in introducing the client to other advisers, in particular, an experienced transaction adviser, business broker, or investment banker. A significant part of the transaction adviser's mission is to find a group of potential buyers and orchestrate a controlled auction.

Only through using an intermediary, such as an investment banker (or a business broker for businesses valued less than \$1 million or \$2 million), is it likely that multiple potential buyers can be simultaneously

approached and developed into serious candidates. Phase I is handled by the financial adviser, the owner, and the owner's other existing advisers. The transaction adviser orchestrates phases II and III. Phase IV is conducted by legal counsel with the assistance of the financial adviser who offers advice on transferring or terminating employee benefit plans and on terminating or rolling out split-dollar arrangements between the owner and his or her company.

Step 5: Transfers to Family, Employees or Co-Owner

Those brave owners who wish to transfer their businesses to family or employees must be aware of two fundamental conditions inherent to this type of a transfer. First, the income tax consequences of the transfer must be minimized for both the seller and the buyer. Second, the departing owner must concentrate on acquiring maximum security for payment of the purchase price.

The reason for the emphasis on these two conditions is based on one fact: The buyer(s) (children or key employees) have no cash. The only way an owner will receive his or her purchase price is to receive installment and other payments (directly from the company) over an extended period of time. All money the owner receives will come from the future cash flow of the business: that is, income the business earns after the client departs. Therefore, it is imperative that the tax consequences to the business **and to the buyer** be minimized in order to preserve a greater part of the company's cash flow for the departing owner. Similarly, the deal must be structured to maximize the client's security because it will take an extended period of time to receive the full purchase price.

The following techniques can be

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used to minimize income tax consequences to buyer and seller.

Minimizing Ownership Value of the Business

The lower the price paid for the ownership interest, the less that money is subject to the income tax levied against the buyer (key employee or family member) and the capital gains tax assessed to the seller (the departing owner). In other words, for the seller to receive money for the sale of his or her ownership interest, the company must first earn it and the buyer must pay a tax on that money when he or she receives it. The key employee then pays that after-tax amount to the seller as part payment for the ownership interest, and the seller (owner) pays a capital gains tax on receiving that money. Hence, there is a double tax on each dollar of cash flow earned by the business that is used to pay for the departing owner's interest in the company.

Avoiding the Double Tax

The best way to protect the business's cash flow from a double tax is to create unfunded obligations to the owner from the business (long before the actual transfer). These obligations include:

- nonqualified deferred compensation for the owner;
- leasing obligations between the owner and the business, such as a building or equipment;
- indemnification fees;
- licensing and royalty fees; and
- subchapter S dividends.

Of equal importance is the need to maximize a departing owner's security. Useful techniques include:

- transferring excess accumulated cash within the business prior to the sale;
- securing personal guarantees from the buyer, including business and personal assets;

- keeping a controlling interest until financial security is assured;
- staying involved until the former owner is satisfied that the cash flow will continue without him or her;
- securing partial outside financing even though this may require subordinating the client's security interest to a bank or similar financing organization;
- selling part of the business to an outside party; and last, but not least, remaining constantly aware that transferring the business to children, key employees, or co-owners is a high-risk venture in which there must always be an "out" That "out" is likely a sale to an outside party if buyers are unable to fulfill their obligations.

The company's existing tax advisers and business attorney, if experienced in the area of business transition planning, are important members of the team. However, in many, if not all, situations, the owner's advisers lack significant experience in designing and implementing an Exit Plan for their owner/clients. Consequently, this presents both a challenge and an opportunity for the financial adviser to take a lead role in directing the client through this step of the exit planning process.

Step 6: Develop a Contingency Plan for the Business

One of the benefits of developing an overall exit strategy is that the client will appreciate how contingency planning is integral to the overall business plan. Taking prudent measures so that the business can continue if the client does not is a natural consequence of the planning process. In the ideal situation, the business continuity needs (upon the death or incapacity of an owner) can be met by a business continuity agreement with his or her co-owner. Most businesses, however, are owned by a single person and are not co-owned.

If sole owners do nothing else, they have a duty to their families and to their businesses to create a written plan that answers the following questions:

1. In the owner's absence, who can be given the responsibility to continue and supervise:
 - a. business operations?
 - b. financial decisions?
 - c. internal administration?
 2. How will these people be compensated for their time and, most importantly, for their commitment to continue working until the company is transferred or liquidated? Key-person insurance on the owner's life to fund this need at the company level should be considered. The proceeds for an employee "stay bonus," which is a cash bonus receivable by employees if they stay and see the company through its transition (usually 12 to 18 months) can be used. Typically, the stay bonus is only available to the company's important employees (often 20 percent or more of the total employees), and it equals 100 percent to 150 percent of their annual compensation.
 3. Should the business, at the owner's death or permanent incapacity, be:
 - a. sold to an outside party?
 - b. sold to employee(s), and if so, to whom?
 - c. transferred to family members?
 - d. continued?
 - e. liquidated?
 4. Who should be consulted in the transfer process described above?
 5. If the business is to be sold, list the names and contacts of businesses that have expressed an interest in acquiring the owner's business.
- When an owner makes the decision to begin transferring the business, the last thing he or she is likely to consider is the need for adequate planning to protect the business if he or she should suddenly die or become incapacitated. Yet this is precisely the

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point when the business is most vulnerable: It has peaked in value. but the event creating liquidity (the sale of the business) is likely a year or more away. The remedy is usually straightforward: adequate legal documentation in the form of a buy-sell agreement or stay bonus program along with adequate funding.

Owners recognize the need for business continuity planning as they inch ever closer to actually exiting their businesses. Perhaps this is because, for the first time, they actually see themselves not running the business. Certainly being led through the exit planning process by a financial adviser gives every owner a keener appreciation of the entire process, including contingency planning for the business and the final step, estate planning.

Step 7: Develop a Contingency Plan for the Owner's Family

With this final step, the exit planning process comes full circle. The adviser should encourage the client to review the financial objectives established under Step 1. If he or she does not survive until retirement, what will the family need? What efforts should be taken to minimize or avoid estate taxation? A business owner's "estate plan" is nothing more — and nothing less — than one part of an overall business plan. Unlike some of the living objectives, however, estate planning objectives and business continuity objectives are relatively easy to meet. The primary objective of acquiring sufficient liquidity to meet financial objectives can be met through life insurance and disability insurance. Death objectives are surprisingly easy to meet. Once the first two steps (Exit Objectives

and Valuation) have been completed, owners often jump to this final step (preparation of appropriate estate planning documents and funding of financial needs by insurance).

The exit planning process also forces owners, usually for the first time, to obtain a realistic valuation of their businesses. This value is normally higher than the value previously used for estate planning purposes and exposes a need for further funding for estate tax purposes. Likewise an analysis of the owner's income objective (Step 1) often leads to the realization that the desired level of income will not be available on the owner's death or disability.

The financial adviser's role in this final step is a familiar one, but the reaction to the adviser's role may be unfamiliar. The financial adviser's suggestions will be welcome as part of an extensive planning process, rather than skeptically viewed as an attempt to sell expensive insurance to someone who simply is not going to die anytime soon.

Conclusion

The techniques which produce operational business success (learning from mistakes, developing a business strategy based upon experience, using trial and error, and conducting business efficiently and effectively) do not guarantee a successful business departure. Unfortunately, the valuable experience that owners develop over the course of their business lives does not equip them to leave their businesses. Experience, learning, and "trial and error" all require time — a luxury most business owners do not enjoy as they approach the end of their ownership lives. Once most owners begin to think about leaving,

they want out sooner, rather than later.

Owners need:

• **An Effective Plan.** With the financial adviser's counsel, they can base that plan on the seven steps summarized in this article.

• **Experienced Advisers.** With the financial adviser's input, owners can select advisers who have seen and learned from the failures and successes of owners exiting their businesses.

• **Time.** Time can be an ally if business owners formulate their Exit Plans sooner rather than later. As the adviser most oriented toward planning in general, the financial adviser has the first and primary opportunity to initiate owners in the exit planning process.

Few owners have experienced leaving a business. Consequently, few know how to approach the exit planning process, whose advice to take, or when to begin. Knowing how this process works is personally rewarding and makes the financial adviser invaluable to the business-owning client. J

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