

The



Planner

February, 1998

A Publication of
Business Enterprise Institute, Inc.

WHAT'S INSIDE

by John H. Brown
President, Business Enterprise Institute, Inc.



→ JOHN H. BROWN

INEVITABILITIES

"...In this world nothing is certain but death, taxes and business owners exiting their businesses."

—Benjamin Franklin Brown

Okay, so maybe there are a few other verities in life besides exiting your business; but few will have such lasting impact and fewer still can be so positively influenced by your input and action. And you will exit your business someday.

Unfortunately, if you are typical of the majority of closely held business owners, you are without a written plan describing your exit planning strategy. You have probably spent a fair amount of time *thinking* about "life after work" but you have *done* nothing to get yourself there. The most common reasons why few owners take the time and make the effort to plan are:

- No Time
- Don't know what can be done
- Don't know how to engage in planning process
- Don't have clearly defined goals
- Fear of the unknown—life after work
- Not ready to leave the business, so why plan now?

This article is designed to sweep away some of the mystery surrounding leaving your business in style. It shows:

- *What* Exit Planning can do
- *Why* you need to start planning now
- *How* to design your exit plan
- *Who* you need on your team.

EXIT PLANNING

by John H. Brown

Exit Planning is based on this 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 converge. The first stream is a feeling that you want to do something besides go to work everyday—either you would like to be someplace else—doing something else—or you simply no longer get the same kick out of doing what you are doing. The second stream is the general awareness that you are either approaching financial independence, or making significant strides toward reaching that goal, or can achieve financial independence by selling your business. When these two streams converge, thoughts flow inevitably towards exiting the business. Hopefully, when that happens, your Exit Plan is in place and you are actually able to leave the business when you want to. That, in a nutshell, is the purpose of Exit Planning—to leave your business on your terms and on your schedule.

But what exactly is an “Exit Plan” that allows a business owner to leave her business in style? And, just how is one created?

Of course, exact plans vary but, properly crafted, each plan has several common elements. I find that business owners best grasp these elements, or steps, when I frame them as questions.

STEP 1: EXIT OBJECTIVES. Have you determined your primary planning objectives in leaving the business, such as:

- Departure date?
- Income needed to achieve financial security?
- To whom you want to leave the business?

STEP 2: VALUATION. Do you know how much your business is worth?

STEP 3: MAKING THE BUSINESS MORE VALUABLE. Do you know how to increase the value of your ownership interest?

STEP 4: SALE TO THIRD PARTY. Do you know the best way to sell your business to a third party which will maximize your cash and minimize your tax liability?

STEP 5: TRANSFER TO CO-OWNERS OR FAMILY. Do you know how to transfer your 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. Have you implemented all necessary steps to insure that the business continues if you don't?

STEP 7: ESTATE PLAN. Have you provided for your family's security and continuity should you die or become incapacitated?

This article summarizes each step and also describes who best can advise you at each step of the Plan. A complete discussion of each step appears in *The Completely Revised How to Run Your Business So You Can Leave It In Style* (available through Business Enterprise Institute for \$19.95).

EP STEP 1: SETTING EXIT OBJECTIVES

“When a man does not know which harbor he is heading for, no wind is the right wind.”Seneca

Seneca was, indeed, a wise philosopher. Today he would probably become a management consultant and make millions of dollars. His advice is as sound for business owners now as it was centuries ago. Yet, few owners heed that advice or appreciate its implicit warning.

Failing to set goals means that an owner will not be able to exit 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 mind. Establishing these goals allows the owner to cut through a lot of muddled thinking that previously prevented him from moving forward. These objectives are:

1. How much longer do I want to work in the business before retiring or moving on?
2. What is the annual after-tax income I want during retirement (in today's dollars)?
3. Who do I want to transfer the business to?
 - family
 - key employee(s)
 - co-owner
 - outside party

No owner can effectively leave his business without setting each of these objectives. Yet, in my experience dealing with thousands of business owners, only a handful have carefully formulated these objectives in advance of the actual transfer

of the business.

Who can help? These are *your* objectives, from which all planning efforts and results will flow. You are the person primarily responsible for this step, but you need not work alone. Who can help?

Ask your insurance or financial advisor if she has the computer capability to create a financial retirement model for you based on at least the following factors:

1. Your retirement income needs based on current lifestyle expenditures (so you need to finally develop that *personal* budget you've resolved to develop...for the past 15 years).

2. Inflation assumptions.

3. Size of current investments.

4. Investment growth assumptions, on current and future investments.

5. Number of years to retirement.

6. Life expectancies, yours and that of your spouse.

As you work through this model you will likely discover that your current investments are not sufficient to allow you to retire with financial security. You need more money, more investments before you can leave your business in style. While you can personally accumulate excess money (along the way) before you retire, the bulk of the needed investment monies will come from the sale of your business.

I suggest you work with an advisor who can run a number of “what if” scenarios using different variables. With your advisor's input you can formulate realistic financial objectives. Empathetic and experienced advisors can be of immense assistance to their clients at this initial stage. They should develop a retirement income needs model based upon your current lifestyle. You will then be able to calculate how much money you want or need when you leave the business. This, in turn, tells you how much cash you need to get from the business—either over time, if you sell to children or employees, or how much you need in *cash* if you sell the business to an outside party. Only by going through this analysis can you empirically determine how much money you need to realize from the sale of the business. A wise financial advisor—usually a financial planner or insurance agent—can be of immense help at this first stage.

I believe that the most important service that I, or other advisors, offer is to listen, to offer suggestions about various alternatives, and then to identify and to quantify each goal.

Take the time here to assemble your advisory team—solicit their views on how and what you should do. If you are not convinced that they know considerably more than you, find new advisors! You are searching for wisdom here and those who offer it had better have more insight than you—after all, you have never exited a business before.

EP STEP 2: VALUATION

A universal ownership objective is to secure an income

stream that you (the owner) and your family will need to support your future lifestyle.

Knowing the value of the business is critical if you are to undertake the planning necessary to successfully exit the business. Why?

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

- The owner and her advisors need to know the current value of the business so that we can determine 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.

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

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

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

- The business's regularly retained CPA firm. The fee charged by your CPA is often nominal: \$1,000 to \$5,000.

- Financial and insurance advisors. Many insurance advisors have access to valuation software and will perform a valuation on a complimentary basis. Owners can derive substantial benefit from using this service. Financial advisors seldom charge for assembling the background information necessary to value the business, nor do they charge for processing that information using valuation software. I believe it is a sound practice to have that information and the valuation report reviewed by your CPA. Your CPA firm can then offer its own opinion of your company's value. This is the most cost-effective means of assembling, preparing and reviewing valuation information. It is a “poor man's” valuation report.

I suggest using these types of appraisals to determine business value for planning purposes and for transfers of businesses interest to “insiders,” family members, employees or co-owners. However, if the business is to be sold to an outside party, I suggest you use a transaction advisor, a Business Broker (if your business is likely worth less than one or two million dollars) or an Investment Banker if the business is more valuable. These advisors are in a better position to properly assess the likely sale price of your business.

EP 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:

1. Maintaining and consistently increasing cash flow;
2. Creating and using efficient systems;
3. Documenting the sustainability of earnings; and
4. Motivating and keeping key employees.

This step goes to the heart of a successful business and to the essence of your role within the business—to enhance value.

Who can help? If your objectives include selling the business for cash to a third party, I suggest you meet with your 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 financial statements for the previous two to three years.

If your 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 shares, etc.) play second fiddle to *minimizing risk* and *increasing security*. A sale to a non-cash buyer means you will want to minimize your exposure to business risk, after you have left the business, while maximizing the ability of the business to pay you off. Motivating and keeping key employees is critical, whether you sell to an outside party (who will pay more for a company with stable motivated management), or sell to an insider (who will run the business after you leave).

Your legal counsel and, perhaps, insurance or financial advisor should suggest several techniques to motivate and keep your key employees, such as:

Stock (or equity) incentive-based plans including:

- Stock bonus
- Stock option
- Stock sale

Non-equity plans including:

- Cash bonus
- Nonqualified deferred compensation plan
- Phantom stock plan
- Stock appreciation rights plan (SAR Plan)

EP STEP 4: SALE TO A THIRD PARTY FOR MAXIMUM DOLLARS

There are a variety of ways to market a business for sale. The most effective method, in my opinion, is a four-phase process 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 on-going operating philosophy that is most attractive to him. 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

- A. Establishing Objectives
- B. Assembling an Experienced Team
- C. Pre-Sale Due Diligence

Phase II. Marketing

- A. Developing a Buyer Profile
- B. Making a Good First Impression
- C. Finding the Buyer
- D. Executing the Confidentiality Agreement
- E. Buyer Due Diligence

Phase III. Negotiating

- A. Maintaining Momentum
- B. Letter of Intent
- C. Final Due Diligence
- D. Maintaining Confidentiality

Phase IV. Documentation and Closing

- A. Definitive Purchase Agreement
- B. Closing

Who can help? Inherent in this process is the need to use experienced transaction advisors. Of particular importance is selecting an experienced transaction advisor, Business Broker or Investment Banker. He will be in charge of the second and third phases of the selling process. A significant part of his 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 owner and often his existing advisors; Phase IV by legal counsel.

EP STEP 5: TRANSFERS TO CO-OWNERS OR FAMILY

Those brave owners who wish to transfer their businesses to family or employees, must be aware of two fundamental conditions present in this type of a transfer. First, the income tax consequences of the transfer must be minimized for both the seller and the buyer. Secondly, 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 you as the owner will receive your purchase price is to receive installment and other payments (directly from the company) over an extended period of time. All money you receive will come from the future cash flow of the business; that is, income the business earns after you depart. 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 your security because it will take an extended period of time to receive the full purchase price.

Techniques to minimize income tax consequences to buyer and seller include:

1. Minimizing ownership value of the business. The lower the price paid for the ownership interest, the less that money is subject to the double whammy of income tax levied against the buyer (key employee or family member) *and* capital gains tax assessed to the seller (the departing owner). In other words, for the seller to receive money for the sale of his 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.

2. Avoiding the double tax. The best way to protect the business's cash flow, the golden goose, 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 you, the owner;
- Leasing obligations between you and the business such as a building or equipment;
- Indemnification fees;
- Licensing and royalty fees;
- Subchapter S dividends; and
- Transfer excess accumulated cash within the business prior to the sale.

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

- Securing personal guarantees from the buyer, including business and personal assets.
- Keeping a controlling interest in your company until financial security is assured.
- Staying involved until you are satisfied the cash

flow will continue without you.

- Securing partial outside financing even though this may require subordinating your security interest to a bank or similar financing.
- Selling part of the business to an outside party.
- And last, but not least: Remaining constantly aware that transferring the business to children or key employees is a high risk venture. There must always be an "out." That "out" is likely to be a sale to an outside party if the buyers are unable to fulfill their obligations.

Who can help? Your existing tax advisors and business attorney, if experienced in the area of business transition planning, are your best sources for this long duration transition.

EP STEP 6: DEVELOP A CONTINGENCY PLAN FOR THE BUSINESS

One of the benefits of developing an overall exit strategy is that you will appreciate how contingency planning forms an overall part of a living business plan. Taking prudent measures so that your business can continue if you don't 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 a co-owner. *Most businesses, however, are owned by a single person.* They 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 my 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? Consider key person insurance on the owner's life to fund this need at the company level. Use the money to offer these employees a "stay bonus," a cash bonus receivable by them if they stay and see the company through its transition.
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 his business, the last thing he is likely to consider is the need for adequate planning to protect the business if he should suddenly die or become incapacitated. Yet this is precisely the 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 with adequate funding.**

This step is simply one part of the overall planning process.

Who can help? Consult with your attorney and insurance advisor to create a short-term and (hopefully) unused continuity plan.

EP STEP 7: DEVELOP A CONTINGENCY PLAN FOR THE OWNER'S FAMILY

With this final step, your Exit Planning process comes full circle. Review your financial objectives established under Step One: if you don't survive until retirement, what will your family need? What efforts should be taken to minimize or avoid estate taxation? As a business owner, your "estate plan" is nothing more 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 upon your death or incapacity. The primary objective of acquiring sufficient liquidity to meet financial objectives can be met through life insurance and disability insurance. I think you will be surprised by the ease with which death objectives can be met. Once the objectives and valuation steps have been completed, owners often jump to this Step (preparation of appropriate estate planning documents and funding of financial needs by insurance) so they

can minimize the impact their death would have on the overall planning process.

Who can help? Consult with your Estate Planning attorney and insurance advisor.

EP CONCLUSION

The techniques which produce operational business success (learning from mistakes, developing a business strategy based upon experience, trial and error and conducting business efficiently and effectively) do not guarantee a successful business departure. Unfortunately, the valuable experience 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.

Instead, owners need:

- An effective plan. Base your plan on the seven steps summarized in this issue of **The Exit Planner**.

- Experienced advisors. Choose advisors who have seen and *learned* from the failures and successes of *other* owners exiting their businesses. They should guide you through the exit process so you can avoid costly mistakes.

- Time. Make it an ally by starting your Exit Plan **now**.

Few owners have experienced leaving a business. Consequently, few know how to approach the exit process, whose advice to take, or when to begin. I suggest that you use this article: 1) to design an exit planning process used by hundreds of business owners, and 2) to choose the type of advisor who can help you at each step. The final element—when to begin—is up to you.

John H. Brown is an attorney with the firm of Minor & Brown, P. C. in Denver, Colorado. He is the author of two books on Exit Planning for business owners and is a frequent lecturer to business owners and their advisors across the United States.



The Exit Planner is published five times per year. Because this newsletter is general in nature, please consult your attorney and other advisors before acting on any information contained in The Exit Planner. ISSN # 1094-4583

PRODUCTION STAFF

Editor Kathryn B. Carroll
Design and Production Georgianne Bender
Andrew H. Leman

All contents ©1998 by Business Enterprise Institute, Inc

Subscriptions to *The Exit Planner* are available for \$49.00 per year by contacting:

Theresa Carlson

Business Enterprise Institute, Inc.
650 S. Cherry Street, Suite 1100
Denver, Colorado 80222
(303) 321-2242

TOLL FREE: (888) 206-3009

FAX: (303) 320-6330