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CREATING A SUCCESSION PLAN

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Clients often ask "How do we create a meaningful business succession plan for our Company to accommodate our retirement, disability or death?"

For most companies, current objectives include (i) growth of revenues; (ii) the creation or strengthening of an infrastructure (mid-level management) to support that growth; and (iii) the creation or acquisition of additional, tangible and intangible transferrable assets, including good will. The realization of each of these objectives are key to the possibility of a meaningful sale (exit) to a third party. In the event growth occurs without the creation of tangible, reoccurring assets or a management team, the current owners "are the business" and no succession plan is possible. Life insurance proceeds could be used to create liquidity for the owners' estate and provide company working capital for a short period of time (to complete ongoing contracts and possibly structure a sale on a seriously discounted basis), but no real continuation of the company as presently incarnate seems likely.

For those facing limited liquidity such as this, it is never too soon or too late to develop an exit strategy and estate plan that will maximize the value received from the business while minimizing the tax bite.

Every exit strategy involves developing a plan for passing on responsibility for running the company, transferring ownership, and extracting the current owners' investment. Because a stable business is worth more than an unstable one, creating a seamless transition is essential to maximize the investment. This requires proper positioning while the company is in good economic health.

Succession within the family - Many owners of closely held companies plan to pass their businesses on to family members or close relatives by:

Giving interests to family members. By giving (gifting) part of the business to the family members who are actively involved in it, such family members are rewarded for their involvement and continuity is (almost) assured.

Selling the business to family members. If multiple family members of the same generation are involved, gifting to that second or third generation equally, regardless of true involvement in the day to day operations, often breeds unnecessary family tension and a loss of clear company vision. Selling the business to only those individuals interested and willing to commit (under favorable terms) may be an alternative worth exploring. This may be the only option if proceeds from a sale are needed for retirement even if all family members are involved in the business. Life insurance proceeds (upon death) or deferred salary (during life) is used to fund the purchase price. Selling to family members

obviously keeps the business in the family but selling only to those members truly interested will free up other assets to be distributed more equitably throughout the family.

Management buyout. Allowing management the option to buy shares in the business is an excellent way to transfer ownership to a group that is dedicated to the business. This may be preferable to having an outside party assume ownership, especially if there is an interest in having the business continue in the direction envisioned. Management buyout may provide for a smooth transition and little or no learning curve for the new owners. Control need not shift until payment in full to the founders.

Employee Stock Ownership Plan (ESOP). Like the management buyout, an ESOP leaves the business in the hands of the people who are committed to the company. Whether planning for liquidity, looking for a tax-favored loan, or supplementing an employee benefit program, an ESOP can offer business owners many advantages. A pre-requisite for an ESOP, however, is a somewhat stable work-force and because valuation issues for an ESOP are unique, having a valuation done specifically for the ESOP is key to making a decision.

Nonfamily succession. Sometimes ownership succession within the family and management succession is not an option for a closely held business. When looking outside the family for ownership succession, it is important to begin planning early to maximize the value of the business at the time of the sale since large salary continuation terms, common to "family" deals, are difficult to negotiate.

Buy-Sell Agreements. When there are two or more active equity holders, a buy-sell agreement is a powerful tool to help control a company's future. Contractually determining what happens to the company stock after a triggering event can help avoid share-holder disputes and can also solve some of an owners' estate planning problems. If owners are, however, close in age and likely to retire within a few years of each other, caution must be taken not to punish the one last left standing. If a lifetime buy-out of the first to exit is too sweet, the last current owner can find it difficult to attract a buyer willing to maintain onerous payment obligations to prior owners let alone give comparable terms to the last founder/owner.

No single, sure-fire method of determining the right or fair price exists, nor is the price necessarily the same in all situations. Having a well thought out and regularly updated valuation of the business is essential. Owners can set a price in several ways:

Objective formula. Many people like having a formula they can generally apply with some degree of certainty. While a formula has the advantage of being objective, it can pose difficulties because it may not capture the many subjective factors involved in arriving at a value and changing times.

Independent valuation. Because objective measures cannot capture so many issues, many owners agree to use fair market value for the purchase price. They usually select one or more outside valuators to find the company's fair market value. If discounts are not to be applied, the parties should agree before the independent valuation is initiated.

Agreement by parties. If feasible, given the situation and personalities involved, the parties may sit down periodically and agree to a value. A formula or outside advisors can help determine a price, and

the amount agreed on becomes the value used for the buy-sell agreement. It is wise to include a formula (in spite of all the inherent faults of a formula mentioned above) that provides for an adjustment to a previously agreed upon price if the parties have not agreed to a value for 18 months or more.

Unfortunately, when discussing most closely-held companies, the valuation analysis to be used in the context of an owner/founder's death is even more difficult. Where a spouse inherits, we don't want to do the IRS a favor and plug in a high value. This is especially true if death makes the company's value vulnerable to discounts. Ron Seigneur, national consultant and founder of Seigneur and Co. (cpavalue.com) advises that the day before an owner/founder's death or incapacity, the goodwill value of a company is 100%; the day of death or incapacity reduces the goodwill value by 10% to 20%; and each day of the first week after death or incapacity reduces the goodwill value by 1% to 3%. He further insists the second week to the end of the first month reduces the goodwill value 2% to 4%, and the goodwill value of the company one month after an owner/founder death is reduced to 20% to 60% of the original value.

Thus, it is imperative that planning for business succession is undertaken before events limit the business options for the owner/founders or their estate.

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