BUSINESS SUCCESSION PLANNING:
NOW IS THE TIME

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Owners of closely held businesses are working hard, especially in this economic climate, to keep their businesses operating and growing. Increasing numbers of these owners have put their exit plans on hold for business and personal reasons. Yet, this is an excellent time for owners to work on their exit plans. The analysis and strategic planning involved in this process is and will be invaluable for the continuing business operations. Current conditions provide a good opportunity to resolve difficult and unpleasant problems ignored in better times. Exit planning and execution takes a long time.

This article is a brief overview of the issues to consider in succession/exit planning and of the options available. It is by no means comprehensive and each business has its own unique factors to consider. Owners should consult their own counsel for a full and complete analysis and understanding of their own situation.

I. Exit/Succession Options

There are multiple ways for business owners to leave their business. A complete discussion is beyond the scope of this article. However, here are brief descriptions of a few options.

A. Internal Succession

This is often a business owner's first choice. It allows the business to continue and provides employment to the people the owner knows and cares about. However, the owner needs to view potential internal successors with a dispassionate eye and examine carefully how such a transfer would work financially. Employees often lack the financial means to pay "cash" for the business and look to the business itself to finance the purchase. It is in no one's interest for the business to fail after transfer. The owner should also be mindful of internal dynamics, which can lead to disgruntled employees who feel "excluded" from control. Road testing successors is particularly advisable in this option.

B. An Outside Successor (merger or acquisition)

Sometimes, business owners will look to acquire or merge with a smaller, often complementary business run by someone with proven entrepreneurial skills as their "replacement". Such a situation can prove to be a great opportunity for the business owner planning his or her exit.

However, this process takes time and requires a back-up plan if the right target cannot be found. Here, especially, internal issues can undermine the success of the plan and should be considered carefully. It is also important to consider whether the "business cultures" of the entities are compatible.

C. Sale of the business (stock sale/merger or asset sale)

Sale of a business may be accomplished as a sale of the ownership of the business (stock sale) or sale of the business's assets (including the name and attributes of an ongoing business). There are tax considerations and liability considerations that cause sellers to favor stock sales and buyers to favor asset purchases. For example, asset sales can be structured to allow buyers to acquire the business without pre-acquisition liabilities and to allocate part of the purchase price to certain assets, giving them a stepped up tax basis and enabling the buyer to take higher depreciation deductions.

Selling the business generally requires that the former owner stay on as an employee for a period of time, which many former owners find difficult. The buyer usually requires a non-competition agreement, so business owners considering this option need to be sure they are ready to leave their industry - at least for a period of time.

D. Closing the business - Dissolution

Many business owners simply close their business when they are ready to retire. They sell off the assets, pay off the liabilities, collect the receivables and distribute the net proceeds to the owners. The business can formally dissolve itself by filing articles of dissolution or it can be administratively dissolved if it fails to file annual corporate reports with the Secretary of State's office. Be aware, though: a corporation that has been administratively dissolved can be revived (voluntarily or involuntarily). Only by filing articles of dissolution can the corporation and its owners obtain complete closure on liabilities.

Dissolution carries its own set of potential pitfalls for business owners. In particular, Massachusetts law states that participating shareholders can be held personally liable for claims against the corporation if they receive "improper" distributions in liquidation. Improper distributions in liquidation are distributions made without adequate provision for existing and reasonably foreseeable debts, liabilities, and obligations, whether or not liquidated, matured, asserted or contingent. Improper distributions also include distributions made without giving preferred shares their required preferred treatment. Accordingly, careful planning is also required with a decision to dissolve.

II. Issues to Consider When Planning Your Exit

A. What Are Your Goals and What is Your Timeline?

Business owners should begin identifying and prioritizing goals in connection with their exit strategy as early as possible. Important questions to consider include, but are not limited to: What are your anticipated financial needs upon leaving your business? What is the actual amount (after taxes and costs) that you expect to realize? Is that enough for you? Is it important to you that the business continues in existence? In what form should it continue? Do you want or are you open to continued involvement in the business? What do you want to see happen in connection with your employees? In connection with your customers? In connection with your community?

Early planning is essential not simply because it saves money and aggravation, but also because planning and executing an exit takes a remarkable amount of time. From initially deciding to explore exiting, to finalizing the transition, business owners should be aware that the process takes multiple years. Three to five years is a very short time line to execute an exit plan. Five to eight years is more reasonable, and will likely yield better results. Eight to ten years is common. Having a realistic timeline when you begin the process will help keep stress low and goals feasible.

B. What Is Your Business Really Worth?

It is a good idea to get a realistic view of what ongoing businesses sell for in your industry sector so you can better evaluate your financial expectations. If you understand what factors are important to achieve value in your industry you can work to improve the value your business ultimately will achieve. However, valuing closely held businesses is difficult because the “fair market value” is not readily apparent. Unlike publicly traded companies there is no active market for the ownership interests of privately held businesses. Formal valuation by an expert can be expensive, but ultimately will be needed. In the meantime, it is helpful to understand the basics.

There are many ways to value a business. Typically business appraisers consider relative valuation (comparing your company to companies with similar operating characteristics) or a discounted cash flow analysis (based on the present value of the future stream of free cash flow). Often the valuation calculation is based on multiples or ratios considering important financial metrics like revenues, earnings before interest and taxes (EBIT), earnings before interest, taxes, depreciation, and amortization (EBITDA), and net income. It is helpful for owners to evaluate these metrics to try to “ballpark” the value of their entity, bearing in mind that a formal valuation will be necessary prior to sale.

Many businesses do not get sold, but are closed. Business owners can and should evaluate the liquidation value of their assets (including accounts receivable which really can be collected) and compare that to the potential value achievable in sale of your ongoing business (with the “goodwill” in the business name and reputation). If the values are close, or there is no ready market for your business, your best exit strategy may be liquidation. Understanding the sale of business option can help you operate your business with an eye to maximizing cash generated by liquidation.

C. How Will You Manage Your Ongoing Business?

It is a big mistake for a business owner contemplating exit to lose focus on the current operations of his or her business or prematurely release news of his or her exit planning. Both are likely to cause business deterioration. If key employees feel insecure, they may leave. Customers concerned about a company’s long-term viability may withdraw their business or slow down bill payment. Vendors may change the terms of credit. All these issues can cause the value of the business to deteriorate.

Business owners should develop information management strategies early in the planning process, identifying whether, when, and on what terms to let people know of the planning process. At some point, business owners may wish to provide employees with incentives to give them a vested interest in maintaining profitability and confidentiality, through phantom stock, performance based bonuses or bonuses contingent upon the successful completion of a sale or merger. Information control is important. While employee confidentially agreements are helpful as a general deterrent, they are ultimately of limited assistance when a premature disclosure actually occurs. By that point, the damage may be difficult to address.

D. Tax Issues

Tax issues in succession planning are complicated and business owners should involve their tax consultants early in the process. The deal structure can have significant tax impact on your net gains from the deal. The specific facts pertaining to your business are highly relevant. For example, if your business is a C corporation, and not a pass through entity, the corporation will be taxed on any gain realized on the sale of assets and you will be taxed individually on proceeds distributed to you by the corporation. Corporate tax rates generally run at 35 percent at the federal level (depending on the corporation's taxable income), and 9.5 percent for Massachusetts, and can seriously eat away at the net after tax proceeds shareholders realize when assets are sold (before personal taxes). It is expensive to convert a C corporation to an S corporation (which avoids the taxes at the corporate level) and takes ten years to obtain the tax benefits. In that situation, consequently, a stock sale is likely to be tax advantageous.

Regardless of whether your business is a pass through entity or a C corporation, the business owner has individual tax and estate planning concerns, which should be included in the exit planning process. There are many ways to incorporate wealth transfer or charitable giving goals into succession planning, generating current tax savings and estate tax savings. For example, there are numerous mechanisms by which business owners can minimize transfer tax liability through an "estate-freeze" transaction. The effect of such a transaction is to freeze the value of your business at a present amount, permitting any future appreciation in the business (including upon the sale of the business) to pass to the future generation outside of the transfer tax system. Examples of such estate freeze transactions include recapitalization and creation of a grantor-retained annuity trust (GRAT). Another strategy to minimize estate taxes is to gift stock to children over time. Similarly, business owners looking to incorporate a charitable gift into their exit strategy should consult with their tax professionals, as there are alternative methods of meeting that objective including making an outright gift or establishing a charitable remainder trust.

E. Potential Obstacles

Identifying and addressing potential obstacles will help maximize the business value and make the transition smooth. Examples of potential obstacles include:

Environmental Issues. To the extent that your business owns real estate, or generates or disposes hazardous materials, you should evaluate known or potential environmental problems. Conducting an environmental study and addressing clean-up early can make your business saleable, as environmental issues can take multiple years to resolve, and can negatively impact the value and appeal of your business. However, consider carefully the consequences to present operations if the study uncovers an unpleasant surprise.

Zoning and Permitting Issues. If your business, its location (or any part of either of them) constitute a "non conforming use" of the property, there may well be constraints on expanding, relocating or otherwise implementing normal business decisions. This will affect the value, desirability and salability of the business and should be analyzed at an early stage to see if addressable issues exist. If required permits are not in place, now is the time to correct that situation.

Employment Issues. Depending on the form of your exit, you will have to address employment issues, with particular attention to employee pension benefit plans, governed by the Employee Retirement Income Security Act (ERISA) and employee health benefit plans. Again, many of the issues are specific to the structure of your exit. Buyers under an asset sale generally do not wish to adopt the seller's existing plans, requiring that the seller shut them down. Under a stock sale or merger, the buyer inherits the seller's existing plans. Business owners who evaluate what liabilities exist under present and past benefit plans, what liabilities will arise on termination or continuation of benefit plans, and what legal requirements they face, will improve their plan structures and transition experience. Owners need to examine their benefit plans to determine whether they are solvent, whether there are any major compliance problems and how, if necessary, they can be changed or terminated.

Additionally, business owners should revisit executive compensation contracts to determine, what, if any, obligations arise due to a change of control or dissolution of the corporation. Change of control provisions often provide that key employees will be entitled to severance benefits in certain situations, and such liabilities should be accounted for.

Buyer Ability to Finance - When evaluating exit options, business owners should consider and attempt to forecast the availability of third party credit for potential suitors and the ability of the business to carry third party (or seller) financing. A business owner trying to sell over the past year likely encountered a very different market than they would have had they tried to sell five years ago (or five years in the future). In times of particularly dry credit, business owners might want to consider financing a potential acquisition. Such a decision has many factors to consider, including the seller's immediate need for money up-front and the risk of non-payment. However, the Internal Revenue Code helps facilitate such transactions by permitting certain eligible types of gain to be reported under an installment method for federal income tax purposes, permitting a seller to defer the tax on the gain.

Minority Shareholders - Massachusetts has long held that shareholders in a close corporation owe each other the same duty of loyalty and utmost good faith that partners owe each other. Majority owners making exit strategy must keep this fiduciary duty in mind, and ensure that actions are taken in good faith, are what a prudent person would do in regard to his or her own business, and are reasonably believed to be in the corporation's best interest. This is a fertile area of litigation and you may wish to "de-fuse" the situation by including minority owners in the decision making process.

III. Preparing for the Exit/Succession Transaction

Once initial considerations in connection with exit planning have been evaluated, certain steps should be followed:

A. Start Working With Your Balance Sheet Now

As early as feasibly possible business owners should begin analyzing their balance sheet in an effort to recognize and address problem areas. This includes identifying sources of debt (both owing and owed), pending litigation and disputes, and contingent liabilities. By working out bad-debt issues, as well as addressing items like employee loans and contingent obligations, business owners can greatly enhance their entity's financial appeal.

B. Analyze your corporate liabilities

Lease expiration is the most common reason business owners recite when they consult us on exit strategies, but there are many other agreements and factors to consider. Legal issues can kill a deal, so business owners may wish to do a legal audit to unearth and address legal issues. Moreover, fully understanding business liabilities can prevent potential shareholder liability issues if the business is dissolved and distributions in liquidation are made.

Legal audits should include discussion and review of the following (among other things): potential environmental liabilities, ERISA and employment obligations, tax liabilities, employee agreements, all agreements with customers and vendors, as well as lenders and landlords, requirements for permits and licenses, zoning and any other governmental authorizations, and possible claims or demands that might lead to litigation. Spending time and resources on resolving such issues now can pay large dividends when executing your departure.

C. Prepare for due diligence

At the outset of a transaction potential buyers will likely submit a due diligence request list. The purpose of due diligence is to help the buyer fully appreciate the nature and value of the entity being acquired, and to allow the buyer to make an informed decision. It is not uncommon for requests to encompass: corporate records; financial and tax records; real estate and personal property leases; employee benefits and other employee documents; material assignment and financing documents; marketing, sales, and operations documents; regulatory matter records; accounting records; insurance records; and litigation and possible claims records.

Accordingly, it makes sense for business owners to prepare for the day the due diligence request arrives. Doing so serves two purposes. First, approaching due diligence preparation without undue pressure saves time and resources, and allows the business owner to maintain focus on other issues relating to the exit strategy and ongoing business operations. Second, the ease with which due diligence takes place can make a good impression on a potential buyer. If documentation and financial forecasts are well organized and easy to access, the buyer will believe the company is run with professionalism and discipline, and the perceived-value of the firm is likely to rise.

D. Road test successors

Getting an appreciation for possible successors can be critical to meeting exit strategy goals. You know better than anyone else what companies and individuals are most likely to acquire your business or its assets. If you plan an internal succession, you need to see whether the potential successors can manage and run all aspects of the business. Buyers without experience may end up being unable to adequately run the business, which can harm workers, clientele, suppliers, and the community. Business owners should be particularly concerned with the reliability of possible successors if the deal is contingent upon future performance. Appreciating the various types of buyers in the market will help the business owner evaluate the price they are likely to obtain and predict the way the business will be run.

CONCLUSION

As odd as it may sound, succession planning should begin the moment one embarks on *forming* a business. However, very few entrepreneurs do that, even though proper planning and decision-making can help reduce ultimate tax liability, ensure achievement of maximal value for the business, and generally ease the transition out of ownership. For that reason, now is as good a time as any to begin laying the groundwork for your smooth and successful exit!

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