Inevitabilities White Paper

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.

What kind of "Exit Plan" allows a business owner to leave his business in style? And, just how is one created?

Of course, plans vary but, properly crafted, each Exit Plan has several common elements or is the result of a proven step-by-step process. Owners often best grasp these elements, or steps, when framed as questions.

Step 1: Exit Objectives . Have you determined your primary planning objectives in leaving the business, such as:

- Your desired departure date?
- The income you need to achieve your financial objectives?
- The person to whom you want to leave the business?

Step 2: Valuation and Cash Flow . Do you know how much your business is worth? Do you know what the business's future cash flow is likely to be after you leave it?

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 how to sell your business to a third party in a way that 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 accomplishing your financial goals?

Step 6: Business continuity upon death or disability. Have you implemented all necessary steps to ensure that the business continues if you don't?

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Step 7: Wealth Preservation Plan. Have you provided for your family's financial well-being and continuity should you die or become incapacitated?

Let's summarize each step owners take to create a comprehensive Exit Plan. Let's also look at who can help you take each step of the process.

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 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 their departure, 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 establishing each of these objectives. Many owners set other objectives as well, such as:

- Providing for one or more employees;
- Transferring wealth to family members;
- Getting maximum value for the business;
- Giving to charity; or
- Taking the business to the next level – with someone else's money.

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Unfortunately, only a handful of owners carefully formulate these objectives before they choose an exit path.

Remember, your objectives control all planning efforts and strategies. 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 he or she has the computer capability to create a financial retirement model for you based on at least the following factors:

- Your retirement income needs based on current lifestyle expenditures. (You must develop that personal budget you've resolved to develop...for the past 15 years!);
- Inflation assumptions;
- Size of current investments;
- Investment growth assumptions, on current and future investments;
- Number of years to retirement; and
- 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 confidence in your financial situation. You need more money and more investments before you can leave your business in style. While you can personally accumulate additional cash before you retire, the bulk of the needed investment monies will come from the sale of your business.

It's important to 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 at this initial stage.

Your advisors 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 reap from the sale of your business.

STEP 2: VALUATION

A universal ownership objective is to help establish 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 usually the owner's most valuable asset. Frequently, the business comprises between 65 and 90 percent of an owner's assets. Accomplishing your financial goals depends on converting that asset to cash.
- An owner and his/her advisors need to know the current value of the business

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to 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 the 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 Certified Valuation Specialist;
- An independent CPA firm;
- The business's regularly retained CPA firm; or
- An investment banker or business broker.

Consider using a valuation specialist to determine business value for planning purposes and for transfers of the business interest to insiders (family members, employees or co-owners). Unless your business has little value – less than $500,000 – it is likely that a transfer to insiders will involve tax considerations centering on transferring at least part of the business at a **low** value in order to save taxes.

Whenever valuation is used to minimize taxes, our friend the IRS may question that valuation. That is why it is a prudent idea to spend a few thousand dollars not just to save the thousands of dollars in taxes, but also to minimize the threat posed by the IRS. If, however, the business is to be sold to an outside party, consider using a transaction advisor, a business broker (if your business is worth less than $1 million or $2 million) or an investment banker if your business is more valuable. These advisors are in a better position to properly assess the likely *sale price* of your business.

STEP 3: MAKING THE BUSINESS MORE VALUABLE

An inevitable by-product of a consistently well-run business is an ever-increasing value. 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 your role within the business: to enhance value.

Who can help? If your objectives include selling the business for cash to a third party, meet with your CPA to discuss the appropriate level of financial review recommended to document earnings 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,

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market share, 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 helping to maximize 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-) based incentive plans including:

- Stock bonus
- Stock option
- Stock sale

Non-equity incentive plans including:

- Cash bonus
- Nonqualified deferred compensation plan
- Phantom Stock plan
- Stock Appreciation Rights plan (SAR Plan)

An experienced consulting firm can be a driving force in the successful design and execution of value-building programs for closely-held businesses.

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 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. 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 a 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

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a. Definitive Purchase Agreement
b. Closing

Who can help? Inherent in the third party sale process is the need to use experienced transaction advisors. You must select an experienced transaction intermediary (business broker or investment banker) as well as a deal attorney. The investment banker will direct the second and third phases of the selling process. (Phase I is handled by the owner and, often, his existing advisors; Phase IV by the deal attorney.)

A significant part of the investment banker's mission is to find a group of potential buyers and orchestrate a controlled auction. Only a transaction intermediary is skilled in approaching multiple potential buyers simultaneously and in developing them into serious candidates.

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 the 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 goals because it will take an extended period of time to receive the full purchase price.

There are several techniques we can use 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 fewer dollars are subject to the double-tax whammy. The first income tax is levied against the buyer (key employee or family member) and the second capital gains tax is 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 partial payment for the ownership interest and the seller (owner) pays a capital gains tax upon 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.

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Create unfunded obligations.

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:

- Non-qualified 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; and
- Subchapter S dividends.

Transferring excess accumulated cash within the business prior to the sale.

Selling a business is more than selling its bare assets and getting face value. Owners often have extra cash, gathered over time, which deserves to stay with the owner even if the business doesn't.

Time again to emphasize the importance of helping to maximize a departing owner's objectives. 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 in the company until you are satisfied that the cash flow will continue without you.
- Securing partial outside financing even though this may require subordinating your security interest to a bank.
- 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 help with a transition to insiders.

STEP 6: DEVELOP A CONTINGENCY PLAN FOR THE BUSINESS

One of the benefits of developing an overall exit strategy is that you quickly 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, 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 one rather than by two or more people. 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:

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- In my absence, who can be given the responsibility to continue and supervise:
  - Business operations?
  - Financial decisions?
  - Internal administration?
- 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 stay bonus (cash) is paid to employees if they stay and see the company through its transition.
- Should the business, at my death or permanent incapacity be:
  - Sold to an outside party?
  - Sold to employee(s), and if so, to whom?
  - Transferred to family members?
  - Continued?
  - Liquidated?
- Who should be consulted in the transfer process described above?
- 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.

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 your overall Exit 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. You may be surprised at how easy it is to meet death objectives. Once the first two steps of the process (Setting Objectives

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and Determining Value) 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 to complete Step Seven.

CONCLUSION

The techniques that 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 successfully. 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 Exit Plan. Base your Plan on the Seven steps summarized in this White Paper.
- 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 time an ally by starting your Exit Plan **now**.

Finally, to orchestrate a successful exit, your Exit Plan should be in written form and should include an Action Checklist. This Checklist describes each action to be taken at each step of the Exit Process. It assigns responsibility for each task to a specific advisor and specifies a date by which this action must be completed.

Armed with these written tools, a team of skilled and experienced advisors, and (ideally) several years, you optimize your chance for leaving your business in style.

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