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Business Exit Strategies

*An interview with John H. Brown, Esq. Author of
The Completely Revised How To Run Your
Business So You Can Leave It In Style*

By Robert L. Moshman, Esq.

Exiting on your own terms from any endeavor with strength and grace is a lofty ambition worth striving for.

Inevitably, every business owner will one day leave the business behind, yet not every owner makes adequate plans for succession. In fact, many business transitions are horrendous, protracted,

“Fans, for the past two weeks you have been reading about the bad break I got. Yet today I consider myself the luckiest man on the face of this earth.”

*—Lou Gehrig, farewell address,
July 4, 1939*

caustic, destructive, and expensive. Yet these tales are repeated time and again.

It makes sense to plan for the inevitable. Just as intelligent and considerate people plan their estates, wise business owners design plans for their professional exits.

Presented With Our Compliments

Cautionary Tales

Although it makes sense to prepare for the inevitable departure from business, many owners continue to ignore the hard lesson of what happens when they fail to plan. Business owners may believe themselves to be too busy to plan, too headstrong to think they'll ever not be in charge, or too demanding to accept any of the alternatives for departure.

How NOT to depart a business? Let us count the ways.

The Unprepared Heir: In this approach, an inexperienced and ill-suited relative is plunged into the role of chief executive after the business owner falls ill or dies. The unprepared heir may appear incompetent due to a lack of training. Customers and clients lose confidence. Employees and staff are disturbed and disillusioned. Revenues go into free fall. The business is ruined, and assets are sold off at bargain prices.

A Family Divided: Number One Son works with Dad and is running the business when Dad dies. Under the terms of Dad's Will, the business is left to Number One Son, and the remainder of the estate is divided among three other heirs. But the business constitutes the bulk of the estate, thus sowing the seeds of bitter family discontent.

A Family at War: Perfecting the previous bad plan to maximize dissension, Dad divides up the business among his heirs, some of whom have worked at the business for decades and others who have never set foot in the place. There is no agreement on how to run the business or divide revenues. The lawyers are called in to wage battle, and the employees are caught in the middle. The customers flee in horror, and the business is ruined.

The Bitter Divorce: Founder and Protégé or longtime partners want to arrange a buyout. But instead of conducting an objective, professional negotiation through representatives, they initiate a long, personal dispute that drags on. The stalemate hurts the business, and both parties are consumed by charges and countercharges until litigation is filed.

The Lingering Consultant: This is the tale of Myron Brickstein and his dental supply business. Big Rival Company buys up the small business and keeps the former owner on as a consultant... who is not actually consulted and whose presence is counterproductive. Hurt and bitter, Brickstein bad-mouths the new owners and redirects clients to some of his former, now sympathetic, rivals. Litigation ensues. There are no winners at the end of this story.

The Scorned Executive: In this scenario, the owner gives key employees no incentive to increase sales nor any

opportunity to gain a share of equity in the business. Some workers are recruited by rival companies, and the others set up their own businesses. Client lists and business techniques walk out the front door, and the business owner's most valuable asset loses half of its worth before he can sell it.

Chinese Water Torture: This is the endless negotiation between two partners or an owner and a key employee. Talk about long good-byes: One drip at a time drives everyone mad, and nothing good can come of this. The parties will walk away without any deal, set up competing operations, or sue each other. It's better to set an arbitrary deadline for a deal to be made and then sell the business to a third party.

Cold Turkey: You wake up one day and you're dead. There is a mad scramble to keep the business going. Without a plan or revenues, key employees take jobs elsewhere. Clients get services elsewhere. Unattended equipment is stolen. Insurance and mortgage payments aren't made. This approach ends badly.

Battle Royale: All the previous elements are combined. This is the Korean kimchi of business outcomes, but instead of cabbage fermenting for three days, the Battle Royale dish is a nasty stew of half-baked shadow equity plans; buyout deals with partners that lack realistic valuations or funding mechanisms; nonparticipating shareholders, creditors, and ex-spouses with competing interests; and a business that has stopped growing or competing. It is a recipe for a legal rumble.

Brutal Tax Attack

As demoralizing as the gamut of bad exit scenarios are, the cruelest blow may be delivered by the IRS at the conclusion of a poorly planned business exit. Here are some predictable problems.

The \$10 million business is an older C corporation that owns fully depreciated real estate and other assets. Buyers want to purchase only assets because they want a fresh start on depreciation and do not want any liabilities that are tied to the C corporation's stock. The arm's-length buyer will offer \$1 million less if required to purchase stock.

A C corporation that sells assets will be hit with multiple layers of taxation. Proceeds will be subject to capital gains and income tax at the corporate level. The same proceeds will be taxed again when distributed to the owners. Layers of state and local taxes may also apply. Whatever remains can be taxed again in the owner's estate.

Any number of smart and practical solutions spring to mind. With sufficient time (generally 10 years), C corporations can be converted to LLCs or S corporations with pass-through tax status. Lifetime transfers of assets can shift future appreciation to the next generation of heirs and owners without transfer tax consequences. Sales of real estate assets can be

coordinated with 1031 exchanges to defer capital gains. Even when the time frame of a sale is limited, there are techniques for structuring the sale to minimize the tax consequences.

Above all, the sale of the business owner's most significant asset should be the centerpiece of an overall estate plan.

Cash Out, Move On

John H. Brown, Esq., President of Business Enterprise Institute, Inc., has specialized in exit planning for business owners for more than 30 years and has written numerous books, newsletters, and white papers on the subject. He points out that the number of possible exit routes may appear limitless, but there are only eight.

Transfer to family members

Sell to key employees

Sell to employees using an ESOP

Sell to co-owners

Sell to a third party

Go public with an Initial Public Offering

Retain ownership as a passive owner

Liquidate

Three of those options dominate business owner expectations. A 2005 PricewaterhouseCoopers survey found that half of owners anticipate a third-party sale, 20% anticipate a transfer to family members, and 14% anticipate a management buyout. With this limited universe of realistic paths, the advantages and disadvantages of expected routes can easily be anticipated.

Some Simple Steps

A complete exit plan doesn't happen instantly or accidentally. Old school businesspeople who rely on handshake deals have an excellent chance of leaving behind a mess. Businesspeople trying to prepare their own succession plans can be left with an amateurish product that fails. Even the usual circle of professionals who advise a business on tax, legal, and accounting matters may not have the background for implementing the appropriate exit strategies.

One of the first steps toward a plan is for someone in the business owner's inner circle (perhaps an insurance agent, attorney, broker, business partner, spouse, accountant, or fishing buddy) to help the owner recognize the need for professional advice. The owner can then get help, compare options, and marshal pertinent information.

John Brown outlines six steps for choosing an exit strategy in one of his recent white papers.

1) **Start Early:** Business exits take time. Sometimes buyout deals take months or years to orchestrate. Brown suggests that owners think about their exits long before they are ready to make the move.

2) **List Objectives:** Owners should prepare a list of their objectives including how much money they will need after leaving the business.

3) **Time Frame:** Owners should anticipate the timing of their departures.

4) **Get Help:** There are professionals who specialize in business transitions. Getting objective assistance with business valuation is extremely important.

5) **Cash Flow:** Realistic projections of cash flow will determine if an "insider" purchase of stock is feasible.

6) **Tax Analysis:** Owners need to know the tax consequences of their plans before committing to any strategy.

The Next Goal

Understandably, a business owner who has worked hard to overcome hurdles and is finally in charge of a business may be reluctant to relinquish control and walk away. It requires changing one's mind-set to work toward the next goal—exiting on one's own terms.

Once the decision is made to prepare for the right exit, the owner should make planning a priority and pursue it as ardently as he or she pursued success when going *into* business. There is no need for an owner to execute exit strategies alone or to reinvent the wheel. There are resources that can identify clear options and simplify the process.

Brown suggests that to travel the road from ownership to successful exit, an owner should use a multidisciplinary team of advisors (at least one of whom is familiar with exit planning) to create a written exit plan. That plan not only lays out the owner's objectives and describes how each will be accomplished, but it also includes deadlines and assigns responsibility for each task. Without this type of an exit plan, an owner's chances of successfully exiting today—on the owner's terms—are minimal.

With the owner's ideal exit clearly defined in an exit plan, the owner can tailor ongoing operations of the business to support his or her exit goals. Strategies include growing the types of activities that add value at the time of the exit, providing for financing of a buyout, designing employee retention programs, and establishing successor management.

An Interview With Author John H. Brown

Q: How can an advisor help an owner recognize the value of planning an exit?

A: Owners generally don't realize that creating an exit plan gives them far more control over their future than does a "wait and see" attitude. We remind owners that the purpose of exit planning is to achieve their objectives while maintaining control, reducing risk, growing value, and minimizing taxes. The advisor's final job is to help owners understand that it takes years (often five to ten) to prepare a business for the owner's exit.

Q. What are the biggest obstacles that owners face today in exiting their businesses?

A. There are three: Insufficient business value, failure to develop and implement a plan designed to grow value; and failure to engage in the income tax planning necessary to reduce taxes by 25% to 100%.

Q. What do Members of BEI (exit planners) do for owners who wish to exit their businesses?

A: Armed with training in The Seven Step Exit Planning Process™, members work to uncover an owner's objectives, create a written exit plan to achieve those objectives (i.e., minimize owner risk, and build business value); and 3) recruit a team of professionals who can help the owner to reach his or her exit objectives.

Q: Business buyout negotiations sometimes drag on like messy divorces. How can owners avoid this?

The methods we use to avoid this situation depend on which exit path the owner has chosen. If, for example, an owner contemplates a transfer to co-owners, we recommend that the owners establish the terms of the buyout years before one of them exits. We document the owner's agreement to these terms in a business agreement (such as a buy-sell) and often pre-fund the purchase.

Q: If a business owner takes back a Promissory Note from a successor, what types of security are most effective?

A: A primary goal of exit planning is to ensure that an owner is cashed out before losing control of his/her company or the voting rights of the part of the business being sold. If an

exit plan is correctly structured, an owner does not receive a promissory note for ownership but receives cash instead.

Q: What flexibility do you incorporate into current exit plans to anticipate the dynamic changes to the Federal estate tax?

A: In a comprehensive exit plan based on The Seven Step Exit Planning Process™, the final two Steps are (a) ensuring that the business continues if the owner doesn't and (b) coordinating the estate and wealth planning goals for the owner. Measures designed to achieve those goals take years to implement. As estate tax law changes, the estate planning advisor on the owner's exit planning team consults with the owner and other advisors (if necessary) to realign the owner's goals to the new tax environment.

Q: What should a potential business buyer do to obtain the best deal?

A: Work with an owner who has a clear plan. The owner who knows (a) what he needs from his exit, (b) when he wants to exit, and (c) what type of buyer he wants to transfer the business to is much easier for a buyer to negotiate with than is a seller with no clear objective.

Q: In your book "Cash Out Move On," you report on how different business owners have adjusted to life after the sale. Many have been very productive. What advice can you provide to a typical business owner for post-exit life?

A: We Baby Boomers are the first generation in humankind that can expect to live for more years after we've exited our businesses than the number of years we owned our businesses. For many of us, that period of post-business ownership provides the opportunity to live a life of significance, to make a difference. In my opinion, all planning should be based on achieving an owner's financial and aspirational goals. If it isn't, why exit?

About the Author: John H. Brown, Esq., has engaged in exit planning for business owners for more than 30 years. Along with Cash Out Move On, Mr. Brown is the author of *The Completely Revised How To Run Your Business So You Can Leave It In Style*. He is currently President of Business Enterprise Institute, Inc., a Colorado-based company that trains advisors of business owners in exit planning. For more information, see exitplanningforadvisors.com or call 888/206-3009.