

The many options to planning an exit strategy

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Millions of business owners face the challenge of meeting their retirement needs with illiquid wealth tied up in their privately held business. Many owners believe that selling is the only way to exit their business and realize their personal financial goals.

This is a myth that must be dispelled, and business owners are encouraged to explore all of their options well before their desired exit date.

There are seven primary options by which a business owner can transfer the interests of a privately held business:

- Sale/transfer to employees,
- Sale/transfer/gifting to family members,
- Gifting to charity,
- Sale/transfer to co-owner(s),
- Sale to outsider (owner retires),
- Sale to outsider (owner stays) and
- Initial public offering.

First steps

Before evaluating each exit option, a business owner should consider her personal goals as they relate to the business exit. When asked for their primary motivator, most business owners cite financial gain.

While money is always a factor, many owners also care about the future of the business and who will be running it in their place.

An owner who has built a foundation of wealth outside the business has more flexibility to consider factors other than price in evaluating her exit options.

An owner who has not built sufficient wealth outside of the business may have more difficulty balancing her financial and personal goals, as the proceeds of the exit are more critical to attainment of her personal goals. All things being equal, it is more work in this case to develop the best strategy.



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In addition to the owner's personal goals, she should recognize that the type of buyer or successor will affect the price of the business, the structure of the transaction and the tax consequences of the sale or transfer.

Transfers to employees, family members or co-owners generally result in fewer dollars up front but allow the owner greater control over the sale-transfer process, potential future cash flow (in the event of a leveraged buyout) and flexible timing and tax characterization of payments.

By contrast, external transfers to industry players, financial groups or by an initial public offering command more money up front but require the owner to largely relinquish control over the timing and tax characterization of payments received.

Finally, the exiting owner should prepare to do a significant amount of business organization and preparation in anticipation of a transfer. A savvy buyer-transferee will require disclosures related to all aspects of the business in evaluating the proposed transaction.

Assembling these records, confessing to any creative accounting or other practices and presenting them to the buyer-successor is very time consuming, tedious and psychologically difficult. Failure to make these disclosures, however, can be even more painful, particularly if they result in a future lawsuit.

With these preliminary steps completed, the owner should consider each option outlined below with her personal and financial goals in mind.

An owner may wish to engage an exit planning specialist to assist her with this process and formally evaluate her personal financial readiness and other critical factors in selecting an exit option.

Transfer to employee(s) or family members

In the case of a transfer to employees or family members, liquidity is a primary concern. Many family members or proposed employee transferees lack the financial resources and, perhaps, the requisite experience to fund and successfully manage the buy-out of the business.

Strategies for dealing with this hurdle include the following.

- ESOP or Employee Stock Ownership Plan. An owner may transfer shares to employees through an ESOP, without the employees contributing money.

ESOPs are tax favored and give the owner time to advance her business succession planning by permitting her to take cash out of the business today without relinquishing operational control.

- Estate planning, gifting. If an owner has accumulated sufficient assets to meet her financial needs, she may gift shares of stock to family members. The gifting program can coordinate with the owner's estate plan over time to manage estate taxation.

Larger transfers to family members can occur in a fast-growing business through a Grantor Retained Annuity Trust (GRAT). These estate planning tools can provide significant tax savings to the exiting owner.

- Leveraged buyout option. Employees or family members can use the assets or equity of the company to secure a buyout of the owner's interest.

In this scenario, the owner finances the buyout and receives a promissory note with payments over time in return as well as a security interest in the equity and/or assets of the business.

The transferees must be comfortable with the payment terms. The exiting owner must be confident that she has received sufficient collateral for the purchase money loan and that the transferees are capable of successfully running the business following the transfer.

Co-owner transfers

If the business is owned by more than one person, the exiting owner may transfer her interest to her partner in the business.

Businesses with more than one owner should have a shareholder agreement in place to govern the ultimate disposition of the owners' interests and foreseeable events that may cause a premature or unintended exit, such as untimely death, disability, divorce or bankruptcy.

The shareholder agreement sets forth the basic rights of the owners with regard to their ownership interest and dictates what happens on certain events. A well-drafted shareholder agreement answers the following questions:

- Can I transfer my shares to a third party without the consent of the other owner(s)?
- Can the company or the other owner(s) require me to sell my shares or redeem my shares and, if so, under what circumstances – death, disability, termination of employment, divorce, bankruptcy, bona fide offer to purchase accepted by the majority owner(s)?
- Can I require the company or the other owner(s) to buy my shares and, if so, under what circumstances – termination of employment, death, disability?
- What will I be paid for my shares on redemption or repurchase?
- How will I be paid and over what time period?
- How will we resolve any intractable disagreements related to the business?

Planning for these events and answering these questions in advance puts the business on the right path from the start and limits the disruption of a premature or unintended exit.

Outsiders

The sale of the business to an outside buyer is the exit strategy of which most owners are already aware. An outside buyer is likely to pay a higher amount for the business than the owner(s) will achieve using the other options presented.

The price will take into account the synergies of the deal (economies of scale, cross-selling opportunities, etc.) that will be realized by the buyer.

A selling owner should be aware of the tax consequences and transaction fees associated with a third-party sale and evaluate the impact of these costs before moving forward with an offer.

An owner selling to an outsider should also consider whether she is willing to work for the buyer during an interim transitional period or, if the parties agree, in a longer-term capacity.

Many owners desire to continue working with the business, but find that it is extremely difficult to serve as a subordinate to the new owner.

In sum, most owners agree that they built their business because they didn't want to work for someone else and expect to work for the buyer only during a clearly defined transition period.

Initial public offering

Larger companies, those worth \$100 million or more, may offer their shares in an initial public offering.

This type of transaction allows the general public to purchase the company's shares. In turn, the company accesses public capital and its shares are traded on a public exchange.

An owner considering this option should be aware of the associated costs, including registration requirements and additional shareholder reporting.

Conclusion

Business owners should be aware of their exit options and begin to consider their personal goals well in advance of retirement. This forethought and planning will give them the most flexibility and the best shot at a comfortable retirement and the continued success of their business.

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