

The End Game: Succession Planning For Private, Closely-Held Business
Valerio Giannini – NewCap Partners, Inc.

Who will run – and/or own – your business in 20 years? Maybe it will be you, but maybe not; and in any event, sooner or later it will change. Businesses go through lifecycles and generational transitions, just like people.

Before starting any discussion of succession, there are three pre-requisites to any end game:

- If there is more than one owner, there must be a shareholder agreement amongst them delineating the process in the event one withdraws for whatever reason.
- All owners must have wills or, better, living trusts declaring their wishes and empowering someone who can act for them in the event of their demise or incapacity.
- Provisions for continuity of the business through a board of directors, powers of attorney or a voting trust.

Excluding IPOs, one of 7 things must, by definition, eventually happen to any business:

1. It shuts down:

This is sometimes inevitable, but still requires forethought to protect against possible assertions against the former owner(s) or successors, e.g. claims from former employees, clients, lenders, customers, suppliers, or government authorities, such as for taxes or environmental infractions.

The best first defense against alter ego claims is to be incorporated (as a Corporation or LLC) and to have adhered to fundamental corporate governance standards. In addition, depending on the business, insurance should be on an *occurrence* (vs. *claims made*) basis or else be continued for a period after the business shuts down.

Even a small professional practice or service business, however, doesn't necessarily need to shut down entirely when the prime mover departs the scene. Larger companies in the same field will often "acquire" very small firms with a book of business to gain a foothold in a new market or geographic territory or just hire to add seasoned employees.

Although the consideration the owner(s) receive may not be more than a year or two's salary and/or a residual on revenue from former clients, it is better than closing it down.

2. One or more partners/owners leave and the other(s) continue the business:

This is when the shareholder agreement becomes critical. Sometimes called a "buy/sell agreement", it must clearly define the method of valuation and terms to buy the other(s) out. Considerations include the period over which payment will be made and who or what, if anyone or anything, guarantees or secures the payment. Such an agreement should be professionally prepared well in advance and updated from time to time.

Tax considerations are also important, since, for instance, under certain circumstances a repurchase of shares may be considered a dividend. Other strategies may include continuing compensation for the retiring partner or using life insurance to fund the redemption of a co-owner's share or payment of estate taxes, which also applies to other scenarios below.

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3. One or more family member(s) continue the business:

Having a son or daughter (or other family member) take over can be a most fulfilling scenario, but success involves clearly agreed-to intergenerational understandings, sometimes best facilitated by a third party.

Generational succession can be tricky since it involves personal, emotional and business elements. It's tough enough if there is only one successor, but if there is more than one, there are additional considerations, which in turn depend upon who will and who will not be active in the business.

Generational succession ideally should follow years of adaptation, and involves a delicate balance between providing the best guidance and letting go. Agreements amongst the family members as shareholders should be done well in advance of when they are needed.

There are some very effective *family business councils*, typically sponsored by a university, that facilitate the process through regular meetings and education on issues common to family businesses. In addition, a board with a couple of experienced, non-family, outside (non-employee) directors can provide dispassionate oversight as well as an objective, independent accountability structure.

The tax issues – and possible adverse consequences - involved in any generational ownership transfer are largely the same whether or not the succeeding generation will be active or passive, as discussed below.

4. The owner's heirs continue to own the business, managed by employees:

This can work if the company a) has an installed management team; b) has assets such as a "brand", patents, technology, customers, licenses, real estate, location, unique equipment, etc.; and c) the family takes pro-active steps to retain financial control and employee loyalty.

Keeping the management team intact and/or attracting new blood usually involves more than just salaries. "Equity participation" can be accomplished through phantom stock or profit sharing without actually surrendering any ownership. Equally important are mutual expectations as to the family's degree of involvement and what the family takes out of the business. Most of all, management needs to feel appreciated and listened to. A board of directors which includes outside business professionals can help facilitate a professional relationship between management and passive family ownership.

Whether or not the family remains active (as in (3) above) or passive, tax planning is critical – many a business has had to be sold to pay death taxes. The Internal Revenue Code currently allows deferring taxes on family owned businesses, but they are currently capped at about \$1.3MM in value..

Company funded life insurance is an option, as is a gifting strategy. The annual gift tax exclusion may seem small (currently \$13,000 a year per donor per donee), but gifting early while the value of the business is lower can aggregate a significant amount. At present rates a husband and wife providing gifts to two children and their spouses plus four grandchildren would take over \$2,000,000 out of their taxable estate in ten years.

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If control is an issue, such gifts can be non-voting shares, promissory notes or a mortgage. Taking real estate and other assets out of the business can also provide flexibility. Then there are family limited partnerships and other structures. The common denominator of all of these, however, is lead time and professional guidance, the sooner the better.

5. Management employees buy out the owner(s)

A Management Buy-Out (MBO) has the advantage of dealing with people you know and presumably trust, and who know the business. The best type of MBO is one in which management finds independent financing and pays most if not all of the purchase price up front. For this to be successful, and also to command the best price, requires most of the same components as selling to a third party, i.e. professional financials and other documentation, regulatory compliance records, intellectual property protection, etc..

Management buyouts with significant deferred payments must be carefully constructed because if at a certain point the successor managers are being successful, they may question why they should continue paying instead of leaving and starting on their own.

In addition it may be possible to carve out certain assets such as real estate, equipment, copyrights or patents and rent/license them to the buyers, or use them as security for money owed. In any case, an MBO with deferred payments needs to provide restrictions on compensation, distributions, borrowings and expenditures until the former owner(s) are paid.

Finally, every effort should be made to have the management-buyers have skin in the game, ideally with as large a cash payment or investment as they can afford (without taking it out of the company), and/or with personal guarantees on the amounts owed. Even if such guarantees may be more symbolic than substantive, they are effective motivators.

6. The owner(s) sell to an Employee Stock Ownership Plan (ESOP):

An ESOP is a legal way to sell ownership to employees using pretax profits from the company. An ESOP requires a profitable company, a multi-year window and the more employees the better. It makes the most sense when there are no obvious successors/buyers, or if the nature of the business doesn't lend itself to an outright sale.

There are two basic ESOP strategies: A pre-funded ESOP and a leveraged ESOP. In the former the company makes contributions to the ESOP and the funds are held in trust until the owner is ready to sell. In a leveraged ESOP the ESOP gives the seller a note and/or borrows to buy the owner's shares and the company retires the debt through future ESOP contributions. The two are not mutually exclusive: ESOPs can be partially pre-funded and partially leveraged.

In addition, the transaction can be spread over time and to a degree be controlled by the seller, who can also continue to manage the company, albeit with limitations on the degree of control. If the Company is a C Corp, the seller can indefinitely defer the capital gains tax on the proceeds of sale through a "rollover" of the proceeds into *qualified investments*.

There are drawbacks, however: Selling to an ESOP is the equivalent of "giving" a significant portion of the company to the employees. If instead of funding the ESOP the Company, if it is an S Corp, distributes the same amount to its shareholder(s), the shareholders would be able to keep 60% (after 40% income taxes) and still own the company. With an ESOP, the owners get 80% of the same amount (after 20% capital gains) but own none of the business.

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In addition, in a leveraged ESOP, the selling owner is at risk if he takes a note and/or may be required to guarantee bank debt incurred by the ESOP. Finally, ESOPs are ERISA (Employee Retirement Income Security Act) plans and subject to a plethora of Department of Labor and IRS regulations, including the appointment of a Trustee to oversee the employees' interests..

7. The business is sold to a third party buyer

Not all small businesses are salable, but if one is, and the other scenarios described aren't available and/or preferred, an outright sale may deliver the quickest and best return.

A successful sale requires even more preparation than other scenarios. In addition to professional financials and other documentation, regulatory compliance, IP protection, etc., a third party buyer needs to see solid evidence of contractual relationships, depth of management to continue in the absence of the current owner(s) and the institutionalization of relationships with key customer/clients and suppliers. Depending on the starting point, preparation for optimum results can take years.

Unless there is one obvious, logical buyer – and perhaps even if there is - the engagement of a person or firm that sells businesses for a living will more than pay for itself in a better return and/or avoidance of costly mistakes. Get to know one well before you need them and don't try to do it on your own. At a minimum align yourself with attorney and tax advisor who are regularly involved in such transactions. Exposure to liabilities and taxes after the sale can eat most or all of the proceeds. A successful sale requires preparation and a professional team.

The foregoing was prepared for general information and educational purposes only, does not constitute legal or tax advice and should not be relied upon without first seeking the advice of an attorney and/or a CPA.

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