The End Game: Succession Planning For Private, Closely-Held Business
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Who will run – and/or own – your business in 20 years? Maybe it will be you, but maybe not; and in any event, at some future date, it will change.

Any discussion of succession must first recognize three pre-requisites to any *end game*:

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

One of 8 things will 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" small firms with a book of business to gain a foothold in a new market or geographic territory or just to add seasoned employees.

Although the consideration the owner(s) receive may be just a year or two's salary and/or a residual on revenue from former clients, it is better than just closing it down.

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

This is when a 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.

Strategies to buy out departing owners may include an ESOP (see # 6), continuing compensation and/or benefits for the retiring partner, or life insurance to fund the redemption of a co-owner's share or payment of estate taxes. Tax considerations are also important, since, for instance, under certain circumstances a repurchase of shares may be construed as a dividend by the IRS.

3. One or more family member(s) continue to manage 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 difficult enough if there is only one family successor, but if there is more than one, there are additional considerations such as who will and will not be active in the business.

Generational succession ideally should follow years of adaptation, and a delicate balance between providing 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 universities, that facilitate the process through regular meetings and education on issues common to family businesses. In addition, a board of directors with one or more experienced, non-family, outside (non-employee) directors can provide dispassionate oversight as well as an objective, independent accountability structure.

4. The owner(s) and/or heirs continue to own the business, but it is managed by non-family employees:

This can work if the company has a) seasoned and loyal management; b) durable assets, e.g. an entrenched market position, steadfast customers, a valuable brand, patents, technology, licenses, long term contracts, real estate, unique equipment, etc.; and c) the owners take 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 profit sharing or phantom stock (SARs) without surrendering ownership per se.

Tax issues and consequences involved in any generational ownership transfer are largely the same irrespective of whether the succeeding generation will be active or passive. In any case, estate/death tax issues need to be addressed early, Many a business has had to be sold to pay death taxes.

Meanwhile, potential death taxes can be mitigated by gifting equity early, when a lower value can be justified. If control is an issue, such gifts can be non-voting shares. Taking real estate or other assets out of the business can also provide flexibility, as can family limited partnerships and other estate planning strategies. The common denominator of all of these, however, is lead time and professional guidance, the sooner the better.

Equally important are mutual expectations between owner(s) and management as to the owner(s)' or their heirs' degree of involvement and what they take 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 the original owner(s) or their heirs.

5. Management employees buy out the owner(s) (MBO)

A Management Buy-Out (MBO) has the advantage of dealing with people who know the business and whom the owner(s) know and presumably trust.

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, regulatory compliance records, intellectual property protection, and a formal, definitive acquisition agreement.

MBOs 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 for the owners to carve out and retain certain assets such as real estate, equipment, copyrights or patents and rent/license them back 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 investments or guarantees may be more symbolic than substantive, if substantial to the buyer(s), they are effective motivators and evidence of commitment.

6. The owner(s) sell their shares back to the Company or to an Employee Stock Ownership Plan (ESOP).

If only some shareholders need to be bought out and the remaining shareholders can’t or don’t want to buy, an option is for the Company to buy them. The advantage of the Company buying is that the sellers’ shares are retired and the remaining shareholders’ % ownership increases. The disadvantage is that it uses after tax retained earnings.

The advantage of selling to an ESOP is that the shares are purchased with money the company has contributed to the ESOP pre-tax (an advantage which has become less significant after the 2017 tax reform bill). The disadvantage is that the ESOP replaces the selling shareholder and the remaining shareholders’ (%) share remains unchanged.

An ESOP requires a profitable company, a multi-year window and the more employees the better. It makes the most sense if the business doesn’t lend itself to an outright sale, or if the owner(s) simply want to pass along ownership to their employees. Also, the tax-deductible contributions to the ESOP reduce current income taxes and provide a sinking fund to buy out minority or passive-investor shareholders in the future.

In addition, an ESOP transaction can be spread over time during which the seller(s) can continue to manage the company, albeit with some limitations on the degree of control. Also, if the Company is a C Corp and certain criteria are met, the seller can indefinitely defer the capital gains tax on the proceeds of sale through a “rollover” of the proceeds received from the sale of shares to the ESOP into *qualified investment securities.*

ESOPs don’t come without strings, however. ESOPs are ERISA (Employee Retirement Income Security Act) plans and subject to a plethora of Department of Labor and IRS regulations, annual valuations and an ESOP Trustee to oversee the employees’ shareholder rights and interests.

The desirability of an ESOP or a company repurchase depends on the nature and circumstances of the company and the needs, objectives of its shareholder(s).

Finally, if time is not a pressing consideration, the economics of an ESOP needs to be compared with the shareholders holding onto their stock, taking distributions, dividends or compensation (instead of ESOP contributions) over 5 or more years, at the end of which they would still own the business.

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, desirable or preferred, an outright sale might deliver the best return.

A successful sale requires even more preparation than the other scenarios recited. 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.

Also, note that many sale transactions involve taking the buyer’s shares as part or total consideration. Even if the buyer is a well-established publicly-traded company, there is market risk and usually a lock-up period during which the seller must agree not to sell the shares they receive for a period of time.

Unless there is one obvious, logical buyer – and even if there is - the engagement of a person or firm that sells businesses for a living should 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.

8. Going Public (IPO, or Initial Public Offering)

Although going public has become a much less likely option for smaller companies in recent years, it still occurs, sometimes through a reverse merger.

A profitable public company's shares are generally valued higher than a private company's, but an IPO is usually not a viable strategy for a near term exit. The fundamental reason for going public is to raise money for the business through the sale of new shares. Most underwriters won't handle an IPO for selling shareholders because the "market" looks askance at bailing out shareholders, who, especially if they are also key management, are expected to hold onto their stock, stick around and share the risk.

Another challenge with going public is that the process has all the requirements of a third-party purchase (#7) on steroids, as well as being very expensive and requiring continual reporting and shareholder relations efforts forever after.

Despite the foregoing, there have been several instances in which a company in the process of registering for a public offering has been swooped up by a buyer at a better price than they would have commanded in a private M&A deal, which is at least partially the result of so much vetting and due diligence (audited financials, etc.) already having been done, as well as making the company's availability obvious.

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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