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THE PRIVATELY HELD BUSINESS

HEADING FOR THE EXIT: SELLING TO A THIRD PARTY

Heading for the exit

For many people who own an interest in a privately held business, the goal is to build the business into a successful enterprise that can be sold. If that describes you, here's what you need to know about positioning your business interests—and yourself and your family—for the sale and for life after the business.

The challenges for a privately held business are similar to what almost any business looking toward the future must confront: the need for additional capital to grow, acquire, modernize or innovate; the general economic outlook (including the ability to respond during economic downswings and upswings); and the competitive landscape.

According to H. Arthur Graper, CFP®, senior relationship manager at CIBC Private Wealth, considerations for selling a privately held business often revolve around three factors: economics, emotion and need. "In addition," says Graper, "wealth diversification for the founding owner is a key factor in the ownership-and-succession decision matrix. Sometimes continuing to own the business moves to second priority as the owner realizes that liquidity and diversification have become more important at a certain stage of life."

When a family decides the right and best choice is to sell its interest in a business to a third party, the work begins in earnest—and so does the uncertainty.

Selling: A long-term process

Although it happens often with business owners, six months is most certainly not the ideal time frame for preparing to sell the business. The family should be thinking more in terms of a planning, preparation and implementation phase of at least three years.

"Certainly, the emotions of selling the business need to be worked through, which may take some time, but it is essential that the business itself be best positioned for sale," says Graper. "First and foremost is to clean up the balance sheet. Often, there are expenses run through the business that really should not be, or loans to family members or other owners that have never been paid back. Receivables generally should be kept as current as possible or written off—bite the bullet and get rid of them. Most important is the structure of the business. Are there valuable strategic alliances and long-term contracts with suppliers or vendors? If so, they may need to be locked down. If the business requires real estate to operate, long-term leases may need to be in place. All of these things can add value to the business when the time comes to sell."

The business also may need to secure agreements with essential employees and key management before a sale to third party. Retaining these nonrelated key employees can be critical, advises Christopher M. Goodrich, an attorney with Crady, Jewett, McCully & Houren LLP in Houston.

"The business owner must focus on how to motivate these employees, who will be instrumental in running the business after the sale," says Goodrich. "They are often in the best position to judge the worth of the company and are very motivated to ensure its continued survival and prosperity. A business can use bonus arrangements, non-qualified deferred compensation plans with long-term vesting requirements, stock option plans and ESOPs, all of which can tie the employees to the business long after the founding owner leaves. If certain key employees decide to end their relationship with the business, 'key man' insurance can be used to fund a buyout, if necessary, and to train and hire replacement employees."

Goodrich says the founding owner must also consider contractual arrangements (such as a franchise agreement), professional licenses, or certifications (minority- or woman-owned business) that can be critical to the successful

transition of the business. Caroline McKay, senior wealth strategistat CIBC Private Wealth, worked with a privately held business client, an engineering firm, in which there was a wealth of organic knowledge, but no written processes and procedures. Another of McKay's clients, a 50-year family business, had dutifully recorded shares sold to family members and gifted to key employees—at least most of the time. "When it came time to sell, there was no accurate record of who owned what percentage," says McKay. "Sometimes you have to really get down in the weeds and look closely for anything that could negatively affect selling and transitioning the business. We also worked with a privately held business that was contractually bound by a controlling distributorship agreement, under which the business could not transition in any way—either to the next generation of family or to an outside third party—without the distributor approving the sale." Key point, says McKay: Selling to a third party requires the business to be *fully self-sustaining.*

Structuring the sale

There are numerous ways to structure the sale of a privately held business: a lump-sum sale, an installment sale, an earnout sale based on a percentage of future profits or a sale to a charitable trust. A business owner may sell the business interest by transferring either the entire ownership interest (stock, partnership interest, membership interest) or just the assets of the business. The desired "end result" will help determine a sale's structure.

"If, for example, the owner wants to sell ownership, but not control, of the business, a tax-free reorganization can be used," says Goodrich. "The interests in the business are recapitalized into voting and nonvoting interests prior to the sale. After the recapitalization, the owner may sell the nonvoting interests to third parties in exchange for cash or a promissory note and retain the voting interests and control of the company. "In a **cash sale**," says Goodrich, in which the owner receives a lump sum of cash or property in exchange for all or a portion of his or her interest in the business, capital gain is generally recognized in the year of sale to the extent that the sales price exceeds the owner's basis, although there are exceptions."

The sale can also be an **earnout**. The purchase price of a business with an earnout agreement includes a contingent payment based on the company's future performance or some other matrix. The contingent purchase price is generally "earned" if certain future benchmarks are reached during a specified period after closing, and often includes a sliding scale on which the contingent payment will be made. "Earnouts are typically useful when there is a gap between a seller's expectation of future profits and a conservative purchaser's estimate of the value of the business without the business owner's ongoing involvement. Earnouts may also be used to motivate and retain key employees of the business," says Goodrich.

An **installment sale** can also be used, although Graper says that this type of sale is more frequently considered if the business is being sold within the family. "The big advantage is that it can provide regular cash flow to the departing founder," says Graper. "But it is best used for the sale of a stable business so that the cash flow is available for the new owners to make the installment payments."

McKay notes that there is a big difference, to both buyer and seller, between an asset sale and a stock sale. In an **asset sale**, the purchaser acquires part or all of the assets of the selling company and gets a step up in basis on the assets purchased. The selling company also keeps liabilities not assumed by the purchaser. As to the tax effect, the selling company recognizes gain or loss on the sale of assets. Tax results differ depending on whether the entity being sold is a C-corporation, S-corporation or an LLC. Taxes may be part ordinary income and part capital gain, depending upon the assets sold. Additionally, the owners of the selling company may incur a second level of tax when cash or consideration is eventually distributed from the selling entity.

In a **stock sale**, the buyer has purchased stock—not assets. Therefore, the buyer gets a carryover basis in the purchased capital assets. Although there is no gain or loss to the selling entity, the selling shareholders recognize capital gains on the difference between their stock basis and their pro-rata share of the purchase price. "Given the complexity of the different alternatives, it is imperative your team of advisors understands the structure and tax implications of your particular deal," says McKay.

Selling the business: A pros and cons checklist

Advantages:

- A sale provides liquidity.
- The investment portfolio is diversified away from concentrated wealth.
- The estate planning process may be simplified.
- It offers the owner the opportunity to separate from the business entirely.

Disadvantages:

- The family usually loses control of the business.
- The business may pursue a different direction than the founder envisioned.
- The business may ultimately fail under new ownership.
- The loss of jobs among family members and the potential for the family's loss of identity are possible consequences.
- Future appreciation of the business is lost.

Liquidity: The thrill, the terror, the "what next?"

Comfortable, controllable and concentrated. The founding owner of a privately held business may have spent decades in the business, and everything about it feels comfortable and controllable—the routine, the risks, the rewards. Even the fact that his or her individual wealth and, by extension, the family's wealth, are concentrated in the business feels comfortable. And then one day the sale of the business is complete, and gone is the comfort, the control and the concentration of wealth.

"A large liquidity event is a *major* life development for business owners," says David L. Donabedian, CFA, CIBC Private Wealth chief investment officer. "The initial stages of the transition can be disorienting. While they understand the advantage of diversifying their wealth away from one source, some are uncomfortable about their level of understanding of the markets, asset allocation and an investment portfolio with unfamiliar holdings over which they have no direct operating influence. Successful business owners are extremely astute people who understand the financial component of running a business, but that's not the same as knowing whether to own one stock or another, or which hedge fund may be right, or on which area of emerging markets to focus. And so many things are now out of their own control."

The segue is best viewed as a necessary mind shift, due to the liquidity event, from being a "business enterprise" to being a "family enterprise," says McKay. "Along with issues of identity, there are new concerns about cash flow, investment portfolios, how family property is held and how to set up trusts, among other things. The new liquidity is an *enterprise* that the family now needs to manage."

The fundamental concept that newly liquid former business owners need to embrace, says Donabedian, is that "when it comes to assets, concentration creates the wealth, but diversification can preserve it." "Many business owners are ready to make the transition to that mindset; for others, it's a much longer process. We start with two general scenarios: wealth concentrated into a single asset or only a couple of assets vs. a more diversified portfolio. As you might expect, the best possible return in a perfect world comes from a concentrated position. But often, that potential reward has already been realized—the business itself. Conversely, the downside risks are greatest with the concentrated position. Part of the

evolving discussion is for the business owner to recognize that phase one—a concentration creating significant wealth—has already been accomplished. Our job now is to preserve wealth in the most prudent ways."

The preservation conversation naturally addresses the issue of risk. What are the potential risks and rewards of equities, bonds and alternative investments—on both an individual basis and when combined in a diversified portfolio? In many ways, the selling business owner is learning to recalculate his or her definition of risk. "When they have run an operating business, or even owned and managed commercial real estate, they have a much more tangible feel for what the risk is," says Donabedian. "They are able to define clearly what a bad year or a bad outcome looks like. Figuring out risk on a diversified portfolio is not as simple. We are evaluating the risk characteristics of each asset class and then putting all that together. A business owner's definition of a 'good return' may also need a reset. A well-diversified portfolio designed to earn 8% a year over the long term may look very acceptable for most investors, but the successful business owner may think: 'I started with $10,000 and just sold my business for $200 million—for me, *that's* a good rate of return.'"

On the positive side, because most business owners are accustomed to working with and understanding spreadsheets, income statements and balance sheets, they're comfortable with numbers. The CIBC Private Wealth advising team's scenarios include a lot of numbers: various types of portfolios over 10 and 20 years, assumptions about inflation, the owner's income needs, the tax implications of each scenario, and best-case and worst-case scenarios. Essentially, it's this: *What might the future look like in terms of your wealth?* In addition, the team must account for other illiquid assets, such as real estate owned, often creating a staged, multi-year process toward more complete diversification.

For members of a family who have been running a family business, the evolution from a "business family" into a "financial family" can feel daunting. Becoming a successful "financial family" requires more structure, more delegation and a different type of management, such as working with a new team of advisors focused on wealth preservation.

For many business owners, the transition to managing wealth involves a major shift in mindsets. Entrepreneurs who have sold their business enter an environment for which they are largely unprepared. While they often have high financial and business literacy, they often lack what might be called "wealth literacy." They feel vulnerable in a world of advisors who speak an entirely new language. Beyond that, the rules of this new landscape are complex, and it is difficult to know whom to trust. They are expected to understand the complex investment concepts and discern effectively among investment alternatives, understand byzantine fee structures and effectively calibrate risks that they don't truly understand. On top of that, families must also navigate estate planning, new tax rules and risk management strategies in very different ways than they have before.

In the face of this uncertainty, says Donabedian, it is important to keep in mind that successful business owners have *always* surrounded themselves with expertise. "This is no different," he says. "Our relationship with clients who experience a liquidity event includes expertise in the broad issues of multi-generational wealth strategies all the way to expertise in narrowly focused segments of investments that represent emerging opportunities. While the transition may be a long-term process, there are many steps along the way to help ease business owners into their new status as *former* business owners who created and realized substantial wealth."

Beyond these technical considerations of wealth management, former business owners often face substantial questions about lifestyle, how to raise their children and how to navigate the personal, familial and social complexities wealth creates. The move from business owner to wealth holder often involves a substantial change in identity. As one former CEO put it, "Last month, I was the guy who had his emails answered in 15 minutes. Now I'm the third guy in line at Starbucks." Just as the former owner is coping with this new reality, the owner's family is undergoing substantial change as well. The transition can put stress on a marriage and other family relationships. Indeed, one major concern parents face is how to prepare the children to ensure that they will not be stunted by inheritance but will grow to become wise stewards of the wealth. Here, too, CIBC Private Wealth can help. We have worked with many families to help them sort out not merely the quantitative issues of wealth management, but also the qualitative issues of inter-generational success. Through education, conferences, growing internal capability and our extensive connections with outside resources, we can help families navigate the complex realities of wealth and succession. ■

Selling the business: When to consider an employee stock ownership plan

An employee stock purchase plan (ESOP) is a tool that allows company employees to take on ownership of a business. They don't fit every type of business, and it's a little more complex than simply "ESOP plans let founders cash out and employees cash in," but an ESOP is a combination of letting go and keeping the business in a *type* of family: employees.

The National Center for Employee Ownership estimates that there are approximately 11,000 employee stock ownership plans for more than 10 million employees in the U.S. Along with millions of other employees who participate in plans that provide stock options or hold their employer's stock through 401(k)s, employees now control about 8% of corporate equity. Because they offer tax benefits, ESOPs tend to become more popular when tax rates are rising.

A main purpose of the ESOP is to provide a market for the shares of a departing owner of a privately held business. Advantages are plentiful:

- An ESOP may be a viable option for a privately held business with a lack of outside buyers or family to which to pass ownership of the business.
- There can be flexibility in structuring the transaction—the business owner can stay on and exit in phases, often providing a smoother transition for the business.
- An ESOP provides a "friendly buyer," and those friendly buyers get a new boost to motivation by sharing in ownership of the company.
- The seller can receive certain tax benefits. For example, if an ESOP owns 30% or more of company stock and the company is a C-corporation, owners selling to an ESOP can defer taxation of their gains by reinvesting in securities of other companies.* An S-corporation can convert to a C-corporation prior to the sale to take advantage of this deferral.
- Selling a minority interest in the business through an ESOP offers a way to diversify business owners' wealth, allowing them to invest in other assets.

Even with all of its benefits, an ESOP should not be entered into without an eyes-wide-open period of careful deliberation, says Arlen Brammer, a lawyer and ESOP expert in Greenwood Village, Colorado. "The first hurdle is a valuation of the business by an independent appraiser hired by the ESOP trustee. Many business owners have a valuation in their mind, which often doesn't match up with the professional, objective valuation of the business. That happens, oh, about 100% of the time. The owner/seller must be willing to sell his or her shares at the fair market value determined, even if the ESOP pays less than the owner thinks an outside buyer would."

In a typical ESOP structure, all or a portion of the company's stock goes to the ESOP, which takes a bank loan to purchase the owner's shares. The collateral for the loan is the business. "The bank is going to be very interested in how the company will be managed as it transitions from the original owner to new management," says Brammer. "It's critical for the business owner to have professional management in place well in advance of the ESOP transaction. They need a track record with the company. Management continuity is critical."

An ESOP does come with its own complexities: It can be an expensive transaction initially, requires an intensive annual valuation, and mandates additional reporting and governance. (ESOPs are regulated by the Employee Retirement Income Security Act, which has its own strict requirements and standards, including that the company cannot pick and choose who can get stock or make allocations based on discretionary decisions.) But in the right circumstances, ESOPs can be a very satisfying way for the business owner to move forward while also giving back.

**Please consult your tax advisor to learn how an ESOP will affect your situation.*