

Exit Strategies

Chapter 14

Exit Strategies for Small Business Owners

Developing an effective exit strategy is one of the most important issues faced by small business owners. It requires careful planning well ahead of the desired exit. Often, however, many owners do not begin planning for an exit soon enough. Two of the more common exit strategies are the succession of the business to a relative and the sale of the business.

Planning for succession

Aside from management issues, the most important aspects of a succession include tax and estate planning issues. Owners many times transfer their company to relatives at a reduced price or for no charge. This can result in estate and gift tax consequences and, therefore, needs to be addressed carefully. In a succession, ownership is often either given away (“gifted”) or sold to the relative.

Ownership can be gifted all at once or over time. Currently, individuals can gift assets valued up to \$12,000 per donee each year with no gift tax consequences. Over a lifetime, individuals can also gift an additional \$1 million without gift tax. These tax exclusions may be doubled if the donor’s spouse also gifts assets. For example, Joe Smith, a business owner, along with his wife, could give \$24,000 worth of stock to each of their two children each year. Above that amount, Mr. and Mrs. Smith could, over the course of their lifetimes, give as much \$2 million of stock in total to their children and pay no gift tax. Mr. and Mrs. Smith would need to file gift tax returns, and should have their stock appraised by a professional appraiser, especially if the valuation includes discounts. A professional appraiser often can discount the value of the stock (and thus perhaps reduce the taxable gift) because the stock is not traded on a public exchange or because the donee does not control the company.

It is advantageous to make gifts early. If the assets are held at death, they may be subject to death taxes. The federal tax is currently 45 percent. The Ohio tax is six percent to seven percent. By gifting early in life, the assets’ appreciation (increased value) does not count against the estate for tax purposes. For example, more shares can be gifted without gift tax when the share value is \$100 instead of \$1,000.

Instead of gifting ownership, family members may choose to sell it, but at a reduced rate. If the sale is financed by a note, interest should be charged at or above the applicable federal rate (published monthly by the IRS). If not, the IRS will expect the seller to pay tax on interest income even though no interest was paid.

Another option is a self-canceling installment note. Generally, such a note automatically cancels the buyer’s obligation to pay if the seller dies during the note term. This has the advantage of giving annual income to the seller during life, but not requiring the buyers to make payments when the seller no longer needs them. The remaining balance would not be subject to estate tax if the self-canceling installment note is properly drafted.

Sale of the business

A business owner may not be able to transfer a business to a relative. If so, the most desirable exit will likely be to sell the business. A sale of the business requires careful advance planning.

The most advantageous time to sell a business is when it is profitable and growing, and when the owner is not forced to sell. Before offering a business for sale, it is a good idea to put the “house in order,” so to speak. Review financial performance and operations to determine whether there

are any problems that might be exposed through a potential buyer's close inspection. Also, it is often a good idea to have a professional valuation performed to get a general idea of what the business may be worth. Remember, that, because there are many different ways to evaluate a business's worth, one professional valuation may differ significantly from another.

Usually, the most daunting task is locating a buyer. Potential buyers include insiders such as management, strategic buyers such as competitors or businesses looking to expand or diversify and financial buyers such as venture capital and investment firms. A business broker can be hired to help identify prospective buyers.

A number of different factors will affect whether the sale is structured as a sale of the company's stock or its assets, or as a merger. These include tax issues, the nature and extent of seller's existing and potential liabilities and the terms of the contracts to which seller is a party.

After the seller and the buyer agree on a sale structure, typically:

- the parties draft a letter of intent to outline the general terms and conditions of the transaction;
- the buyer investigates the seller's business;
- the parties draft the transaction documents and negotiate with the buyer about price and sale details; and
- the parties satisfy any conditions spelled out in the transaction documents, such as a requirement of shareholder approval or the consent of creditors and other third parties.

After these steps are taken, the transaction can be closed and the sale consummated.

—by D. David Carroll and Harlan S. Louis of the Columbus law firm of Bailey Cavaliere, LLC.

Planning To Sell Your Business?

Merger and acquisition activity rode a wave of good fortune from 2002 through the end of 2007. A competitive banking market allowed acquirers to marry bank financing with private equity in acquiring new business. Multiples increased significantly during this time—even to the point where it became difficult to justify. Buyers were pleased because they were able to capitalize new acquisitions with relatively inexpensive money. Banks were happy to lend more money, even at a low interest rate on risky transactions. Sellers went along for the ride by cashing in at previously unheard of multiples.

All that began to change in 2008. By the end of that year, both businesses and banks saw stock prices significantly diminish, profits erode and market confidence evaporate. At the time this article was written in February 2009, very few large acquisitions had occurred and mid-market deals were scarcer. The result is that buyers have not been able to garner the necessary funding often required. Private equity and other non-traditional financing availability has decreased significantly, and such investors are more reticent about investing in companies in these uncertain times. Finally, sellers who have not needed immediate liquidity have been deferring sales until such time as capital becomes more available and sales multiples increase.

Despite all of the foregoing issues and obstacles, certain business owners may feel a need to sell, and certain strategic buyers will favorably consider acquisitions at these reduced multiples.

If you, as a business owner, are thinking about selling your company, consider the following:

- **Shore up your management team.** While some business buyers only want to acquire business assets or a particular product, most look to current management to help build the business with them. Review key personnel and hire appropriate people to fill any existing gaps. The additional salary cost may yield a higher selling price.
- **Modify your business plan.** Seek professional assistance to hone your business plan and ensure it reflects your current operation and any growth plans.
- **Review your financials.** If you have failed to consistently meet projections, revise them to more realistically reflect the realities of your business and true growth opportunities. Hire competent tax professionals to insure that the financials reflect standard accounting principles.
- **Follow corporate formalities.** Make sure your business has annual meetings; record the minutes of all board meetings. Engage a board of directors/advisors to give you input on key decisions. Update employee handbooks and other corporate policies.
- **Make peace.** Whether it is with the IRS, a former customer or an employee, try to resolve all outstanding disputes and legal challenges.
- **Maintain financial discipline.** Take charge-offs now for bad debt and other problems. Repay any shareholder loans, take non-working family members off the payroll and finance only true business expenses.
- **Make appropriate capital expenditures.** Sellers often delay capital expenditures when selling the business is within sight. This merely causes a disproportionate reduction in the purchase price. Make the expenditure now and remove that burden from the new owner.
- **Maintain all personal and real property in working order.** Allowing equipment to fall into disrepair sends a strong negative signal to potential buyers.

- **Meet with your business advisors.** Let your accountant and attorney know of your plans to sell so that they can begin to advise you about maximizing your purchase price, minimizing any potential taxes and optimal deal structures.
- **Keep your eye on the ball.** Positioning your company for a sale takes a great deal of time and effort, but do not forget to tend to the day to day running of the business so there is something of value to sell.

–by Thomas C. Washbush, an attorney with the Columbus firm of Benesch Friedlander Coplan & Aronoff.

Life Insurance Figures in Business Succession Planning

Q: *I own a business with two other equal owners. We believe that the business is worth more than \$750,000 if we were to sell it. The business owns a total of three policies of term life insurance, \$250,000 on each of us, payable to the business. If one of us dies, will that owner's family receive the money?*

A: No. The business receives the money as the designated beneficiary of the life insurance policy.

Q: *Does the deceased owner's family inherit the share of the business?*

A: Maybe. It depends on several factors. Transfer of a share in the business may be restricted by written documents commonly known as *buy-sell* agreements. Otherwise, the deceased owner's share is left to the person(s) designated in his or her will.

Q: *What are buy-sell agreements?*

A: They are written agreements between: a) a business and an owner; b) the owners; or c) a combination of (a) and (b). There are two major types. The first is a *redemption agreement* in which the *business* agrees to buy the owner's interest upon a "triggering event" (such as that owner's death). The second is a *cross-purchase agreement* in which the *owners* agree to buy the share of another owner upon a triggering event. The buy-sell agreement may stand alone or may be incorporated into other, more comprehensive agreements, such as partnership agreements or close corporation agreements. The agreements usually will address conditions which trigger a buy-out, as well as the price and terms of payment.

Q: *If there is a buy-sell agreement, must the business buy the deceased owner's share of the business from the deceased owner's family, and must the family agree to the sale?*

A: Yes, if the agreement requires a sale.

Q: *If the family members of a deceased owner receives a business share through inheritance, may they sell it if they wish to?*

A: Yes, assuming there are no restrictions on the sale. The family can sell to anyone, including the other owners. The sale price and the terms are all subject to negotiation.

Q: *Is the business required to use the life insurance money to "buy out" the deceased owner?*

A: No, not unless the business and the owner have agreed to this in writing.

Q: *What are the advantages of life insurance and a buy-sell agreement?*

A: Life insurance in combination with a buy-sell agreement provides liquidity (available cash), assures all the owners of a market for the sale of their share in the event of death, and provides protection for their families. It further ensures that the business and surviving owners will not have to borrow money, reduce working capital or divert future earnings to buy the share. The surviving owners also avoid potential meddling and disputes caused by those who may have inherited or bought the deceased owner's share.

The family of the deceased owner does not have to worry about finding a buyer and is assured of receiving cash shortly following the death in order to pay bills, estate taxes, etc. They also do not have to worry about overseeing and protecting their share of the business.

Q: What is the best way to require the business to buy the deceased owner's share?

A: Prior to someone's death, the business owners sign an agreement which obligates the business to buy an owner's share should one of them die. The deceased owner's estate is likewise required to sell the share to the business. Of course, the availability of life insurance to fund the buyout is dependent upon health and cost.

Q: What determines the price of the deceased owner's share?

A: The price is usually defined in the written agreement and may be based on many factors. For example, the business may operate in an industry which uses traditional measures of value, such as "book" value, one year's gross revenues, one year's earnings, etc. A fixed price may be set periodically by the owners or it may simply be based upon the life insurance proceeds received.

Q: If life insurance proceeds are less than the defined price of the business share, what happens?

A: Usually, the written agreement will anticipate that possibility and provide an alternative way to fund the buy. For example, the business may either borrow the difference or pay it over time in installments.

—by Paul S. Klug, an attorney with the Cleveland firm, Ziegler, Metzger & Miller, LLP.

Make Your Succession Plan a Plan To Succeed

When siblings Mike and Amy started a cleaning service business 30 years ago, they started out small—cleaning a local office or two. Through careful planning, they added employees and commercial clients. Fifteen years ago, his two sons and her three daughters joined the business, all learning it from the ground up.

One of the founders died unexpectedly; the business floundered. Did Mike’s widow, who had no interest in business, inherit his share? Who was in charge? Where did their children fit in?

Every entrepreneur who starts a business writes a plan to succeed. They often overlook the need for a well-thought out succession plan. Who will carry on their dream when they cannot?

Two compelling forces pull on business founders. Their business creation—their baby—can pull them one way. Their children’s desires and abilities as successors pull them another. These forces ignite strong emotions.

A succession plan considers the future. It sets a plan for how to carry on the business with minimal acrimony and transfer value to a second generation at the least possible tax cost. The plan recognizes that poor choices could lead to financially devastating lawsuits.

To begin, all owners forge an agreement on business objectives. They should address the “what-ifs” such as incompatibility, disability, retirement, or death. Then they put those objectives in writing in a *buy-sell* agreement: an agreement either between a business and an owner, or the owners—or both.

Consider two types of buy-sell agreements:

- A redemption agreement. The business agrees to buy the owner’s interest upon a “triggering event” such as that owner’s death.
- A cross-purchase agreement. The owners agree to buy the share of another owner upon a triggering event. The agreement usually addresses conditions which trigger a buy-out, as well as the price and payment terms.

Next, all the owners should review the feasibility of funding the agreement with life insurance if the death is the triggering event—to pay off the deceased or retiring owner’s shares. Make sure all the owner’s personal objectives and that wills and trusts, if any, are coordinated accordingly.

Advice to owners: Do not tackle it yourself. This is an emotionally and legally complex area of law; seek counsel from a qualified estate or business planning attorney. If a business is to survive into a second and third generation of leadership, it needs a succession plan to succeed.

—by Paul S. Klug, an attorney with the Cleveland firm Ziegler, Metzger & Miller, LLP.

Business Succession: The No-Tax Solution

Can the owners of a closely held corporation sell their stock without paying taxes on the gains?
Can the selling owners substantially reduce or eliminate estate taxes attributable to the stock sold?
Can the corporation's stock obtain an exemption from United States and Ohio income taxes?
Under certain circumstances, the answer to all three questions is "yes."

The *Internal Revenue Code* permits certain closely held U.S. corporations and their owners to obtain the following benefits:

- Owners of C-corporations who sell their stock to a qualified employee stock ownership plan (ESOP) can defer gains taxes to the extent the proceeds are re-invested in the securities of U.S. operating companies. Under certain circumstances, the capital gains taxes may never have to be paid. Selling shareholders may be able to borrow against the investment portfolio in order to diversify their holdings.
- In the tax year after the stock sale to the ESOP, the shareholders (*i.e.*, the trustee of the ESOP and other qualifying shareholders, if any) can elect to be taxed as an S-corporation. Thereafter, the owners of the corporation (other than the ESOP), and not the corporation itself, will be subject to taxes on the profits.
- An ESOP is eligible to be a tax-exempt S-corporation shareholder. Therefore, to the extent the corporation is owned by the ESOP, the ESOP does not have to pay federal or Ohio income taxes.

Careful business succession planning does more than help company owners cash out income tax-free. It also addresses company management succession and owner estate tax projections.

- First, an ESOP may help attract a quality successor management team by giving team members a stake in the company profits as a plan participant. It may also inspire greater dedication and productivity by the employees, who are new owners of the company as plan participants.
- Second, the company owners may save significant taxes by creating a charitable remainder trust (CRT) and an Irrevocable Life Insurance Trust (ILIT). Subject to certain conditions, owners can contribute their stock to a CRT. The trustee of the CRT, in turn, can sell the stock to the ESOP at fair market value. The owner who contributed his/her stock to the CRT receives a current income tax deduction in addition to a stream of income for life from the CRT. Upon the owner's death, the remaining funds are transferred to the charity named in the CRT. In addition, the owner, while living, can use that stream of income from the CRT to fund the ILIT premium payments, which will eventually benefit the owner's children or other beneficiaries. If the ILIT is properly structured, the death benefits from the insurance policies in the ILIT, which are payable upon the death of the owner, are not subject to estate taxes.

Thus, all of these business succession tools, when properly and expertly applied, can provide owners of closely held corporations with a solid business succession plan that attracts and retains high quality successor management at a significantly reduced tax cost.

—by Timothy C. Jochim, an attorney with the Columbus office of Kegler Brown Hill & Ritter and adjunct professor of corporate finance at the Capital University School of Law who has served on the legal advisory committee of the ESOP Association, Washington, D.C. Updated by Paul S. Klug, an attorney with the Cleveland firm of Ziegler, Metzger & Miller, LLP.

Business Bankruptcy: What, When, and How

Q: What types of bankruptcy are available?

A: Corporations, partnerships, limited liability companies and individuals who operate businesses are eligible to file for bankruptcy under Chapter 7 or Chapter 11 of the Bankruptcy Code.

Chapter 7 bankruptcy is known as *straight liquidation*. In a Chapter 7 case, a trustee (assigned by the U.S. Trustee's Office or chosen by the debtor's creditors) may liquidate, or sell, the debtor's non-exempt assets to satisfy all or a portion of the creditors' claims. Any portion of debts not paid by the trustee (with certain exceptions for individuals) is discharged, and the creditor cannot force the debtor to pay the remaining amount.

Chapter 11 *reorganization* is typically used by corporations or businesses that want to stay in business as an alternative to Chapter 7 liquidation. A Chapter 11 reorganization is available to individuals, but it is typically an expensive process that is not frequently used by individuals. In a Chapter 11 reorganization, the debtor may keep its property, and agrees to pay creditors with future earnings according to a plan of reorganization.

Q: When is it appropriate to file for bankruptcy?

A: The decision to file bankruptcy varies according to each unique situation. Anyone considering bankruptcy should consult with an experienced bankruptcy lawyer who can determine whether such an option would be appropriate, and when it would be most beneficial to file.

Given that each case must be independently evaluated, it may be appropriate to file for bankruptcy when: 1) a significant event occurs that would subject the business assets to a creditor's claim, such as a large judgment lien or tax lien; 2) the business is unable to pay its debts and regular operating expenses; or 3) it has property that it wishes to keep from the reach of creditors.

Q: What process would I go through in order to file bankruptcy?

A: You would file a petition in bankruptcy at the bankruptcy court and provide the bankruptcy court with a schedule of assets and liabilities. These documents would include a list of everything the business or an individual owns and everything the business or individual owes to creditors, as well as information concerning transfers of money made within one year or more before filing for bankruptcy. In addition, in a Chapter 7 bankruptcy you would pay a \$299 fee to file these documents, and in a Chapter 11 bankruptcy, you would pay \$1,039. In addition to the filing fee, there is a quarterly fee to be paid to the United States Trustee in Chapter 11 cases. After these documents are filed, you would have a meeting with an analyst from the United States trustee's office for the district and a meeting with an assigned trustee. The meeting with the assigned trustee may be attended by your creditors, and the documents you filed would be checked for accuracy. Also, you would be asked additional questions about your own or the business's finances.

Q: Can a discharge of debts in bankruptcy be denied?

A: Yes. The filing of a bankruptcy petition does not guarantee the discharge of debts for individuals.

General discharge of debts in bankruptcy may be denied to an individual if a person commits certain acts of misconduct before or after the bankruptcy petition, such as destroying, concealing, or removing assets which might otherwise be used to pay creditors in the bankruptcy case. Also, a discharge of debts may be denied if the person has destroyed or concealed records which show what assets are available to pay creditors. Finally, a person may be denied a general discharge if he or she has lied under oath during the bankruptcy case, or refuses to answer questions without a good reason.

Aside from acts of misconduct, a person will not be granted a general discharge if he or she has obtained a discharge in a Chapter 7 case within six years of the date that a second bankruptcy is filed.

Additionally, a Chapter 11 business debtor's discharge may not occur if: 1) the plan provides for liquidation of substantially all of the debtor's property; 2) the debtor does not engage in business after the plan is consummated; and 3) the debtor is not an individual. Consequently, corporations and partnerships that either sell their assets through a Chapter 11 case or cease doing business after a Chapter 11 case is completed, do not receive a discharge of their indebtedness.

Q: If a general discharge of debts in bankruptcy is granted, are there still any debts that would have to be paid?

A: Yes. Even if a general discharge is granted, some debts cannot be discharged in bankruptcy for individuals. These include: 1) taxes which the debtor has incurred in the three years prior to the date of bankruptcy filing, or taxes assessed within 240 days of the bankruptcy filing; 2) certain "trust fund" taxes such as sales tax and 941 taxes; 3) certain student loan debts; 4) child or spousal support and any other debts arising from or assumed under a domestic court order; 5) criminal fines and debts arising from a DUI; and 6) any debt incurred because the debtor has committed fraud, breached a fiduciary duty as a trustee, or committed a "willful" act causing injury to a creditor.

The debts listed above typically do not appear in bankruptcy cases for businesses with the exception of tax liabilities. Nevertheless, if an individual files a bankruptcy case as a sole proprietorship, his or her personal debts are also included in the filing. Therefore, a sole proprietor's bankruptcy filing would address all of the business debts and personal debts, such as child support, student loan debts or others, and would be treated as discussed above.

Q: How would a bankruptcy discharge affect my company's credit record?

A: It depends upon the facts and circumstances of each case. Of course, the bankruptcy will be noted on the company's credit record, but the effect of this notation depends upon the outcome of the case (the case is dismissed or a reorganizing plan is confirmed). Also, individual creditors have differing policies regarding those who have filed for bankruptcy protection. What is certain is that a bankruptcy filing will appear on credit records for up to ten years, and will most likely cause difficulty in obtaining loans, either because the loan will be denied, or because a higher rate of interest will have to be paid, or because additional collateral or guarantors will be required by the lender.

—by Anthony J. DeGirolamo, a Canton attorney.