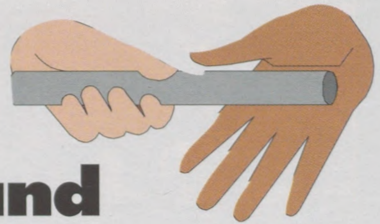
Passing The Bucks



Business Continuation and Management Succession

By Ben M. Brahinsky

Developing and executing a comprehensive exit strategy from your company is the ultimate test of a truly successful business owner. Many owners underestimate the time and difficulty involved in accomplishing this critical task. A simple five-step process will help you plan for transferring the ownership and management of your company.

1. Gain an understanding of the problem and the issues.
2. Define the objective and parameters.
3. Determine the value of the firm.
4. Identify, train, and transfer management and leadership to successors.
5. Evaluate, select, and model the proper equity transfer technique.

1. Understand the problem

The first step in solving any problem is to recognize that you have a problem. A business continuation "problem" is an easy one to ignore, because it is not nearly as pressing as an upcoming bid, an unhappy client, or a job in trouble. Besides, you are going to live (and work) forever—right?

Part of the problem is that construction-related companies do very little actual planning in this area. This fact was reinforced by a recent contractor survey conducted by FMI which revealed that only 40 percent of the companies had written plans to address the continuation of their firms. Further analysis revealed that many of those plans were no more than simple wills, leaving everything to spouses or trusts. In other companies, the plans consisted of large life insurance policies payable to the company. The real issue is that most of these plans function only at death and did not address a transfer while the owner was alive.

Furthermore, only 15 percent of those surveyed had actually communicated their plans to their employees. It is difficult to implement a plan if no one knows about it. Optimistic as always, 84 percent of the contractors surveyed believed that their businesses would survive into the next generation. Statistics reveal, however, that less than 20 percent of those companies will actually make it. Proper planning and time, not luck, is required to ensure a smooth transition.

The two impediments most frequently cited to a successful transition were: 1) a lack of financial resources by the employees to conduct an internal buyout; and 2) the existing owner/manager refusing to transfer control and management. Procrastination and delay of continuity planning was also common. Other obstacles included:

- Unwillingness to delegate.
- Fear of a younger successor taking control.
- Management style which is not conducive to the development of competent successors.
- Belief that one person is better than a team.
- Complete identification with business and few outside interests.
- Owner who fears a decrease of importance in the company and the community.
- Owner who fears retirement will drop both income and standard of living.
- Reluctance to make tough decisions regarding family members.
- An unwillingness to sell the business for fear of losing the firm's individuality or changing its culture.
- Reluctance to reveal the company's true financial position.
- Reluctance to set up a will that dictates procedures to be followed in the event of death.
- Misinformation or ignorance about equity transfer techniques.

Most of these reasons are ego-driven, emotional, and difficult to address. In a family-owned company, it is often easier to not tackle important decisions in order to avoid potential conflicts or family stress. If there are three children, then each is entitled to equal ownership of the company—right? What if one child is the heir apparent due to his or her active participation in the business and the other two are totally uninvolved in the business? Avoiding such situations with family or employees impedes planning and reduces the chances for an effective transition.

Due to the complexity, the tough decisions, and the emo-

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tions involved, many contractors retreat into inaction. There are, after all, a bundle of interwoven issues which need to be simultaneously addressed. Some of these are tax, legal, financial, management, family, estate, valuation, insurance, risk, leadership, and performance. Contractors and consultants should avoid becoming experts at management succession, tax matters, and corporate reorganizations. The "how to" should be left to the experts while the owner should assume responsibility for deciding what is to be accomplished, by whom, and in what time frame.

2. Define Objectives and Parameters

Where do you start now that you realize that there is a problem and you have a desire to solve it? Most business people assume that the first step is to become thoroughly familiar with all of the tax, legal, and accounting issues affecting the transfer of ownership. They often spend a great deal of time consulting their attorneys, accountants, and insurance advisors. Then they spend even more time consulting someone else's attorney, accountant, and insurance advisor. As a result, they find themselves trying to absorb and sort out confusing and often conflicting advice about the techniques and ramifications of transferring ownership. By addressing the following questions and issues, you will build a blueprint for your succession plan.

Business Continuation
- Internal transfer
- Sell
- Liquidate

Stock Ownership
- Who
- When
- How much
- How will it be paid for

Voting Control
- Who should have it
- One person or a group
- When should it change

Contingency Plan
- In event of death
- In event of disability

Retirement
- When
- To what extent
- Role you want to play
- Compensation

Family
- Involvement
- Ownership
- Employment opportunities

Financial objectives
- Cash flow
- Equity removal
- Estate issues
- Insurance

Indemnification and Guarantees
- Reducing risk
- Transferring risk to the next generation
- Who else signs and when

Buy-Sell Agreement
- Triggering events
- Price
- Terms

Management Succession
- Who will manage
- Who will lead
- Timing/training

Now that you have a better understanding of the questions and issues, the next step is to develop and implement a comprehensive plan. My experience suggests that selecting an outside advisor to direct the process and guide the development and implementation of your plan will yield the best results. Your advisor's responsibility should include gathering input from you and your employees and coordinating the process with your other professional advisors. Resist the temptation to acquire information from numerous outside

sources and to manage the entire process above. You will only find yourself creating and becoming the victim of confusion.

3. Determine The Company's Value

"Beauty is in the eye of the beholder." That bit of wisdom also applies to the value of a construction or consulting company. The primary question in the valuation of a business is, "who's asking?" Is it the IRS, a third-party buyer, or the employees? Each has a different perspective, different objectives, and resulting value. A detailed treatise on corporate valuation is beyond the scope of this article. However, a few key points about valuing companies should be made.

- There are three generally accepted methods for valuing closely-held firms. They are assets, earnings, and market, and they all should be considered in making a determination of value.
- The earnings value of the firm should ultimately be such that a buyer would be able to earn, via the after-tax profits, at least a 15 to 20 percent return on the investment.
- Book value or adjusted book value may or may not reflect the real value for the firm. Most transactions in the construction industry are closely supported by the underlying asset values. Many sellers will not take large discounts from book value, and most buyers will not pay large premiums over book value.
- In selling stock to employees, the abstract value is much less important than the ability of the employees to pay. Setting the value at $1 million if the employees can only afford $250,000 is futile.
- Perceptions of "value" vary greatly, depending on one's perspective, knowledge, and attitude.
- Unrealistic expectations of value can kill a deal before it gets started. As a seller, ask the question, "What would I pay for this company?"

Before continuing in the planning process, a reasonable, defensible value should be determined for the business. Knowing this value is one key to implementing a successful plan.

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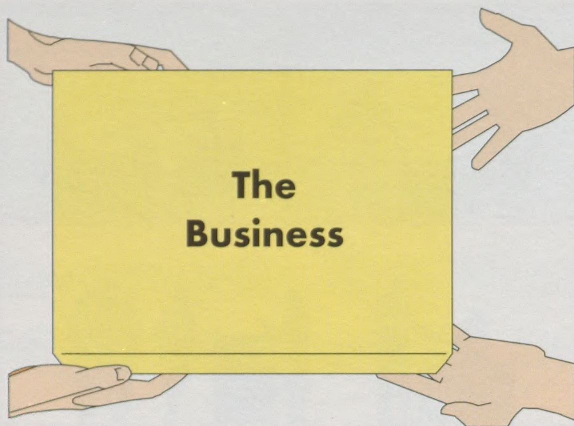

4. Transfer Ownership

Simply put, there are only *three* options for removing equity from your business: liquidate, give away, or sell.

LIQUIDATION

First, you can shut the company down, sell everything that is salable, pay your taxes, and take the money. The company, for the most part, simply ceases to exist. This alternative should always be considered, as it does have strong advantages. It is clean, usually quick, minimizes future risk, and avoids difficult family and employee situations. There is, however, a large price to pay for this alternative from both a financial and emotional perspective. Contrary to popular opinion, liquidation is an option that should be seriously evaluated by nearly every owner. It is usually the last choice, sometimes the only one, and often the best.

GIVE YOUR COMPANY AWAY

When contractors and consultants choose to give their companies away, they often think of family members first. That option works well, particularly if the recipients of the gifts are working in the company and performing in responsible management positions. There are some major disadvantages associated with *giving away* your company. Sometimes the recipients of gifts are not psychologically prepared to seriously accept the responsibilities of ownership. Successful owners invest a great deal of themselves in their companies, and people who make no personal investment often lack the commitment required to successfully run a company. Maybe the initial investment was sweat equity rather than financial resources; nevertheless, a substantial personal investment was made. Usually, however, the owner has no desire to give the business away and simply cannot afford to do so.

SELL YOUR COMPANY

If you don't want to liquidate and you can't afford to give the company away, your only other choice is to *sell*. Selling is the alternative that most owners choose. There are two potential buyers for your stock: "outsiders" or "insiders."

OUTSIDE SALE

A sale to a third-party buyer is a perfectly acceptable alternative. Many construction and consulting companies are purchased by other companies who know the business, even though they may not be familiar with your particular market, customer base, or type of work. A third-party sale has several advantages:

- It eliminates ongoing bonding and credit risk.
- The problems of succession and the business belong to the new owners.
- The seller is generally cashed out at closing.

There are numerous ways to structure buyouts and to keep your management team intact. In fact, an outside sale may offer new opportunities and an exciting future for key personnel. Structuring the buyout so you can remain in management for some time can allow for an income stream. It also enables you to train your successor and, subsequently, build a stronger future for your company. If a buyer can be found, selling to a third party is often the best alternative.

INTERNAL SALE

Ideally, however, most contractors and consultants would choose to sell their companies to family or key employees. In general, we believe that the people who buy your company should be the same people who are actively involved in the day-to-day management. Absentee ownership in a closely-held company is difficult and can create problems.

Advantages of an Internal Transfer

- Flexibility
- Ongoing involvement
- Opportunities for key employees and family
- Continuing income and earnings participation

Disadvantages to an Internal Transfer

- Strong profits are required
- Ongoing risk
- Five- to ten-year time frame
- Must give up earnings to fund the transfer

There are many approaches and combinations that can be used to transfer ownership. Every alternative should be considered and evaluated. The resulting structure is usually a combination of techniques and concepts. The ownership transfer plan should be fully modeled for ten years with tracking of earnings, equity, ownership structure, cash flows, etc. Various what-if scenarios must be evaluated given different assumptions and variables. The most frequently used techniques are listed below.

- Direct sale for cash or note
- Leveraged buyout
- Stock redemption
- Stock recapitalizations
- Stock options

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- ▼ Stock bonus
- ▼ Restricted stock
- ▼ ESOPs
- ▼ Subchapter S buyout
- ▼ Joint venture—old company./new company
- ▼ Permanent joint venture
- ▼ Spin off/split off/split up

RETAINING THE NONSTOCKHOLDER EMPLOYEE

Sometimes the decision is made to keep the stock in the family or to sell to only a small group of people. If key employees cannot be stockholders, how can you compensate them in such a way that they will remain with the company?

There are several techniques for assisting those key employees in their efforts to accumulate long-term wealth without making them stockholders. These include deferred compensation, phantom stock, off-balance-sheet partnerships, profit sharing, and insurance arrangements. The key objectives of these techniques should be to reward those employees who remain with the company and perform. Most contractors have compensation plans that give employees the incentive to quit. This is a fairly strong statement, but look at the facts. When employees leave, they typically leave nothing behind. They take with them their bonus and salary and any of their qualified retirement funds, as well as their proceeds from the repurchase of corporate stock. Financially it did not cost the employee to leave the company. A better plan is to structure long-term incentives, so that a terminating employee takes little or none of his or her benefits upon termination. The plan should allow them to accumulate wealth if they stay.

The internal transfer is generally the most complicated and time-consuming approach. It is also, however, the most rewarding and frequently the best choice. All internal transfers take time and profits. The more you have of both, the greater the chance of a successful transaction.

5. Making It Work

Rarely has there been a situation where the owner's reasonable objectives could not be accomplished in an ownership transfer plan. You may need to exercise creativity in your individual situation—every family and company is different. Once you envision what the future ought to be and what you would like for yourself, your children, your key employees, and the company, then there is a technique or a combination of techniques that will allow you to meet your objectives. Insist on answers that *will* work—don't accept excuses about why your visions cannot be realized. Pick a person in whom you trust and have confidence to oversee the process. There is only one opportunity to plan correctly. The costs of making a mistake can be enormous and may cause legal or personal difficulties. The approach outlined in this article will yield a comprehensive and integrated plan that accomplishes your objectives.

About The Author

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