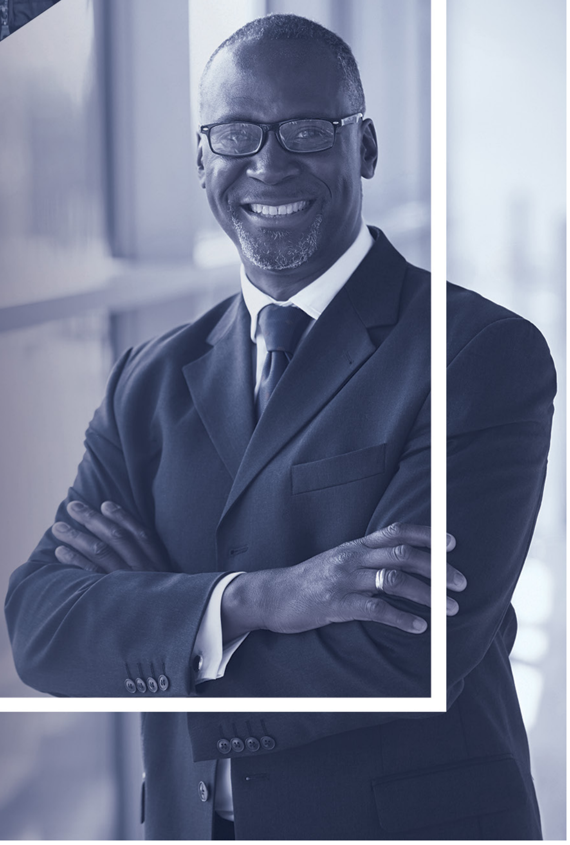
Business Succession Planning

An Owner's Manual

Chris Cooper
and the staff of the
Ohio Employee Ownership Center
At Kent State University



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Design and layout by Shane McGinnis

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The Ohio Employee Ownership Center of Kent State University is a non-profit, information, outreach, technical assistance, training, and research organization that supports the development of employee ownership.

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Introduction

You will, like every other business owner, exit your business in one way or another. It can happen on your timeline, or it can be forced by circumstances – but it will happen. The question is whether you will be in charge of the succession planning process, or if circumstances beyond your control will be driving what happens.

What do we mean by the term "succession planning"? It can have a number of meanings, or perhaps more accurately, shades of meaning. You may hear the process described as exit planning, or perhaps something else. What we mean by the term, and what we are assuming throughout this book, is that you would like to see the business continue—in one way, shape, or form – after you leave it. If this describes you, you're in the right place.

Succesion Planning Steps

↓

Defining My Goals and Objectives

↓

Value - How Much is My Company Worth?

↓

Exploring My Available Options

↓

Developing & Implementing My Plan

↓

My Personal Planning

We believe that almost every successful business owner understands their business, at least in terms of the product or service they offer their customers. In other words, they know how to work *in* their business. What is sometimes lacking is the knowledge, skills—and sometimes merely the time—to work *on* their business. This deficit is often felt hardest when it's time to figure out how to exit their business successfully.

As a business owner you have a lot of demands on your time and your attention. Finding the bandwidth to devote to an important, sometimes complex, activity like succession planning can be hard to do. What we've found to be an effective way to increase the odds of success is to break down the process into component steps, each one leading to the next (see diagram on the right).

How you handle this "last, and greatest, test of entrepreneurship" will go a long way to defining your legacy and the future of the business. It will also impact family and personal relationships, how you spend your time in the next stage of life, and of course the amount of money you put in your pocket.

We cannot decide what is important to you and the people you care about. We will likely never understand your business, and what it means to you, better than you do yourself. What we can do is share ideas and experiences—as well as concepts and strategies—that can help you develop a road map to your future outside, and beyond, the business. The ultimate destination, the speed at which you get there, as well as the sights and sounds you experience on the way, are in large measure up to you.

Each company is different; each business owner is an individual; and each succession plan will be a specialized document. Therefore, the scope of this book is intentionally broad, at a 50,000-foot level.

We do not claim any special "big picture" succession planning insight that will change everything and make all your dreams come true. Most of the books that make such promises are most likely engaging in a marketing exercise. What we do offer is concrete, hands-on advice gleaned from years of working (and talking) with business owners—of all kinds and from all situations.

This book has three main components:

1. The main text of the book is divided into 4 sections—Getting Started; Defining Your Goals and Objectives; Next Steps; and Transfer Options. Each section provides an overview of the respective topics, and outlines the pros, cons, and important considerations for each.

2. Throughout this book are what we call “sidebars,” short informational segments on narrower topics, and from a different perspective than our own, from practicing professionals in the field.

3. A set of worksheets that follows the general order of the main text. They will help you think about, formalize, and record what you want—and what you will need—from your succession plan. The worksheets can form the basis of your initial succession plan, and develop material that you can provide your professional advisors when you engage with them.

During the course of this book you will be asked questions, some of which might challenge you or make you think in a new way. That’s the intention.

The succession process can be complicated, and often very emotional too. So many of us tie our sense of self-worth and our sense of who we are to what we do. This is especially true for the “average” business owner. Your business is your baby, and you’ve watched it grow up – and when it’s time to “set it free” and “live its own life”, it can be difficult to address the issues and challenges that appear along the way.

We hope you think of this book as the first step on your succession planning journey. There might be a few bends in the road, and it probably won’t be a perfectly straight path ahead. Rest assured though, all challenges can be overcome with commitment, and a little bit of knowledge—in other words, the same dedication you’ve shown as a business owner over the years. **We wish you sucess!**

Acknowledgements

This book was made possible by a grant from The Cleveland Foundation, as part of the Cleveland Succession Planning Program.

We’d like to thank each of our expert professionals for sharing their expertise and perspective as this book was being developed; and specifically for their respective sidebars. Their input and contributions were invaluable. Also deserving of thanks are Steve Storkan and Roy Messing of the Employee Ownership Expansion Network (EOX); Don Jamison of the Vermont Employee Ownership Center; and Michael Palmieri of the OEOC for reviewing the text, and providing feedback.

Finally, we’d like to acknowledge the debt to the two editions of the OEOC’s “An Owner’s Guide to Business Succession Planning” and the authors; Stephen Clifford, Alex Teodosio, and John Logue. This is in many ways a new book, with a new structure and focus, but as they say, we do stand on the shoulders of giants.

Part One: Getting Started

When should you start planning for ownership succession?

The short answer is **today**.

The longer answer is as soon as you can – and regardless of your current age or how long you plan on working in and running the business. Too many business owners wait until they feel fully ready to retire to begin even thinking about succession planning. Waiting generally leads to less flexibility and fewer options, while proactive planning results in more control and fewer hiccups along the way. In our experience, succession planning is most difficult when circumstances force your hand into a hasty exit. These situations usually don't provide for the best outcomes for you, your family, or the business.

There are two important things to remember:

1. Just because you have begun your succession planning journey, does not mean that you are leaving immediately, or even soon. Nor does it mean the plan(s) won't change as circumstances change. What it does mean is that you (and not circumstances) will be in control of the process to the fullest extent possible.

2. Good succession planning is a sibling of good contingency planning. What happens to you, your family, and the business if something bad and unforeseen happens – like getting hit by the proverbial beer truck? Planning for the future is like a good insurance policy—it won't stop bad things from happening but will certainly help to mitigate the impact.

Since you are currently reading this book, you've probably begun the process—or are at least thinking about it. But if you are just glancing over this book, and saying to yourself "next week or next month or year I will really start planning for succession," we encourage you to do more than that.

Do I have to write all this stuff down?

Throughout this book you will find worksheets and other exercises that will be asking you a number of sometimes difficult questions and to write your answers down on paper. We encourage you to be diligent in actually doing so. We have had countless conversations with business owners who, when asked if they have a succession plan for their business say, "yes it's all in here," while pointing at their head.

No matter how much thinking you have done, or how many people you have talked to about your exit strategy—until you begin to formalize it (and yes, write it down) you do not have a succession plan of much value.

> **There is no ultimately right answer that someone else can impose on the situation — it is up to you.**

Taking the time to write things down helps to focus the mind, clear the head, and gives you and others the ability to review and update any plans that are in process. Plus, it leaves others a record of your plans and intentions should the worst happen.

Embrace the emotions

We've already mentioned that exiting the business you've built is a big deal, full of discussions about taxes, legal strategies, and other technical minutiae. However, there is another side of succession planning, and it's a side that many hard-nosed and detail-oriented business owners don't generally like to talk about.

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How Should a Business Owner Prepare for a Meeting with An Advisor?

Matthew Cropp, Vermont Employee Ownership Center

To make the most of your initial meeting with a succession planning expert, it is helpful to do some preliminary preparation that includes both thinking and information gathering.

First, it is important to think throughyour personal goals and considerations. Financially, what do you need out of the sale of the business? How much of that do you need immediately upon sale, versus how much are you willing to receive over time through seller financing? Who besides yourself has a stake and a say in this decision, such as family members or minority business partners?

Professionally, is the sale the moment that you intend to leave an operational role behind as you drive off into the sunset? Or do you plan to stay with the company for a period of time as a leader or consultant who gradually reduces their role over time?

Second, it is helpful to collect and organize relevant information about the business, such as:

- A brief and coherent "story of the business": its founding, its growth and evolution, its challenging times, its present condition and future prospects.
- Summarized financial information, such as profit and loss statements going back several years, a recent balance sheet, etc.
- A summary of your plan for management succession, especially if you are currently leading the company.
- An overview of the workforce, including size, tenure, key employees, information sharing practices, and a sense of the organizational culture.

While much of this can and will be covered in the first conversation, the more information that can be provided in advance, the easier it will be to quickly narrow the conversation to a discussion of the best approach for your particular situation.

Matthew Cropp is Executive Director of the Vermont Employee Ownership Center, and has been with the organization since 2014. He lives in Burlington, Vermont, where, beyond advising dozens of business owners per year, he has been involved in starting several cooperative businesses.

Yes, we are talking about that squishy and sometimes squirrely emotional side. It's a mistake to think of your exit plan as merely a technical exercise, involving lawyers, accountants, financial planners. For sure, that's a big part of it, but it's not the only part. In fact, we've found that an inability or unwillingness to address the "softer side" of planning can be a powerful de-motivating factor for a business owner and their succession process.

This is completely understandable. Whether it's impending changes to your lifestyle or what you do every day, conflict with family members over who's getting what, or even nagging thoughts about mortality and getting older, many things will be changing in your life. All of these factors are bound to have an impact on you, your peace of mind, and emotional well-being. It's not unusual.

It's not all doom and gloom. As you get closer to finalizing your succession plan, you may feel lighter, as if a weight is gradually lifted from your shoulders – we've seen that happen. Your next stage in life may turn out to be better and more fulfilling than you ever could have imagined. You have the ability to influence the direction of your thoughts and your actions. The important thing to internalize is that planning early—before necessity requires haste—can help you address and solve these issues in a more manageable way. There are also advisors that can help you work through these issues should you need them. Don't be afraid to embrace the emotions!

Part Two: Goals and Objectives

Starting and running a successful company is a significant achievement—it represents a considerable investment of time, money, and effort— from you, and your family. You've likely experienced some good times and some bad times; missed family and other personal commitments to "take care of business"; experienced great highs, and maybe a few lows too.

As we've just mentioned in the previous section, that process will be more than just a legal or financial transaction. So how should you make sense of all of this?

We believe it's important that you begin by developing your goals and objectives—for you, your family, your employees, the business, your community—and any other "thing" that is important to you. Just about everything else will flow from there.

We usually begin this process by asking a bunch of questions of the business owner (reflected in worksheets One and Two at the end of this book):

1. How much money do you want (or need) from the sale or transfer of the business?
2. What do you want to see happen to the business once you exit?
3. Are there other stakeholders who need to be considered?
4. What are you going to do with yourself the day after exiting the business?

Each of these questions will lead to other questions. Many of them will also be on the worksheets, but many others won't—you still need to answer them too! And of course, each business owner will have a different set of answers to them; that's ok too. What is ultimately most important is that you actually sit down and think about your goals and objectives—for you and your family, the business, and anything (and anyone) else of importance to you. Let's discuss a few of the big questions in detail here.

How much money do you want (or need) from the sale or transfer of the business?

Surveys typically show that roughly 70-80% of the net worth of a typical business owner is tied up in the business. For most business owners, the proceeds from a sale or transfer of the business will be used to pay for the needs (food, shelter, health care) as well as the wants (beach house, fishing boat, travel) for the duration of retirement. How much will that cost? It will come as no surprise that it is usually more than you think.

Different exit options can result in different sale prices, and perhaps have different tax implications, and will impact what you are left with at the end of the day. We will discuss this in more detail later. As you figure out what you have, and what you will need, you may find that you'll have to postpone the sale, or grow the value of the business, for a few more years to generate additional income.

> **We believe its important to begin by developing your goals and objectives.**

Worksheets 3 and 4 will help you outline, broadly, what your current needs are, and what your future needs might be. When thinking of your needs, you should take into account the difference between the top line value or price of the business, and how much money you will be putting in your pocket when the process is complete. Professional fees (like closing costs, or success fees) and taxes are just two of the likely difference makers. Being able to make a good estimate of how much those costs will be is vital in understanding whether the proceeds will actually be enough for the next stage of your life.

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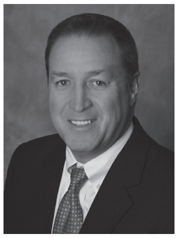

Three Questions Every Business Owner Needs to Address in Their Succession Plan

Tim Jamison, Prairie Capital Advisors

When it comes to succession planning, most business owners probably realize there are many important factors at play. Even so, there are some key questions that every business owner needs to address relatively early in the process.

1. What's My Transition Timeframe & the Value of My Business?

The first question to answer is, what is your timeframe for exiting the business? Is it immediate, 5 to 10 years from now, or currently unknown? What often drives that decision is how much money the owner needs to realize from the sale or transfer of the business. This directly leads to getting an understanding of what your business is worth. Many business owners think they know, but it is important to get a valuation done by an independent third-party appraiser. This will set a baseline for what the expectation of value should be.

2. What's my Vision for the Future of My Company?

The next question is, what kind of future do you envision for the company and its employees after the ownership transition? Many times, we run across business owners who are more concerned about personal and family issues, while other business owners care about the culture and legacy of the company, as well as the ongoing benefit and performance for their employees. That's where an internal sale option (like an ESOP) is especially handy versus a traditional third-party outside sale.

3. What's My Ongoing Level of Involvement in My Company?

The third question is, how long the owner wants to stay involved with the business. Do you want to exit entirely and sail the Bahamas? Or do you want to stay involved, perhaps on the Board of Directors or as CEO, and gradually transition the company management to others? If an immediate exit is desired, then a third party or outside sale will probably be a better option than a typical inside sale. If you want to stay with the company in a leadership position, an internal transfer (like an ESOP or perhaps a Management Buyout) is an excellent option since it's a gradual way to exit the business, both from an ownership perspective and a management perspective.

Bonus: You Need a Team of Trusted, and Capable, Advisors

We always ask the owner if they have good legal counsel, either from an Outside Sale/M&A perspective or an Inside Sale/ESOP perspective—ESOPs in particular can get highly technical, but outside sales can get complicated too. You will need to know whether your current attorney is able to handle these issues, and transactions. You will also need a CPA that can handle the tax issues and implications of a transaction. Having a good relationship with your bank, and your banker, is an important piece of the puzzle, especially with an internal sale like an ESOP. As the selling owner, you will need the services of a wealth manager - no matter the type of transaction, you will have an influx of cash. A solid group of advisors will be an important source of advice on your transfer options and eventually on the transaction itself.

Tim Jamison is a shareholder with Prairie Capital Advisors, and is responsible for business development and growth initiatives. He focuses on advising business owners about the full range of ownership transition alternatives, including Employee Stock Ownership Plans (ESOPs) as well as Mergers and Acquisitions (M&A).

What do you want to see happen to the business once you exit?

Individual business owners usually have very different views on what they want to see happen to the business once they exit. Some business owners have a strong belief in maintaining the legacy and independence of the business that they've built, and care deeply what happens to the employees that helped them build it. Others have goals (such as charitable aims, buying a beach house, starting another business) or important needs (medical or similar) that require maximizing the sale price. Other business owners are somewhere in-between.

This is one of those cases in which the buck stops with you, so to speak. You have to figure out the answer(s) that work for you, and your situation. A good general recommendation is to consult with key stakeholders—family, trusted friends and advisors, or perhaps key employees—as you explore this question.

The important thing to keep in mind is that different options will have different implementation timelines, so getting going early is important.

Are there other stakeholders who need to be considered?

When it comes to the stakeholders of a privately held business, most of us will think of ourselves and our immediate family. After all, it makes sense, right? Well, it does, but we encourage owners to at least think about a broader set of stakeholders—their employees, their customers and suppliers, and even the community in which the business is located.

We've worked with many business owners that weren't prepared for the changes to the business—as well as the impact on employees and the community—that occurred as the result of an "outside sale" of the business. We've worked with others that were equally unprepared for the demands on their time, and sometimes their pocketbook, of an "inside sale". Regardless, it is important to consider all of the potential consequences of whatever option you choose. You will likely be much happier in the long run for having done so.

Your family will likely be the most significant stakeholder impacted by this process. Whether you have children (or other family) in the business or not, they will have expectations arising from the transaction, even if it's "only" access to a trust fund. It's important to plan out what, if any, role children or other family members will have in the business going forward; what those family members should expect from any sale proceeds; and other important, and sometimes tricky, emotional issues.

We have seen a few situations (and thankfully only a few) where lack of attention to this family dynamic has quite literally torn a family apart—even to the point of grandparents not being able to see and be with grandchildren. Being up front and open with family members is important, but some may not be able to handle honesty, especially if it doesn't coincide with their expectations.

If you've done any estate planning, you may have heard that its better to be fair rather than equal. It's probably equally true with your succession planning too. It might not make sense to divide a fmaily business into pieces just so each child can "get their share." It's hard to be truly equal with an asset as complex as a business. It may be folly to try.

Without a doubt, these are tough things to think about, let alone talk about. Depending on the complexity of your situation, there are Family Business Counselors that can assist you in working through the issues. We will also revisit some of this in our section on transferring the business to family members.

What are you going to do with yourself the day after exiting the business?

Owning and operating a successful business can be an all-consuming commitment, one that can rarely leave time for other interests. Many business owners are completely unprepared for the abundant free time that becomes available to them after exiting the business. We've heard more than a few former business owners say, "You can only play so much golf."

As it is with most things, heading into this next phase of your life with an I'll-figure-it-out-when-I-get-there approach will probably not be too successful. But there is a deeper question you need to answer that goes beyond how you will fill your time—are you ready to let go of the business?

Are you ready to let go of running the "show" and let others make the decisions on how to run the business? Are you ready to let go of the status that comes with being a successful business owner? Are you ready to find new and engaging things to do with your time?

Lest these issues seem less important than other aspects of your succession planning process, we've unfortunately seen deals get waylaid (on the cusp of completion) because business owners have not fully come to terms with this next stage of their life. These types of situations are (thankfully) not typical. What is more typical are business owners who are not enjoying what ought to be a very enjoyable stage of their life.

Part Three: Next Steps

Once you've taken a hard look at your goals and objectives, its time to get a better grasp of some of the more technical components of the process. First on the list is to get a good understanding of how much your business is really worth.

How much is your company worth?

In our experience, many business owners don't always have a realistic sense of the true value of their company. This is understandable – close proximity can often mask the major flaws, or in some cases the real strengths, of a business that an objective observer may see quite clearly. A business owner may place value on different aspects of the business than what (for example) a third-party buyer will focus on. Then there is basic economic theory – a seller will likely want to maximize the sale price, while a buyer will want to minimize it. Those differing bargaining positions can influence both the perception of value, and the actual value, of the business.

We strongly recommend getting an independent, third-party valuation of the business before getting too deep into the succession planning process. A high-quality, and independent third-party valuation of your business will provide some good data points that will inform all facets of your succession planning, including:

- A basic analysis of your company, including its overall financial health and your operations, processes and procedures, as well as an analysis of the industry and market conditions that impact current and future operations.

- A range of company values, based on specific valuation methodologies (more on this in a bit), and whether you are targeting a third-party (financial or strategic) buyer, or a family member or other form of internal sale like an Employee Stock Ownership Plan.

- An analysis of whether the proceeds from the sale or transfer of the business will be enough to finance the things you will need and want during retirement.

The only real measure of value of an asset, even of a business, is what someone else will pay for it. Because of this, valuations typically provide you with a range of value possibilities for the company, using multiple valuation methods. There are 3 commonly used valuation methods, or approaches:

1. **The Asset Approach –** Like the name suggests, this method will look at the value of the company assets, generally those that appear on the balance sheet, but might also include less tangible things like goodwill.

2. **Market or Guideline Company Approach –** This method compares your company to recent company sale transactions, usually those of similar industry, company size, geographic area, etc.

3. **Income Approach –** This method looks at your company as an operating business, or specifically how much income it can produce. It will take into account future projections of company earnings, overall market conditions, and similar things. With this approach, the appraiser will try to "normalize" the value of the company by adding back excessive compensation and other personal expenses you might be running through the company.

You might also come across terms like discounts and premiums in your valuation. A common example is a lack of control discount on an ownership interest of less than 50% of company stock. Conversely, a control premium may be placed on a majority (51% or more) portion of company stock.

Not all company valuations are created equal, and can be dependent on the purpose of, and who is performing, the appraisal. Our general recommendation is that you hire an accredited valuation expert to perform the valuation. In fact, some options may require it. There are others that can perform various levels of valuations, including business borkers, CPAs, or even some Small Business Development Centers (SBDCs). The cost will tend to

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Factors That Determine the Value of Your Business

Eric Flickinger, Apple Growth Partners

Many factors are involved in determining the value of a business. In our work with business owners, we find there are some common misunderstandings about what drives business value – here are four of the most common.

Understanding the difference between enterprise value and equity value

Enterprise value is what the total operation of the business is worth, and is usually based on its current earnings stream or projected earnings. This is typically what a business broker or buyer will mean when talking about value. However, most buyers will require the seller to pay off any interest-bearing debt, but will keep the cash and any non-operating assets. Therefore, equity value is the value of the operations less the debt the seller pays off - plus the cash and non-operating assets they keep. Depending on the amount of debt, cash and non-operating items, enterprise value and equity value can be significantly different.

Understanding the difference between fair market value and strategic value

Fair market value is the standard of value used in Employee Stock Ownership Plan valuations, as well as Internal Revenue Service valuations for estate and gift tax purposes. At its core, fair market value is what you would expect a financial buyer to pay for a business. A key point is that a financial buyer will only pay what the business is worth as it is currently being operated. Conversely, strategic value will include synergistic premiums. If the acquisition is very accreditive to value, the buyer may share some of the synergistic value with the seller to ultimately help close the deal. The more a strategic buyer, or any buyer, "needs" to acquire the business, the more of the strategic value the seller may get to share in.

Incorrect Market Comparisons

Headlines of extremely high multiples tend to get a lot of attention, and can drive perceptions of value. However, not all businesses are the same, and many factors are taken into consideration, including size of the business and if there was a strategic premium. For example, a small business that needs to be run by an owner-operator will sell for a significantly lower multiple than a larger company in which the buyer can act as an investor. Another factor is how much the business model can be leveraged for growth. Finally, caution is advised in comparing to just a single company. Typically, multiple transactions are used as each transaction can include unique circumstances.

How recent capital expenditures impact a capital Intensvive Business

A business owner will often assume their business is worth more after making significant investments. However, this may not be the case. If the investments were for efficiency or new capabilities, these investments could be harder to sell as there is risk in achieving those results. Also, many investments are slow to show results. Conversely, if the business previously suffered from under investment, investments may have been required to remain competitive and there may be a deduction in value.

Eric Flickinger is a Senior Manager in the Business Valuation and Litigation Consulting Group with Apple Growth Partners. He performs business valuations across multiple industries primarily for employee stock ownership plans, estate and gift tax corporate planning.

be reflective of the level of analysis conatained in the appraisal, as well as the purpose for which it was done.

Ideally, you will be able to give the appraiser a rough sense of what exit strategy or strategies you are leaning towards, it will make the valuation much more useful. However, it's fine if you are not completely sure yet—just be sure to let the appraiser know that too.

It's important to remember that a valuation will likely have a limited shelf life. How long that life ends up being will depend on the purpose of the valuation, the type of exit strategy you end up choosing, and the circumstances of the business and economy at large. The good news is that updates usually cost less than the original valuation.

Selecting the Right Advisors

Figuring out how to exit your business effectively is a big deal, and it is usually a complex process. It's important to have the right people on board to help you do it. The areas of expertise you will likely need as you progress through the planning process are:

- Legal
- Business Accounting and Tax Planning
- Valuation
- Banking and Finance
- Personal Financial, Legal, Tax, and Estate Planning
- Insurance Planning
- And others, depending on circumstances

Remember that you will be planning for both the business and for yourself throughout this process. Don't let just one of these areas crowd out the other during the process.

We always recommend that you confer with your current set of "everyday" advisors first to determine if they have the resources and personnel to help you with your succession planning. If they do, you will benefit from their prior knowledge and understanding of your business. If they don't have specific expertise that fits your situation, you will need to find additional specialists to help.

Ideally, your current set of advisors will be forthright in outlining what they can and cannot do for you. If you are not sure, it is within your rights, and perhaps an obligation, to ask them tough questions on their ability to do what you need.

The process for vetting additional experts can be daunting – the key is to not let it overwhelm you. There are many good sources of quality referrals:

- **Your current advisors** should be able to provide referrals and will have a good understanding of the type of additional specialists that may be needed.
- **Other business owners** that you know, and ideally that are going (or have gone) through a succession process can be a great resource.
- **Public and Non-Profit Support Organizations** like the OEOC, Small Business Development Centers, Chambers of Commerce and others, will know of, and have experience working with, advisors in a wide range of fields.

It is also important to ask prospective advisors about their expertise and experience in the particular area or exit strategy you are seeking help with—they should not be surprised by the question. They should have the necessary credentials and qualifications to do the work you need from them. Ask them for those credentials. You can even ask to talk to a client or two (privately) to get their perspective.

Finally, it is important that you, as the business owner, drive the process. You are in charge. This may seem obvious, and of course it is, but we've seen situations where a business owner becomes unsure where they are heading after talking to an advisor. It's not due to some nefarious motive on the part of the advisor. Usually it's more a case of the business owner not understanding why something is happening, what's being recommended, or what alternatives might be available.

It is part of human nature to defer to the professionals. We all do it. After all, when it is time to have major surgery, we want a professional and experienced surgeon to do the work. One of the benefits of mapping out your goals and objectives is that you have the opportunity to revisit them. You should ask your advisors—and yourself—if what is being proposed stays true to your goals, and if not, why that is the case.

As the adage goes, there are no stupid questions, so ask all of them. If you understand why specific things are happening, you will sleep easier knowing you are staying true to your vision. You will probably be happier with the outcomes after the transition too.

Management planning - who's running the store?

We've previously mentioned how integral being a business owner is to a "typical" business owner. Let's face it, it is a big part of who you are, and perhaps a big part of how you understand your place in the world, and where you spend a lot of your time. But when it becomes time to exit the business, having a significant role in the business can also be a bit of a problem.

When your business is in start-up or growth stage, your company is dependent on your skills, knowledge, and expertise. You provide a lot of value to your company. But the paradox is, the more important you are to the day-to-day operations of your company, the more value you will take with you when you leave. This means that the company has less value for any buyer, and ultimately will mean less money in your pocket at exit.

One of the first questions we ask business owners is, can you go on a week's vacation without constantly checking your email or answering business-related phone calls? Clearly, there are specific emergency situations that may require your immediate attention. Realistically, as long as you are the owner, you will likely never be able to fully disengage from the business. But in order to fully realize the value of the company at exit, it's important to become less important.

The first step is understanding the scope of the issue, and the "Roles and Responsibilities" worksheet can help you think about, and document:

- What you do, on a daily basis
- The relationships you have with key customers, suppliers, and other stakeholders
- The relationships you have with key advisors, such as the corporate attorney, CPA, and banker
- Any other key responsibilities you have
- Who might have the skills, ability, and desire to step into these roles going forward
- How much training and preparation will they need to do so

Maintaining operational continuity is most important with typical inside sales or transfers, such as to family members, key management, or employees. Assuming you will need some level of outside financing for the transition, no bank or other lender will fund a deal if they believe company operations will collapse the minute you leave the company. It is vitally important that you begin to hand off key roles and relationships relatively early in the process.

On the other hand, a third-party buyer may want to bring in their own management team and other key people - as well as operational perspective - to your company. Or they may look at such operational continuity as a key part of what they are buying. It's important to know what an outside buyer's expectations are before going too far in the sale process.

Earlier we mentioned understanding the goals and objectives of other stakeholders in the business – well, this is one of those moments. It's not uncommon for key leaders and managers in your company to look at your ownership succession event as an opportunity to explore other career options. Conversely, their retirement timeline may be only a few years longer than yours – it doesn't make much sense to set the company up for another, and relatively immediate, succession issue so soon after the first.

If management continuity is important to your strategy, it's also important to know whether your key people will be sticking around. You may have to incentivize them to do so, perhaps through some type of executive compensation plan.

> **"Can you go on a week's vacation without constantly checking your email or answering business-related phone calls?"**

Finally, understanding how involved you want to be in the company after an ownership transition will be pivotal in this area of planning. The more complete you want your exit to be, the more vital this leadership and management planning becomes for success. We've seen a few situations where a business owner was expecting to sail into retirement, only to be pulled back into the business because of poor management planning. It's a tough thing to see a business owner grow to resent the business they spent the greater part of their life building. Good management and leadership planning can help in avoiding such situations.

Part Four: Transfer Options

There are many legal and technical mechanisms for transferring a business. This section will provide a high-level perspective on the main categories of available transfer options, drilling down into some specific examples for each.

Starting at the highest level, we categorize transfer options into two major categories – Outside and Inside sales. They mean what you probably think they mean, but let's flesh them out a bit.

Outside Sales – This segment broadly includes buyers that come from outside the company, or your family. Within this broad category, there are sub-categories:

- **A Strategic Buyer** will be buying another company as part of a long-term business plan. Typical strategic buyers might be a competitor looking to capture a larger market share, or enter a new geography; or it could be a current customer or supplier looking to control their supply chains. Fundamentally the purchase is primarily for a strategic business purpose.
- **A Financial Buyer** will typically buy a company in order to generate (sometimes considerable) financial returns from doing so. Private Equity is a common example of a financial buyer, but occasionally a company will be a financial rather than a strategic buyer of businesses. Fundamentally though, the purchase is primarily a financial investment.

Inside Sales –This segment broadly includes buyers that come from within the company:

- Family members of the current owner(s), most commonly children who may (or may not) be already working in the business.
- Sale or transfer of an ownership interest to an existing partner.
- Key employees and/or managers in the business.
- All (or most) of the employees through a formal structure like an Employee Stock Ownership Plan (ESOP), Worker Cooperative, or Employee Ownership Trust (EOT).

Occasionally, a category-defying strategy will be developed that will straddle these broad categories, but most transitions or transactions will fall within one or the other. Let's take a look at all of these in more detail.

Outside Sales Basics

Selling to a strategic buyer can be a very appealing prospect for a business owner. In most cases, a strategic sale will provide you with the highest price for the business, sometimes quite a bit higher. It makes sense why that is. You have something (like a customer list, a product line, intellectual property or patents, or talented people) that they want – sometimes really want – so they may be willing to pay more to get it.

With a strictly financial buyer, the price you will receive will likely be a bit lower than with a strategic buyer, but may be higher than other types of transitions. We can think of it as a negotiated market value price. This makes sense too—financial buyers are making a financial investment to get a specific rate of return. They won't want to overpay unless they expect to recoup that investment down the line.

There are other factors that can impact price, however, and some of them relate generally to what you will have to do to get your business ready for an outside sale, whether strategic or financial. The general principle is that you will need to get things in order—it can sometimes be called "professionalizing" your business. How are your HR practices and procedures? Are your company financials up to date and in order? Have you done any of the management planning described in the previous section?

Make no mistake, any outside buyer will be looking at your business with a magnifying glass, and turning over every stone, to make sure that there will be no surprises the day after closing. You will need to be ready to share more information about the business than you might imagine. And you will need to protect yourself and your company while doing so.

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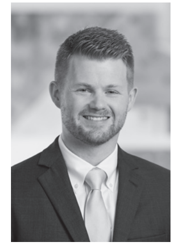

Perparing for a Sale to an Outside Buyer: Three Considerations Before The Ink Dries

Dan Schiau, Tucker Ellis LLP

For any business owner contemplating a sale of their business, the first s tages o f p lanning c an b e b oth e xciting a nd n erve-wracking. The need for planning and internal reflection cannot be understated in the early stages, as they are key for a successful transition. To start the conversation, here are three important steps that every business owner should take before jumping in.

First, identify potential impediments to closing in advance. The biggest mistake we see sellers make when starting the sale process is not reviewing the business internally to identify hurdles to a closing in advance. Early in the process, you should begin analyzing your business, in consultation with both your tax and legal advisors, so that you can identify and resolve any issues that would otherwise cause buyer consternation. Some examples include:

- Does the business have concentration issues with a handful of large customers or suppliers that will need to consent to the transfer of their business to the buyer?
- Does the business have any valuable, intangible assets such as intellectual property that the buyer will need, and are those assets sufficiently registered and protected?
- Is the business part of a regulated industry where licensure or permitting is required, and if so, what types of approvals will be needed to transfer to the buyer?

Next, discuss expectations of your post-closing involvement. This is a two-way street. You should consider whether you want to remain involved following closing and whether the business or buyer will need your expertise post-closing to ensure a smooth transition. On the buyer side, you will want to understand and clarify the buyer's expectations of your involvement – including compensation, benefits, and time period – and be prepared to adjust your expectations accordingly.

Lastly, consider your employees. One of the largest risks you can take when venturing into a sale is not considering how the process and ultimate transaction will affect your employees, in both practical and business aspects. On the practical side, you want to ensure that the buyer will take care of your employees. We typically advise sellers to discuss the buyer's plans with employees well before the sale, including the buyer's plans for retaining employees and the types of standard benefits the buyer offers. On the business side, you want to make sure that the buyer is aware of the value of key employees who are particularly important to the success of the business (such as top salespersons). Internally, you should make it a point to ensure that these employees are willing to stay with the buyer following the sale. One tool to consider with respect to the latter is retention-type bonuses, payable by you or in some combination with the buyer, to incentivize those key employees.

With some critical thinking and planning in advance of the letter-of-intent stage, a selling business owner can make the deal process smoother and more efficient for all parties involved.

Dan Schiau is an attorney with Tucker Ellis LLP in Cleveland and practices in a broad range of business areas, including mergers and acquisitions, corporate governance, private equity, real estate, real estate finance, and commercial finance. In just the past year, Dan has closed more than 20 deals, working with buyers, sellers, and investors of all sizes and sophistication, helping each of them to achieve their unique goals.

First and foremost, you will want to make sure that the offer is a serious one. The last thing you want to do is share important business information with a non-serious buyer. Selling your business is complicated and you don't want to waste your time. You have likely already received inquiries about selling your business and you've no doubt noticed that some "smell better" than others. So the first test is smell—does the offer seem legitimate, or does it feel like a fishing expedition?

Next, you can ask some key questions of the potential buyer. Do they have the financing in place to do the deal? Where are they getting that financing from? Are they willing to sign a formal Letter of Intent or Term Sheet? How about a Non-Disclosure and/or Confidentiality Agreement? If they balk at any of these, they may not be serious. You will need to find out whether the proceeds from the sale will be paid out in a lump-sum, in multiple payments over time, or some other method—and whether there will be provisions that allow the buyer to "clawback" some of the sale price should any issues arise post-transaction.

You will want to be in constant communication with your current advisors – they can help inform and protect you throughout the process. You may also need the services of specialist attorneys and accountants (and eventually a financial planner), as

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Four Reasons Your Business Won't Sell

Eric Zaleski, PCE Investment Bankers

The process of selling your business takes a lot of preparation. If you find you are not getting a lot of interest from potential buyers, there are usually some key reasons why— here are 4 of the most common ones.

You Have Unrealistic Value Expectations

Companies are bought based on the value that can be transferred to their new owners. Due to the emotional attachment owners have to their business, it's common to find their perception of its value exceeds the true market value. The hard work, decisions you've made, and the culture you've built have created your company's cash flows - today. A buyer will primarily value your company by the cash flows that the business can generate now and in the future.

Remember, buyers have likely done multiple transactions, whereas you may be selling just one company in your lifetime. If your expectations are too high, you likely won't be able to come to terms. But if you approach the transaction process by trying to walk in the buyer's shoes, it will expedite the sale, facilitate a strong working relationship, and smooth the transaction on both sides.

You Have Poorly Kept Financial Statements

Disorganized, inaccurate, or incomplete financial statements are one of the quickest ways to alarm buyers. When buyers see poor financials, it tells them that they are in for a lengthy transaction process filled with uncertainties. With the help of a qualified CPA, well-organized and accurate financials identify strengths and weaknesses in operations, guard against the unknown, and track the company's present and future growth. You must maintain detailed financial records to substantiate the company's performance and assure potential buyers of the transaction value.

Your Business Operations Are Too Concentrated

Too much dependence on a handful of customers and suppliers is a key valuation metric for potential buyers due to concentrated risk, which can fundamentally change the business's profits. Diversifying your customers and suppliers as much as possible will show buyers that your business performance is resilient. Start by working to grow your customer base, and be sure to work equally hard on customer retention.

Develop relationships with new suppliers and keep your current suppliers in check. If your current suppliers cannot expand with the new business's growth trajectory, buyers will take that into consideration on value. A three-year plan to evaluate suppliers is recommended to ensure you're receiving the best terms and relationships.

You Have No Transition Plan

In a transaction, the loss of knowledge during the ownership transition can be detrimental to a buyer's perception of value. Will the company continue to run as effectively if or when a strong and experienced management team leaves the company? Buyers focus on the path forward after the sale, and many times, owners stay on after the transaction to ensure the effective transfer of knowledge to the new owners. If you cannot provide buyers with a clear plan on how the business will operate without you, your company will not sell for the value it should.

There could be other reasons why your company doesn't sell. The good news is that most of the reasons can be mitigated with proper planning, realistic expectations, and having a strong advisory team who can help ensure that you get full value for your business.

Eric Zaleski leads PCE's ESOP Investment Banking practice in the Midwest and Northern regions of the US. PCE provides a full suite of investment banking services for business owners and companies, including sell side, buy side, capital markets and valuation advisory.

well as brokers or M&A (Mergers & Acquisitions) professionals.

The big difference between a business broker and an M&A professional is usually the size of the business. Brokers generally handle smaller transactions, M&A professionals the larger ones—with the dividing line being somewhere between $5-$10 million in sales.

A word of caution—industry surveys have found that about 25 percent of businesses that go to market actually end up selling, and this roughly coincides with our experience. Buyers are out there kicking the tires on a large number of businesses and if yours doesn't check all the boxes they will move on.

Our last words on outside sales are more personal ones. One aspect of an outside sale that appeals to many business owners (besides sale price) is the possibility to sign the legal papers, disconnect from the business, and proceed towards the next phase of your life. In other words, you may be less likely to be tied to the company after the transaction.

We've also seen many cases where a selling owner is quite unprepared for the changes to the business that occur with an outside sale, and they come to regret doing so. The scale and scope of the changes can range from somewhat minor (changing the name on the sign out front) to quite extensive (wholesale layoffs of employees or shuttering the company). You can try to negotiate in advance how changes happen but the fact remains that you will no longer own the business, or be in control of its future. Other transfer options do provide greater opportunity to impact the future of the company you've built, even after you leave it, and we will discuss them further in the next section.

Inside Sale Basics

In most situations, one of the real benefits of an inside sale is continuity of business operations. Hopefully, and if you've done the management planning described in part 3, the people currently working in, and running, the business know what they are doing.

With inside sales, there aren't as many commonalities across types as there are with outside sales, so we will cover each separately.

Sale or Transfer to a Family Member - Ask any business owner whether they'd like their business to stay in the family (and specifically children) and you'll likely get a resounding yes. It's a very human desire – and 30-40 years ago it would have been a common occurrence. Even though it's not as common today, for some small business owners it's still a preferred option, so let's review some important aspects of this type of transfer.

Typically, though not always, a sale or transfer to children (or other family members) will not result in getting the highest price for the business. And it makes sense – especially with children. Few parents will want to "put the squeeze" on a child as they get started in their new career as a business owner. In fact, if circumstances permit, you may actually gift the business to a child, over time. Depending on other circumstances, you may end up getting paid out over time with some sort of installment plan.

Similarly, keeping it in the family will often (but not always) result in lower transaction costs. Again, this makes sense as (hopefully) the buyer and seller will be on friendly terms and interested in playing nice with each other. Conversely, if there is dissension in the family it can quite literally make a family transfer one of the more expensive options, especially if a result is legal action, or perhaps most expensively of all, a breakdown in family relationships.

> **Buyers are out there kicking the tires on a large number of businesses, and if yours doesn't check all the boxes, they will move on.**

If you have one or more children working in the business, it's important to take a close look at who the best person is to run the business going forward. We love all our children (even those that might have some less than desirable qualities) but bringing in someone without the necessary skillsets or abilities is not ideal, and likely won't be successful in the long run.

Many business owners have insisted that their daughter or son go out into the world—and work for someone else than Mom or Dad to develop the necessary skills to one day take over the family business. Still others may skip the second generation and go directly to the third. Whatever the specifics, its important to take off the "parent goggles" and look at what's best for the business going forward—it may end up being best for the family too.

Sale to an Existing Partner, or Key Management - If you are one of multiple owners or partners of the business, a (relatively) simple sale of your interest to one or more of your partners might be the right solution. One of the benefits is business continuity, which would help in retaining the value (and hence the price) of your share of the company. Overall though, the value of the business will be lower than with an outside/strategic sale, but that can vary depending on specifics.

It's not unusual for the partners to disagree on what the sale price should be, or how it is determined. Certainly, the selling shareholder will want a higher price, the buyer, not so much. The negotiations can occasionally get contentious, sometimes devolving into disagreements about how much "value" each partner or shareholder has brought to the company through the years.

One of the ways to guard against this, and protect each shareholder, is to create a buy-sell agreement. A buy-sell does what the name suggests – it sets out the processes and procedures for how one shareholder buys out another, regardless of who ends up being the seller, or buyer. It may even outline the process for how the value of shares being sold/purchased is determined. Ideally, the buy-sell is created when the various shareholders are getting along, and a potential buyout is some time in the future. Waiting until a transfer is imminent, or after significant relationship issues occur, can lead to difficulties. Selling to a partner can also get tricky if all the owners are of a similar age, and have a similar timeframe for exiting the business.

A Key Person or Management Buyout (MBO) has some similarities with other internal sales—business continuity and the value of the company are both likely to be maintained. Of course, all this assumes that management is both capable, and interested in staying and moving up into ownership. You may have heard that within every manager there is a small business owner waiting to get out, and in many cases this is true. However, when push comes to shove, many managers may also back away from the opportunity.

One of the primary reasons why this might happen, and one of the biggest impediments to a management buyout generally, is the financing—where will the managers get the cash to buy the company? There are ways to work through the financing dilemma, but it will take planning, and can take some time to implement. Typically, an MBO will be a leveraged or financed transaction, but this will need to be secured by some collateral, probably from both the buyer(s) and the seller. Another option might be to transfer smaller amounts of stock, over time, via some sort of stock purchase plan or similar compensation-based plan. An MBO can also be combined with a leveraged Employee Stock Ownership Plan (ESOP), which eliminates the need for management to raise the entire purchase price of the business.

It is important that the business, and your ownership interest, is protected through the MBO process. First, you will want to be very sure that management is committed to following through, and that they are both willing and able to help secure the financing. You should talk to your attorney about specific legal agreements that incentivize commitment, but also protect company assets and company stock, if the sale falls through.

Broad-Based Employee Ownership - There are three major forms of broad-based employee ownership we will discuss in this final section: Employee Stock Ownership Plans (ESOPs), Worker-Owned Cooperatives, and Employee Ownership Trusts (EOTs). We will first cover some broad similarities, then cover there differences individually.

A sale to employees can have many appealing aspects, not least ensuring business continuity. For the business owner who doesn't have a child waiting to take over the business, or an outside buyer willing to make a bona fide offer, then this might be a viable option. In fact, in some respects, these 3 options allow an owner to essentially create a buyer for the business where one didn't previously exist. Depending on the specific option chosen, the resulting sale price will be fair, generally a middle-range fair market value standard, and can be combined with some substantial tax breaks—for the seller and the business—that can add to the appeal.

In our experience, employee ownership appeals to many business owners because of how it addresses their legacy, maintains employment, and anchors the business in the community. Some of the happiest selling owners we've met over the years are those that have chosen this path.

The three employee ownership options discussed here have their own set of rules and regulations and will require specialists in their respective fields. For example, an ESOP specialist may not know how to structure an effective worker cooperative, and vice versa. Due to the uniqueness of each of the three employee ownership strategies discussed here, the importance of using specialists is high.

An important incentive for selling owners considering either an ESOP or a worker cooperative is what's known as the 1042 Rollover. 1042 refers to the specific Internal Revenue Code section, that allows a selling owner to defer capital gains tax on the sale proceeds. At least 30% of company stock must be part of the transaction, and the company must be a C-Corp at the time of the sale. The proceeds must be invested (and remain) in what are known as Qualified Replacement Properties, or QRPs, and if held until death can pass along to heirs with a step up in basis for tax purposes. There are investment and financial products that can allow the seller to access their wealth for income purposes while maintaining QRP status.

There can be a wide variance in transaction costs, with ESOPs generally being the most expensive of the three employee ownership options. This is due to an

Why You Should Think About Selling to Your Employees

Corey Rosen, National Center for Employee Ownership

Mike Hart worked hard and took a lot of risks to build EEA, a successful Austin, Texas-based engineering firm. He could have sold it to a private equity buyer or another company, but Mike had a different goal almost from the start. As he saw it, he built this company with his employees, and they deserved the chance to own it. There would be benefits all around. Mike could sell over time and eventually stop being the CEO, become the board chair, and have time to work on the engineering and strategy issues he really enjoyed. His employees could carry on the legacy and reputation he had built with them while securing their futures. It didn't hurt that the government provided generous tax benefits as part of the deal to both Mike and the company.

Mike stepped aside from being CEO in 2019. The company has grown by about 30% since then, and, as a testament to the culture Mike helped create, has had virtually no voluntary turnover for some years. Mike has gotten a fair financial reward, but he would be the first to tell you the best reward is the satisfaction of seeing how EEA and its employees have thrived.

Selling to an ESOP means you can use pre-tax future corporate profits to buy your shares, profits the new employee owners create. The employees don't buy the shares, but they do earn them. And you can defer taxation on the gain from the sale while retaining whatever role suits you going forward. You can sell all the company or just part of it.

Of course, you could sell to private equity, and see your company flipped in a few, or several, years, probably with some reduction on workforce. Or you could sell to a competitor and hope they don't move the company out of state or eliminate "redundancies." You could—but Mike would tell you will be happier on the end if you don't.

Corey Rosen is the founder of the NCEO. Over the years, he has written, edited, or contributed to dozens of books, articles and research papers on employee ownership. He has been called the leading expert on employee ownership in the world, and has been interviewed widely by major media and been a featured speaker around the world.

ESOP being a qualified retirement plan that invests in the stock of the sponsoring company. Compliance with IRS and Department of Labor (DoL) rules requires very specific expertise. ESOPs provide additional tax breaks (apart from the 1042 Rollover mentioned above), for the seller and the company, that can ease the pain of the higher costs.

Because a worker cooperative is a type of corporate entity rather than a qualified retirement plan, transaction costs are lower – but they still have their own complexities due to the variability (on a state-by-state basis) of cooperative statutes. An Employee Ownership Trust usually has lower transaction costs, but additional options (like a profit-sharing plan) can add to the expense. More information on transaction costs for each model can be found in their respective sections.

A basic necessity is sound management planning—it is imperative that a strong management team, that is capable of running the business effectively, be in place at the time of the transaction. Depending on how you've run the business up to this point, you may need to develop the right management team, and that can take time, and perhaps delay your exit date. Conversely, for business owners who wish to (or must) stay involved in the business beyond the transaction, all three of the employee ownership options are flexible enough to make that possible too.

A final word before covering each of the three options in detail. We've mentioned previously that a common concern for a typical business owner is what happens to the business after they exit. This is where employee ownership really shines. As it turns out, incentivizing employees by providing them with a financial stake in the business in which they work – actually works in improving company performance. The effectiveness is magnified further when a financial stake is combined with an ownership culture – higher levels of participation, input, and influence on the job. Decades of research have consistently shown that employee-owned companies with a participatory culture enjoy higher levels of profitability, productivity, resilience, and employee retention—as well as lower turnover—when compared to their non-employee-owned counterparts.

It takes deliberate actions on the part of the company, and management, to achieve these results. Education and training programs are key components of the strategy. Most employees will have pre-existing ideas about what it means to be an owner, and how to think and act like one. This may not always connect with the structures of a specific employee ownership model. More on this will be covered in an expert sidebar at the end of this section.

A quick additional note on the way this section is laid out. Both ESOPs and worker cooperatives have historical presence in the U.S. This not the case with Employee Ownership Trusts (EOTs) which were first created and utilized in the U.K. and are relatively new on “this side of the pond.” Both ESOPs and cooperatives are covered in the main body of the text, but EOTs are covered in one of our expert sidebars.

Employee ownership is not a magic bullet. But if you are a business owner for whom maintaining the legacy of what you’ve built is important, or you want to stay involved while cashing out some value, employee ownership is an option worth considering.

Employee Stock Ownership Plan (ESOP)

A sale to an ESOP is typically classified as an internal sale, but it also has aspects of an outside sale. These factors are what make it a somewhat singular option of those available to a business owner. There are also three sets of available tax breaks that can make the option an appealing one for a selling owner.

An ESOP is a qualified employee retirement plan trust, governed by ERISA legislation passed in 1974. Unlike other qualified retirement plans, ESOPs invest primarily in the sponsoring company’s stock, and can also borrow money. Because of this, company contributions to the ESOP are tax deductible – this includes contributions to repay the principal borrowed to buy stock in the company. This can significantly lower the financing costs when selling to an ESOP.

A sale to an ESOP provides a high level of flexibility. You can sell anywhere from 1 to 100 percent of the business to an ESOP. This flexibility allows you to “dip your toe” into employee ownership and see if it is for you. And, the company can stay a minority ESOP forever, there is no requirement that it ultimately become 100% employee owned. It can be a great fit for situations where you are more interested in cashing out some equity rather than exiting the business completely. An ESOP can also be combined with a transfer to family members, as well as a Management Buyout – in varying percentages – that can solve multiple planning issues you may be having. As mentioned above, if you sell at least 30% of the company to an ESOP and are a C-Corp at the time of the sale, you can use the 1042 Rollover to defer or avoid capital gains taxes on the proceeds.

“If you are a business owner for whom maintaining the legacy of what you’ve built is important, employee ownership is an option worth considering.”

Most ESOPs are set up as leveraged transactions involving commercial financing. Many will require some level of seller financing, and some will be completely seller financed, the specifics of your business will determine the mix. Transaction costs for selling to an ESOP are generally the highest of the three employee ownership options. This is because as an ERISA-governed qualified retirement plan, ESOPs have a regulatory and legal framework that requires compliance, and specialist advisors, that will increase costs. However, ESOP transaction costs tend to compare very favorably with the cost of selling to an outside buyer, especially after the available tax breaks are considered.

Typical transaction costs for an ESOP run between $125,000-$400,000, but larger companies and complex situations can drive them higher. The ESOP option is generally not the best fit for smaller companies with fewer than 20-30 employees.

By law, an ESOP can pay no more than fair market value for the business, and an ESOP transaction will require an independent third-party valuation of the business. In addition to the usual set of advisors for a typical sale of a business, an ESOP is also a trust and therefore requires a trustee. The ESOP trustee represents the employees as participants and beneficiaries of the plan, and will also represent the ESOP (and the ESOP participants) as the buyer of the business. The ESOP trustee has a fiduciary responsibility to not overpay for company stock and may engage in a formal negotiation process on the sale price. This unique facet of ESOP law can also mirror the process of an outside sale.

A word of caution—anyone can serve as an ESOP trustee, including the selling owner, and some advisors

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Exploring the Feasibility of the ESOP

Brian D. Bornino, GBQ

A great first step to getting an understanding of ESOPs is visiting the websites of organizations that support employee ownership such as the Ohio Employee Ownership Center, the National Center for Employee Ownership, and the ESOP Association. In addition to helpful information hosted on their websites, these organizations offer in-person and online education sessions about ESOPs. Next, you may want to speak with ESOP advisors that are specialists with ESOPs. Most "general" business advisors have very limited (if any) experience with ESOPs.

After conducting the initial research, many business owners become intrigued. They like the idea of an ESOP, but now they want to apply this concept to their particular situation to really evaluate whether an ESOP is the best option - for them and the business. If a business owner is in this situation, the next logical step (and perhaps the most critical step) an ESOP Feasibility Study.

An ESOP Feasibility Study provides business owners with a comprehensive picture of what an ESOP transaction would look like for their company. To use an analogy, an ESOP Feasibility Study is to an ESOP transaction what a blueprint/engineering drawing is to a building. You need to see and understand the former before pursuing the latter. The contents of ESOP Feasibility Studies can vary, but they should definitely address a business owner's key questions so they can make a "go" or "no-go" decision, including:

- What price will sellers receive in a sale to an ESOP?
- When will the sellers receive their money?
- Can the company afford an ESOP?
- How will the company benefit with an ESOP?
- How much tax will I save with an ESOP?
- How will key management benefit with an ESOP?
- How will employees benefit with an ESOP?
- What is the best ESOP transaction structure for me?
- What is the cost and timeline to implement an ESOP?

A high-quality ESOP Feasibility Study is not a "quick and dirty" exercise. An ESOP trustee and appraiser will conduct rigorous due diligence when analyzing an ESOP transaction, so an ESOP Feasibility Study should match this level of rigor. Also, for the most reliable and helpful results, an ESOP Feasibility Study should ideally be conducted by a financial advisory/valuation firm with significant experience assisting both business owners and ESOP trustees with ESOP transactions.

Brian D. Bornino, CPA/ABV, CFA, CBA is the National Practice Leader for GBQ's ESOP Advisory. He has led 3,000+ valuation engagements, including 1,000+ ESOP projects. GBQ works with 100+ ESOP companies annually and specializes in both trustee-side and company-side ESOP advisory services, including: ESOP valuations, feasibility studies, formations, and transactions.

may even recommend that you be the trustee for the transaction. However, we highly recommend (even insist) that an independent third-party trustee be used for any transaction involving the purchase of company stock.

ESOP trustees have a fiduciary obligation to ensure that the ESOP is not paying over fair market value for the business. When the business owner takes on the role of ESOP trustee during the sale, they are essentially representing both the sell and buy sides of the deal which can lead to actual or perceived conflicts of interest. Using an independent third-party trustee helps with both kinds of issues.

There are also ongoing expenses (including annual valuation and administration expenses) that will cost money. But these added costs can be mitigated by the final, and perhaps most significant, tax break for ESOP companies. This is commonly known as the ESOP S-Corp benefit and is based on S-corps being pass-through entities for income tax purposes. In an S-Corp, income taxes are paid at the shareholder level, not the corporate level. As a qualified retirement plan, and a pension plan trust, ESOPs do not pay any federal income tax. Therefore, an S-Corp that is 100% owned by an ESOP will pay no federal income tax on earnings—and many states will match this benefit with state income taxes. This is a significant benefit that can help set the company up for success as it heads into the future without you.

From a governance standpoint, there is no requirement that an ESOP company provide employees with full voting rights similar to what (for example) shareholders enjoy in a publicly traded company. Since it is technically a trust, the ESOP trustee will vote shares in most cases but there are certain situations in which a pass-through votes are required by law—these include a merger, liquidation, dissolution, or sale of substantially all of the assets of the company. There is no prohibition on providing additional pass-through voting and governance rights to employees if you so choose.

Worker Cooperative

Unlike an ESOP, a worker cooperative is a form of corporate entity (like an S-Corp, or LLC), and this has an impact in a number of important areas and that differentiates them from an ESOP or an Employee Ownership Trust.

- A worker cooperative is part of the broader family of cooperatives that include agricultural co-ops (like Ocean Spray or Land 'O' Lakes); retail/consumer cooperatives (like REI or your local food co-op); insurance mutuals (like Nationwide); credit unions; housing cooperatives; and many others.
- A worker cooperative has members instead of shareholders, similar to an LLC. Agricultural cooperatives are usually owned by the farmer-members who supply products; insurance cooperatives are owned by policyholders; retail cooperatives are owned by the consumers; and so on. In a worker cooperative, the company is owned by the employee-members who work in business.
- Cooperatives have their own set of tax laws that govern how the corporation and/or members pay taxes, and that share some similarities (but also differences) with other corporate structures.
- Worker cooperative statutes are generally state specific and several have favorable worker cooperative statutes. Existing cooperative statutes in some states can make it difficult to establish a worker cooperative there. Worker cooperatives can incorporate in different states (with a favorable worker cooperative statute) other than the primary state where they operate.
- Cooperatives approach corporate governance, control of the business, and financial benefits for its owners differently than conventional corporations. Each member-owner has a single membership share, and a single vote, on major corporate decisions, including voting for the Board of Directors. Company profits are distributed to the owners based on the amount of patronage of (or to) the cooperative. In an worker cooperative, this typically means that the more labor provided to the cooperative, the larger share of annual profits.

Because a worker cooperative is not a federally regulated retirement plan like an ESOP, setup costs are lower, usually in the $60,000 - $100,000 range, with marginal annual costs. Consequently, smaller companies (fewer than 30 employees) may find the model a better fit. However, there is nothing inherent in the model that prevents worker cooperatives from being a a fit for larger companies too.

Apart from the 1042 capital gains treatment for the selling owner, worker cooperatives do not benefit from additional tax breaks as an operating employee-owned company.

Most sales to a worker cooperative will be financed. Commercial finance can be a bit harder to obtain (though it is improving) than with an ESOP, and usually some or even all of the transaction will (or can) be seller-financed.

> “
> **Because a worker cooperative is not a federally regulated retirement plan like an ESOP, setup costs are lower.**
> ”

As a type of corporate entity, the company will either be a worker cooperative or it won't—there is no option to be a 20% or 30% cooperative. However, there are ways to structure a sale to a cooperative over time, in a stepped or staged transaction—with the assumption that the employees will eventually own 100% of the company.

We briefly mentioned this above, but it is important to reiterate that, because of the way cooperatives are structured, democratic voting rights are built-in to the model, at the least on major issues (like voting for, and serving on, the Board of Directors). This can be a bit of a culture shock for the typical entrepreneur; but there are others who have found that model appealing.

The universe of advisors that can help you set up and maintain an employee-owned cooperative tends to

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What Is An Employee Ownership Trust?

Chris Michael, EOT Advisors

An Employee Ownership Trust (EOT) is a flexible, private, simple, low-cost, and sustainable structure for employee ownership. The company stock is held by a trustee on behalf of the employees, just as with an ESOP. The company culture should also reflect its ownership structure, just like an ESOP. However, unlike an ESOP, an EOT is not a retirement plan. Employee-owners are "naked in, naked out" – employees do not pay for shares on the way in, and they are not bought out when they exit.

Employee-owners do not accumulate shares in individual retirement accounts. Rather, they usually receive a percentage of ongoing profits (or gains), in accordance with a custom-tailored formula, throughout the duration of their employment. These distributions are typically paid out at the corporate level in the form of cash bonuses or 401(k) contributions, and are therefore tax-deductible.

Similar to what happens with an ESOP, the selling owner establishes a trust and their stock is redeemed. Typically, the selling owner will take a promissory note with principal and interest payments over a period of years. Unlike with an ESOP, there are currently no selling owner tax breaks for setting up an EOT.

In most cases, governance will be the same as with an ESOP (i.e., a "circular" structure where the board appoints the trustee and the trustee appoints the board). However, if so motivated, the founder can also provide some voting rights to employees –– for example, to elect one or more board directors.

Because an EOT is not a retirement plan, and is therefore not regulated as such under ERISA, EOT implementation costs – as well as annual costs – are a fraction of the expense of setting up and maintaining an ESOP. In addition, EOTs are also less expensive than the typical M&A advisory fees on a sale to a third party.

Finally, EOTs offer substantial flexibility to selling business owners with respect to timeline and other planning options. An EOT can be installed in as brief a time as two months, although a six-month timeframe would be more common. With an EOT, the seller decides how long they would like to remain in a leadership role. The seller might decide to hand leadership over to successor management from months to years after the EOT transaction.

And when it comes to designing the employee ownership program, the options are wide open. For example, if a seller prefers a more "ESOP-style" approach with gain sharing, the company can use broad-based equity compensation in addition to the EOT. A seller might also want to restrict participation in their employee ownership program to employees with more than six months of tenure. Or, a seller might want to preference more senior employees in the company's profit sharing. Perhaps the seller has ideas about other social values, or family concerns, that they would like to include within the framework of an EOT structure. And sellers have the option of protecting the company from a future sale out of employee ownership. For all of these reasons and more, EOTs warrant serious consideration by any business owner who is considering employee ownership for their succession plan.

Chris Michael is the Founder and Managing Director of EOT Advisors. He is responsible for developing the Employee Ownership Trust as a new financial and legal mechanism in the United States. He is also a professor at Rutgers University, where he is a director of the Institute for the Study of Employee Ownership and Profit Sharing.

be on the smaller side, it is truly a niche of a niche. However, it is usually not too hard to find the right assistance, and the field is growing every day; you may have to look outside of your immediate geographic area to find the right help. In today's world, this is not a limitation that should be of concern.

Finally, like all of the broad-based ownership models discussed in this section, a sound management succession process is important, maybe more important for a worker cooperative than the other models. Because of the broader governance rights inherent in the model, training and education of employees on how to think and act like an owner is vital to success. You may need to upskill some of the employees to be able to fill new and more complex roles within the business.

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The Day After Selling to Your Employees

Kyla Alterman, Workplace Development

Congratulations, your company just became employee-owned! Your leadership team is ecstatic. You have spent months, or maybe years, learning the technical details, thinking about the benefits, and dreaming of the wealth-building possibilities for all employee owners. Now is your chance to tell your employees all about it. How are you going to communicate it?

Tell your story

Make the conversion to employee ownership more than an announcement and a sharing of the dull details of the technical details; share the "why." There's no one right way to share your employee ownership story, but employees need to understand the passion behind your decision. Consider in-person meetings, celebratory events, webinars, videos, letters – or all of these – to get the message across.

Say it over and over in different ways

To get employee buy-in during the early days, keep the communications going, and in as many different ways as possible. If you've ever heard the old marketing "rule of seven," a person needs to see or hear something around seven times before they take action. To turn your employees from hired hands into engaged employee-owners, will take more than an announcement meeting. Include ownership themes in fun in-person meetings, newsletters, brochures for family, quick facts and infographics, and short videos. Get diverse voices in the mix, this may mean different internal voices or outside experts to share how great employee ownership is.

Be prepared to answer questions

Think about how many questions you had at first (or may still have) about employee ownership. Your employees are going to have questions and concerns about what it means and what's in it for them. It's essential for leadership to have answers to common and difficult questions. You don't want to be unprepared when an employee innocently asks, "How much did we pay for this?" We coach leadership and management on agreed-upon answers that squelch rumors before they start and set clear ownership expectations for everyone.

Keep the enthusiasm

After the initial excitement, how do you keep everyone from going back to business as usual? Employee Ownership can be an invitation to think in new ways. Research shows that employees who are engaged and informed will help the company perform better. To make sure you are getting the most out of employee ownership, create an ongoing strategy for training and opportunities for two-way communication through your managers, committee or a team of ESOP employee ownership advocates.

Don't be afraid to ask for help

You don't have to start from scratch. If you join a local or national employee ownership organization, you'll find a community of corporate and professional members who can lend a supporting hand. There are a number of firms, including ours, that bring tools, field-tested training resources, and decades of experience to new employee-owned companies wanting to start off on the right foot. A solid initial communication brings significant rewards in establishing a foundation for employee ownership success.

Kyla Alterman is an Associate Consultant at Workplace Development Inc. (WDI), and provides customized communication, business education and organizational development services that maximize the impact of employee ownership. Her early work in housing and worker-owned cooperatives nurtured her commitment to the power of an ownership mindset.

Postscript: Life After Business

You've created a succession plan, implemented it, signed all the paperwork, collected the proceeds, and you are "free."

Now what?

It can be the hardest problem to solve for a business owner used to being always on the go, or having a greater purpose day in and day out. In some respects its not that different than parents dealing with "empty nest syndrome" after the kids are grown and out doing there own thing.

Far too many business owners end up regretting or being dissatisfied with the experience of exiting their business, and their life after the transaction – some surveys put the number at as high as 70%. Reasons for the high level of unhappiness are varied. Some owners may believe they didn't realize enough money from the sale. Others may become disillusioned about what has happened to the business, the employees, and community after selling. Still others can't seem to find a purpose or passion in their post-business life. Whatever the reason, the number is far too high, which makes it vitally important to do some planning for this next stage in your life.

You may be thinking to yourself that, after a lifetime of being in charge and always having something to do, the last thing you want to do is engage in another planning exercise. Well, that's ok – in fact, most experts (and us too!) recommend taking some time off to settle into your new reality. It's an opportunity to rest, re-engage with friends and family, find a new hobby, and stop and smell the roses. At some point however, the charm of having nothing to do will likely begin to wear off.

One of the questions we ask business owners is whether there is something that you've always wanted to do, or someplace that you've always wanted to go, that you've never done, or gone to. Depending on the type of person you are, you may do better by creating a formal plan—is now the time for creating your bucket list, and gradually checking items off one by one? Or are you more of a free spirit—always willing to try new things, but letting opportunities find you. Whatever works best for you is just fine.

Many business owners find civic or philanthropic opportunities both fulfilling, and fun. You may want to give back by volunteering for local non-profits or serving on their boards; or by putting your experiences to work as a mentor for prospective entrepreneurs. Don't underestimate the value that your experiences, and knowledge, can have for someone just starting out.

One last number—other surveys have found that only 40% of business owners find their post-business life as rewarding as their pre-business life.

Will that be you?

A Few Last Words

We've reached the end of this owner's manual, but you've just begun your succession planning journey. We recommend that you now take the time to review and think about what you've read, and begin to fill out the worksheets directly following. As we mentioned at the beginning, doing so will help you form your thoughts; develop your goals and objectives; analyze what you have, and what you will need in the future; and have something tangible to provide your advisors, and drive your discussions, as you explore your options.

We also hope we've demystified a few things, and shown that the process is manageable, with the right planning. The good news to always keep in mind is that countless business owners have in fact passed this last and greatest test of entrepreneurship - you can too!

Planning Worksheets

For Business Succession

Worksheet I

What's the Story of Your Business

When was your business founded?

How many current owners are there?

Please outline some highlights of the business' growth and evolution

What are your business' greatest:

Strengths

Weaknesses

Opportunities

Threats

What else would you like say about your business?

Worksheet II

Identify Your Goals

This worksheet is designed to help you to begin exploring your personal goals for succession planning. Each topic should be explored more carefully, but briefly identifying each will help frame your plan. Take a few minutes to summarize your personal goals. Later, take each topic and write down your personal goals in each category.

Future Income: How reliant are you on the business to finance your retirement?

Retirement: What income do you need for a secure retirement?

Involvement in the Business: How much continuing involvement do you want? For how long?

Investment: Do you want to cash out immediately, maintain an equity stake, cash out over some years?

Legacy: How do you want to leave the business and how do you want it to continue?

Values: What personal values impact your succession choices?

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Worksheet III

Define Your Current Income

This worksheet will help you define your current income. Once it is clearly defined, it is easier to make adjustments and identify your desired retirement income.

What is your current cash compensation? ____________________

What is the cost of your additional benefits

Medical insurance ____________________

Dental insurance ____________________

Other Benefits

Company car

Maintenance ____________________

Insurance ____________________

Travel Expenses ____________________

Memberships

Recreational clubs and greens fees ____________________

Professional organizations ____________________

Other

______________________________ ____________________

______________________________ ____________________

______________________________ ____________________

Total current compensation (total of all lines) ____________________

This worksheet should give a reasonable estimate of your current income from business. Based upon this income level, you can make adjustments (Worksheet 3), project the level of income expected in retirement to maintain your current standard of living and your level of dependence on the business for that income. Some advisors assume that the owner will need 70% of their current income in retirement to maintain their standard of living.

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Worksheet IV

Define Your Dependence on the Business for Future Income

This worksheet will help you define your expected future income. Once it is clearly defined, it is easier to identify your dependence on the business for that income and desired retirement income.

What is your total compensation (from Worksheet 3)? ________________

Adjustments to expenses (+ or -)

Change in Auto expenses ________________

Change in club membership expenses and greens fees ________________

Change in travel expenses (Professional) ________________

Increased personal travel ________________

Reduced professional organization memberships ________________

Other

__________________________ ________________

__________________________ ________________

__________________________ ________________

Total desired future income (sum of above) ________________

Expected annual future income from other sources

401(k) ________________

Other retirement plans ________________

Social Security ________________

Other investments ________________

Total expected annual future income from other sources ________________

Annual income desired from the business (Total minues desired income) ________________

Remember, this is an annual figure, it can include direct income from the business, special retirement packages, or income from proceeds reinvested after the sale of the business and ongoing income from serving on the Board of Directors or as a special consultant to the business.

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Worksheet V

Identify Needs and Goals of Other Stakeholders

This worksheet is meant to spark a though process to think through those also connected to the business. Their goals and needs also play a role in the process.

Who are the other stakeholders?

Family-

Partners-

Managers-

Employees-

Others-

What are their needs?

Family-

Partners-

Managers-

Employees-

Others-

What are their goals?

Family-

Partners-

Managers-

Employees-

Others-

Worksheet VI

Roles and Responsibilities

This worksheet is meant to spark a though process to think through those also connected to the business. Their goals and needs also play a role in the process.

What are your top five most important current roles in the business?

1.
2.
3.
4.
5.

How will each of these be covered when you retire?

1.
2.
3.
4.
5.

Assess the skills and abilities of your potential successor and management team.

What are the plans of your potential successor and management team?

What incentives are needed to keep managers on board?

Worksheet VII

Succession Summary

Summarize your needs and goals

Income -

Investment -

Involvement -

Legacy -

Values -

Summarize the needs and goals of others involved

Family -

Managers -

Other owners -

What is necessary to ensure smooth management succession?

1.

2.

3.

How long will this process take?

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Worksheet VIII

Summary - Design a Unified Set of Goals

Your desired annual income or cash out value

Ownership transition

To whom-

Time frame-

Management transition

To whom-

Time frame-

What continuing involvement in the business do you desire?

Personal goals

Income to spouse-

Income to other family members-

Charitable goals-

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Worksheet IX

"Life After Business" Plan

What are your broad post-exit goals?

What activities do you wish to partake in?

Do you have any volunteer, civic or philanthropic interests?

Do you have an interest in starting another business?

Is there something you've always wanted to try, that you've never found the time to do so?

Notes

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An Owner's Manual
Business Succession Planning

One way or another, you will exit your business. Will you be in charge of the process, or will someone else? This book will assist owners of small and medium-sized businesses develop a road map to a successful succession plan. Inside you will find:

- An outline of a process that helps you identify your goals and objectives, and ensures that they are driving the planning, and not the other way around.
- An overview of the more common strategies and tools from which you can choose.
- A series of worksheets that can assist in determining what you need, and what you want, from your exit plan.
- A series of short segments from professionals in the field of succession planning.

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