

BUSINESS SUCCESSION PLANNING SEMINAR

Agenda, Case Studies and Related Issues for Session 1 - September 20

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I. INTRODUCTION.

Welcome and introduction to the topic and the seminar.

II. TOPIC OVERVIEW: *Business Succession Planning*:

Process for maximizing the likelihood that a business owner's goals will be attained when he transitions out of the company, by preparing for transition of ownership and control of company.

Importance of planning for succession situations; timeliness of topic in terms of baby boom demographics.

Need for advance planning:

- Studies suggest that only 30% of family-owned businesses successfully transition to the second generation; less than 15% make it to the third generation.
- Many companies identify succession as their biggest risk, but few adequately prepare for it, because it raises challenging issues and requires skills and expertise different from those used to manage the business.

Multiple constituencies and factors to be considered: For example:

- Owner's financial situation;
- Family relationships and participation in the business;
- Future prospects of the business;
- Which succession options are realistically available;
- Sometimes varying goals are contradictory requiring priorities and compromises;
- Results in a need for a multidisciplinary team approach to evaluate alternatives and plan for execution.

III. PROCESS = SUCCESS.

Begin Business Succession Planning early.

- Evaluate Owner's/Business' goals, strengths, weaknesses, opportunities and threats ("SWOT") in the context of succession of management, ownership and tax minimization.
- Evaluate realistically and plan accordingly.
- Which alternative is right (and realistic) for you?
 - Family Transfer
 - Management Buy-Out
 - Sale to Third Party
 - Strategic Buyer
 - Financial Buyer
- Develop and implement a plan.
- Consider obtaining professional help in developing and implementing a successful plan.

IV. CASE STUDIES

Case studies used to draw out various issues and possible solutions. Every situation is unique.

PROCESS IS KEY!

Introduction of Panelists.

**Carroll Hurst
Mike Gracik
Ben English
Kevin Muldowney**

A. Case Study #1: Intra-family Succession.

ACME Corp. was founded in 1977 by R. M. Nixon (the “founder”), who recently celebrated his 63rd birthday, who is looking ahead to retirement and has also experienced some health issues recently. In its 30-year history, the company has grown into a profitable business with \$20 million in annual revenues and a value of about \$10 million. The founder is the sole shareholder of the company. The founder has accumulated some savings over the years, but company earnings generally have been left in the company to fund growth and provide stability, resulting in a lack of diversification. As a result, founder will need substantial liquidity or a stream of income to support his retirement. He owns the real estate on which the company’s business is located.

One of founder’s four children has been involved in the business for 8 years and currently serves as Vice President of Marketing and Business Development. A second child with seven years of business experience in a large corporation has expressed interest in joining the business. Two other children have no present intentions of joining the business, although one has expressed an interest in doing so later.

The company has a good management team, with experienced people in operations and other key areas who report directly to the founder. But the founder is integral to most management functions; he has the key relationships with the company’s customers, vendors, bankers, etc. and is the sole guarantor on the company’s credit facilities. The CFO recently left; his understudy is competent, but does not yet have the skills to step up to the CFO position.

The company’s senior lender has been encouraging the founder to consider a business succession plan in order for senior lender to continue to provide the company’s financing requirements.

Founder’s primary goals are to:

1. Create liquidity and a stream of revenue to fund retirement and to help pay college expenses for grandchildren.
2. Create ownership and management opportunities for his children who wish to be involved in the business, while treating fairly those who do not.
3. Ensure the ongoing viability of the company for the benefit of its owners, employees and customers.
4. Implement a tax-effective transfer strategy to minimize future estate and transfer taxes with respect to the company.

Discussion Issues and Possible Solutions.

(i) Family Issues. How does founder create opportunities for the kids interested in the business while being fair to other kids and employees? What if other kids want to join the business later? Is the oldest kid ready to take over the role of CEO? Should family members not actively involved in the business own company stock?

Possible Solutions.

- Implement a training and mentoring program for prospective CEO.
- Create a set of requirements for family members seeking to join the business (education, work experience, etc., making clear that they will be subject to the same performance requirements as all other employees).
- Consider a “family council” as a forum to discuss and address family issues relating to the business; Prevent family issues from driving business decisions.
- Consider a bifurcation of “management” and “ownership” among family members based on involvement and aptitude/ability.

(ii) Management Issues. Can the management team successfully operate the business without the founder? What issues will result from the son moving up to the CEO position? How can the company retain key non-family employees who may have aspirations of becoming CEO?

Possible Solutions.

- Hire a CFO. And, as noted above, implement a training and mentoring program for prospective CEO and other key management personnel.
- Founder should increasingly delegate key responsibilities to management team and reduce his involvement over time.
- Institute measures designed to retain key employees (e.g., deferred compensation arrangements such as equity or equity equivalent incentive compensation with golden handcuffs).

(iii) Financial Issues. A need for realistic expectations. Does the company have the financial capacity to buyout the founder while continuing to operate and grow the business? How will control be given to the son(s)? How will the children not involved in the business be taken care of? Are there transaction structures through which taxes can be minimized?

Possible Solutions.

- Founder can gift stock, directly or indirectly, to family members or a family estate planning vehicle gift and estate tax exclusions and credits.
- Redeem at least 80% of founder’s remaining interest with a subordinated promissory note. Prepare cash flow projections to determine the extent to which founder buy-out can be funded. Negotiate terms with senior lenders which will facilitate current payments to junior debt issued to founder. Upon his death, remaining balance due on his redemption note becomes an asset of the estate and passes to his heirs. Estate can then exercise a put right to sell remaining shares to company or CEO-son and other family owners. Key man life insurance on new CEO son would provide additional security for notes.

- Note terms and/or voting agreement will keep founder in control of significant decisions until a substantial portion of the note has been paid off, or his death (do not separate majority economic interest from majority control).
- Founder could enter post-transfer consulting arrangement with Company to provide continuing guidance to business, which provides additional cash flow to founder. Founder can continue to hold real estate used in the business and obtain additional retirement income through a market-rate lease to the company, with a company right to purchase real estate upon death of founder.

Additional Thoughts

Redemption at fair market value accomplishes four principal goals.

First, it freezes the value of the company and gives the founder a means to get that value out of the company over time (resulting in the liquidity noted as a primary goal) without placing an excessive debt burden on the company (due to flexibility in payment terms) This also avoids problems which can arise when family members not involved in the business hold stock.

Second, it freezes the value of the company includable in the estate of the owner (which would equal the value of the note) and transfers future business appreciation to the next generation as new owners.

Third, it creates a mechanism for getting majority control into the hands of the new CEO son and positions him to take control if he can make the company perform well enough to pay off the founder debt.

Fourth, it addresses the bank's request (and the overall need) for a business succession plan.

This plan represents a compromising of goals. Note that the founder must remain on bank guaranties until value starts to shift to new CEO son, so there should be an indemnity arrangement. While the Founder has greater liquidity in his principal asset, he continues to have his financial condition tied to the operating results of the company. That is not ideal when viewed strictly from the retirement funding perspective, but it represents a balancing of the goals of funding retirement while also enabling the business to stay in the family.

B. Case Study #2: Management-Led Buy-Out with Financial Buyer.

Same situation as Case Study No. 1, except no family members are involved. The founder is the sole shareholder of the company. As a result of health problems the founder experienced several years ago, he has placed greater emphasis on developing the company's management team, to the point where senior management is capable of running the day-to-day operations of the business.

The founder and key members of the management team have differences of opinion about the strategic direction of the company as the industry evolves. Management has expressed interest in buying out the founder and, with his permission, they have had preliminary (and confidential) discussions with several private equity groups which may be interested in financing the transaction. Each potential private equity investor has indicated that it would want the management team to receive and the founder to retain (i.e., equity rollover) a substantial ownership position in the company post closing. They also have indicated that they would use new mezzanine and senior lenders to leverage their investment in the company.

Founder's primary goals are to:

1. Get Liquid! Increase liquidity and diversification of his personal assets while minimizing taxes, so he will be able to fund retirement and to help pay college expenses for grandchildren.
2. Have a meaningful role in the business while he remains involved, but ultimately exit completely to pursue other interests.
3. Honor commitments he made to new management personnel, that they would ultimately have control of the business.
4. Get the transaction completed on a timely basis at a favorable valuation (avoid the turmoil which can result from a protracted sale process.)

Discussion Issues and Possible Solutions.

(i) Family Issues. Generally, in this situation as compared to Case Study No. 1, the family issues are less important. The situation is instead driven primarily by (a) founder's financial desires (without regard to family ownership by the next generation) and the requirements of the new investor which will finance the founder's exit from the business, and (b) to a lesser extent, management issues that may arise while the founder retains a substantial stake in the business. The principal players in the process are the founder, management and the third party investor.

(ii) Management and Financial Issues.

- What is the best way to balance the founder's desire for liquidity while satisfying the new investor's requirement of founder to retain an ownership interest in the company, as well as founder's own desire to continue to retain some influence with the company?
- How will the issues concerning strategic direction of the company be resolved?
- Knowing that the new investor will have a controlling position and the company will have greater financial leverage, how can founder get comfortable that new investors will take the company in a direction that serves his interests and those of management?
- How does founder know he is getting a good deal financially?
- How can founder minimize disruption of the business in the process?
- How will management participate as equity holders in the business?

Possible Solutions.

Manage the Sale Process.

- Identify and engage an investment banker with experience in the relevant market space to identify potentially interested investors and run a sales process to elicit "real" purchase offers without excessive disruption to company operations, while maintaining confidentiality.
- Properly prepare and position the company for sale; prepare for expected due diligence requests and put the Company's "house in order".
- Founder should do his own due diligence investigation of the "short list" investors - talk to management of their other portfolio companies; evaluate the investor's knowledge of the industry and ability to provide contacts, expertise and other non-cash resources which will help the company grow.

Transaction Structure.

- Use a leveraged recapitalization of the company in which a portion of the investor's money will be used to redeem a substantial portion of the founder's interest in the company, with the rest being used to finance growth. To qualify for taxation of his gains on sale of his stock at capital gains rates, the founder must sell at least 80% of his ownership interest in the Company. Redemption proceeds will be paid partly in cash and partly in a subordinated note. Founder should have the right to sell his remaining interest after 3 to 5 years.
- Management will receive stock options representing an aggregate 20% interest in the company. Related issues include option type, vesting requirements, taxation, transfer restrictions and the like.

Anticipate Post-Closing Relationship Issues Pre-Closing.

- Work with CPA to analyze company financial projections and find ways to increase cash flow available to make payments on the redemption note.
- Discuss buy-sell issues and control issues, in terms of the need to balance the liquidity interests of the founder with the growth interests of the investor. Discuss issues of subordination of the redemption note to senior lenders. Discuss terms on which founder can have his remaining 20% interest in the company redeemed.
- Discuss strategic direction of the business with management and investors to ensure everyone seems to be headed in the same direction. Discuss management expectations for non-equity compensation, etc.

Wrap-Up: Preview of Session Two; Adjourn.