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a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON

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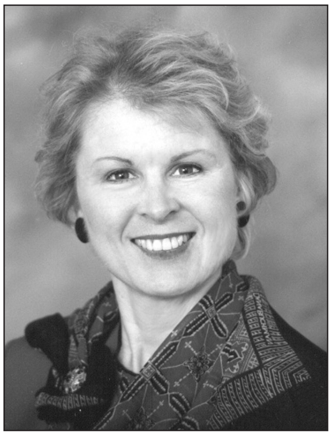

Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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EXIT STRATEGIES FOR BUSINESS OWNERS

by Mary Hanson

Every business owner needs an exit strategy, a way of retiring and permanently leaving the business - whether by selling, liquidating, or passing the business on to the next generation.

The owner's exit strategy needs to fit with the business plan of the business. Many business owners expect to sell their businesses at a good price in order to retire, but don't operate the business in a manner to enhance the likelihood of a good sale. For many businesses, the focus is on day-to-day survival, ignoring longer term objectives. Even in the best of times, it is easier to focus on making money today than on longer term objectives, including the business owner's exit.

Here are alternatives most business owners consider for exiting a business:

Sale of the Business

A sale of the business is the most commonly anticipated exit because of the possibility of obtaining a healthy purchase price. The sale of an on-going business is usually at a price that reflects inventory, fixtures, and equipment at a good price, plus something for goodwill. However the price is determined, it normally reflects the on-going potential of the business to make a profit for the buyer. In addition, the sale of a business as an on-going enterprise usually includes the hiring of employees by the buyer, the renting of the business premises from the landlord, and other steps that have the effect of decreasing the liabilities of the seller.

The sale of a business at a good price requires that the business be profitable, have good future prospects, have a good reputation, have good financial and business records, and be viable without the seller.

In the ideal sale the buyer pays the purchase price at the closing. In the current economic environment finding a buyer with adequate funds or adequate credit to get a loan can be difficult. Taking a promissory note as part of the payment is risky. Even the best buyers can default. The owner expecting to retire comfortably may instead find discomfort if the buyer is unable to meet financial commitments on the purchase price, consulting fees, or rent on seller-owned property.

Liquidation

If it is not possible to sell the business as an on-going business, the assets are sold and the business is closed. Business owners resist this alternative, since the piecemeal sale price of furniture, fixtures, equipment, and inventory is typically low. In addition, the business owner must confront the employees' loss of their jobs and the disappointment or inconvenience of customers. The proceeds of the sale can be very low if the closing is abrupt. There can be complicating factors such as contracts to fulfill, collateral agreements on assets, and storage of unsold goods and equipment. Sale proceeds may not

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be adequate to pay all the obligations of the business.

However, an orderly liquidation involving a well-planned closing, good marketing of sales, and negotiation of outstanding liabilities can provide an acceptable exit in some situations.

Transfer to the Next Generation

Whether the business is sold to the kids or given to the kids as a gift or a bequest, a business is often an unfortunate inheritance. I think that the inherent challenges in running a business make a business a "bad gift." The second generation may not recognize the true amount of effort necessary to successfully run a small business until it is too late to sell the business to a more appropriate buyer. The amount of time required - and the additional capital needed to compete - may be more than the second generation is willing or able to commit. The financial results may be inadequate to support the second generation's lifestyle.

This "exit strategy" is not a realistic exit strategy if the former owners (the parents) have to keep on working to keep the business running or have to keep advancing funds to prop up the business or the kids or both.

There are greater challenges to running a small business today than there were in the past and the financial rewards are less. Management today must deal with more government regulation, greater competition, higher overhead, higher taxes, more laws intended to protect employees, and a cultural shift away from long work hours.

Sale of a Percentage

A common trend in service businesses is to bring in a colleague as a co-owner with a view toward a future buyout. This approach is fraught with peril. The key risk is that the new co-owner lacks the real commitment or the financial ability to make the ultimate sale hoped for or expected by the seller. Another risk is that the colleague lacks the ability to really run the business without the seller's skills and guidance.

This arrangement is likely to involve a junior member of the business as the hoped-for successor. It is often premature for either the buyer or the seller to know the true level of the potential buyer's commitment or capability. Once the arrangement is made, the expectation can present a moral dilemma, if not a legal one, when more appropriate opportunities to sell the business to better situated buyers arise. The commitment to the junior colleague can foreclose other opportunities to sell the business for the best price.

In addition, the time and effort spent with the colleague who ultimately declines to buy the business could have been spent building up the business and/or establishing the right relationship with a better potential buyer.

If the arrangement was made without a commitment regarding buyout terms, price, and timing of the ultimate buyout and the young colleague is shrewd and capable, the seller may be in for a difficult experience. It may be necessary for the seller to entertain lengthy negotiations to accomplish the ultimate goal of selling the business at a good price. The business owner may unwittingly put himself or herself in a difficult situation for negotiations.

Merging Two Businesses

Sometimes it seems like a good idea to merge two businesses to achieve faster growth or diversification and to provide an exit to one of the parties to the merger. The risks in this situation are similar to the risks in selling a percentage of the business. The business owner wishing to sell his or her business really needs a buyout commitment. Once a business is merged with another, the business owner no longer has a business to sell.

The seller needs the merger agreement to provide all the terms of the ultimate buyout, even if the agreement includes years of working together to build the combined business. The agreement needs to cover both the ultimate sale and the interim management of the merged business. How long will the seller work for the merged business? Does the "buyer" in the merger have the financial strength to meet all the commitments of the merged business?

How will each of the business owners be compensated? Can the business afford to either pay both owners or to lose the efforts of one owner?

ESOPS, Private Equity, and Going Public

There are other exit strategies that offer much higher potential returns to the business owner. Many small businesses "can't get there from here." Revenues and profits must be much higher than are typical for a small business in order for these options to be viable. In addition, a "deep bench" of highly capable management is necessary for the more sophisticated transitions.

One option for larger and financially strong businesses is the ESOP – Employee Stock Ownership Plan. Special laws allow the business owner to be bought out by a trust owned by the employees of the business using loans to the business. After 100% of the stock is transferred, the employees own the business and the business owner is completely bought out. Capable management must be in place so that the employee-owners can successfully run the business without the business owner. The dollar values and the tax benefits inspire interest in ESOPs, but the burden of compliance with complex legal requirements makes this alternative less attractive.

Some businesses are well-situated to attract investment from private equity firms looking to invest and build up a business for future gain. A business owner may be able to sell most of his or her business to a private equity firm and remain involved with a small percentage ownership as the business is grown and then sold at a much higher price.

The prospects must be very good that the business can be taken to a new level at which the value of the business will be much higher. The interim work relationship can be difficult for the business owner who is now a mere former owner working for the PE firm.

Going public is a theoretical option. Current laws make a public offering of stock unlikely except for the biggest and most profitable of private firms. This exit strategy is one for business owners to dream about rather than plan on.

"Make sure the exit you envision is consistent with the general business plan and that the day-to-day operation of your business is consistent with long term objectives."

Publisher's Note

The death or illness of the business owner can necessitate the sale of a business, whether or not the business is ready for a sale. Because the value of the business as an on-going concern drops rapidly after a death or other serious loss, it is important to act quickly. Employees must be kept working, the doors must be kept open, vendors and customers must be maintained, and sales must continue until the business is sold.

The business owner's spouse - or other individual handling the matter - must be briefed on the actions to take to get the best value out of the business. He or she needs to be advised of the importance of selling the business quickly and given the names of key advisors to contact.

A friend in the industry should be identified as a person to turn to for industry knowledge.

Most importantly, the spouse (or other individual) must have the legal authority to sell the business quickly. This commonly involves having the business owned by the business owner's living trust so that the co-trustee or successor trustee has the immediate authority to make a disposition of the business.

Mary Hanson
Attorney/Publisher

Things to Do

Check your exit plan against the business plan. Make sure the exit you envision is consistent with the general business plan and that the day-to-day operation of your business is consistent with long term objectives.

Get the right people and avoid the wrong people. Even if a plan is terrific, its successful implementation depends upon having the right people involved. The "wrong people" can be management, key employees, buyers, co-owners, or advisors. And the "wrong people" can be terrific people – just not the right people to implement the plan to meet your objectives.

Try to take steps that make the business more likely to sell to a good buyer.

- Bring in additional managers, if possible, so that the business appears to be viable without you.
- Broaden your customer base so that the business does not appear dependent upon one customer or just a few customers.
- Maintain books and records in a manner that make review of the business easy, clear, credible, and up-to-date.
- Keep an eye on profits. Any buyer of an on-going business wants to see that the business runs profitably.

The time to start looking at the big picture is now. BA

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