PRACTICE MANAGEMENT

Know the Secret to a Successful Business Succession Plan?

A coordinated effort is vital for an effective business exit and succession plan.

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The challenges of exit and succession planning and execution are many. There is great need for effective management and coordination of this vital element in assuring the perpetuation of a mid-market company, as the majority of closely held companies don't have a documented exit or transition strategy for the owners—and many of those that exist aren't effectively implemented.

A company is built over time by a CEO-entrepreneur who is able to bring together a close-knit management team ingrained with the necessary discipline to recruit, train and motivate employees to produce a quality product or service. Those CEOs who retire and then watch the company they built continue to grow and prosper have delegated authority, responsibility, risk and reward out to their associates, not down. They help people learn how to think for themselves and become independent members of a group of like-minded individuals engaged in a common cause—building a company dedicated to rewarding everyone involved:

- The client or customer with consistent, high-quality services or products
- Its employees, who feel like partners and who earn above-average current income

These associates also build future value through beneficial stock ownership, which helps solidify the value of stock ownership in the company for all the shareholders when the company has an employee stock ownership plan (ESOP) that is well designed and operated—and properly funded to meet future repurchase liability.

The enlightened CEO recognizes that two kinds of equity are essential in building a company: dollars and sweat. Those who feel that only capital is necessary will have to sell their company before its prime, as highly intelligent, motivated people will normally not stay with an organization that has as its creed: "From each according to one's ability, and to the founders and their family according to their need." Only those family companies with a large number of relatives will build an enduring company that can be perpetuated over the years.

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Employee owners, on the other hand, have a different attitude about their company, their jobs and responsibilities that make them work more effectively as an ownership team.

Recent studies have demonstrated the stabilizing effect of employee ownership plans on a company. The survival rate of ESOP companies is markedly higher than for comparison companies. They outperform their competitors in terms of return on assets and shareholder returns.

Most people want to have more control over their own destiny. Joining a shared-ownership company is a good way to do this.

What is shared ownership? How do your owner-CEO clients share ownership without giving up control? Why should your clients want to share ownership? These are all good questions.

Three distinctive legislative developments related to ESOPs from 1974 through 1996 have influenced their design.

In 1974, the Employee Retirement Income Security Act (ERISA) provided for the early development of ESOPs. Because of economic circumstances that existed at the time, most ESOPs were designed to gradually share ownership over a number of years. These were referred to as progressive ESOPs. This design provided some liquidity for the selling shareholder(s) and shared ownership with employees—and did it without incurring any debt.

In 1984, the Tax Reform Act was adopted. It contained attractive provisions related to ESOPs, one of which allowed a shareholder to defer federal income tax on a sale of his/her stock if, immediately after the sale, the ESOP owned at least 30 percent of the outstanding stock and the shareholder invested the proceeds or a like amount in qualified replacement property within one year (Section 1042).

The Act also contained provisions -that allowed banks to exclude 50 percent qualifying interest on ESOP loans from their taxable income to encourage banks to lend to ESOPs. Dividends would be deductible if used to amortize ESOP debt or were passed through to participants. The ESOP could assume the estate tax due on company stock for states that qualified with long-term financing from the IRS. There was a sunset provision on the 50-percent exclusion and estate tax provisions. However, the estate tax assumption provision resulted in ESOPs for many large private companies.

Many ESOP transactions were larger because a company could now leverage its earning potential to fund a larger purchase through the acquisition of debt and the 30 percent ownership requirement under Section 1042. Many large banks created ESOP lending departments and joined the ESOP Association to learn more about this new technique of finance.

In 1996, legislation was adopted that would dramatically influence the design of ESOPs. The Small Business Job Protection Act of 1996 amended the S corporation law to permit ESOPs as eligible shareholders of an S corporation- Because ESOPs were exempt from paying federal tax, shareholders rushed to sell 100 percent of their stock to an ESOP to create what was essentially a nontaxable entity for federal income and, in most cases, state income tax purposes.

As you can imagine, ESOP transactions started to become even larger than the 30 percent ESOPs encouraged by the1984 Tax Reform Act. While not necessarily a negative outcome, the 1996 legislation had unintended consequences that could affect the health of the sponsoring company if not carefully monitored.

Your clients who have built successful companies should consider some major issues related to an ESOP exit strategy as they approach traditional retirement age. How much stock should they sell to the ESOP? Should they revoke S corporation status to take advantage of the deferral of gain on the sale provided by Section 1042? Should they sell all their stock to the ESOP and become a 100 percent-owned ESOP S corporation?

When ESOPs were smaller in size they still had the powerful effect of acknowledging the employees' contribution to the success of the company by sharing ownership and did not over-leverage the company with too large an ESOP.

So, where do you start? You have heard of the "rule of 72!' This is the process of determining the approximate number of years required to double your money at a given interest rate. When it comes to exit, succession and/or perpetuation planning for the privately held company we believe in the rule of 77.

This is a process whereby the owner of a privately held company will be required to address seven issues relating to his/her company and seven issues relating to his/her personal situation.

If these issues are truthfully addressed with the assistance of trusted advisors, the result will not only be a clear delineation of the goals of all interested parties, but a clear path to those goals through an executable plan.

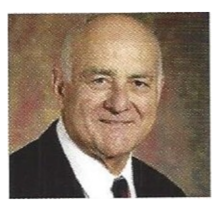
Address the first seven issues dealing with the company to provide goal clarity and viability:

1. Perpetuation or exit
2. Succession for perpetuation
3. Income continuity
4. Corporate reserves
5. Business objectives
6. Alternatives
7. Human resources

The next seven issues focused on the individual owner(s) deal with whether the owners have compiled sufficient independent resources for personal and emergency needs and address some emotionally sensitive topics necessary for the trusted advisors to help determine which goals are a priority and that they are in congruence with the company goals.

1. Independent resources
2. Freedom of action
3. Lifestyle goals
4. Independence of heirs
5. Philanthropic views
6. Political concerns
7. Personal life alternatives

All of the issues for the company and the individual must be addressed for the exit or perpetuation strategy to be successful. One solution developed to resolve one issue should not complicate the solution for another.



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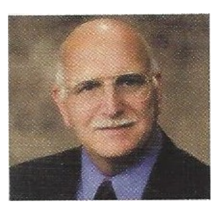

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