Selling Your Business? Advantages and Drawbacks of the “Whom”

Adam Allan, CPA

Choosing the right type of buyer can make all the difference in your exit planning strategy. It’s not something to take lightly and there are many types of buyers.

Lang Allan & Company, CPAs
A Professional Corporation
6130 Greenwood Plaza Blvd, Ste 130
Greenwood Village, CO 80111
info@langallancpa.com
langallancpa.com
t 303.792.9445
f 303.792.9449

(c) 2014 Lang Allan & Company CPA

Exit Planning Strategy is About The Who and The What
When it comes to selling your business, it's never an easy decision. There are many steps, twists, and turns that could happen along the way.

One thing to keep in mind is that the planning and execution of your exit planning strategy are dependent on to **WHOM** you sell and **WHAT** you sell. Overall, to whom you sell and what you sell are your decisions and either or both may affect a willing buyer's purchase price.

To Whom You Sell
Choosing the right type of buyer can make all the difference in your exit planning strategy. It's not something to take lightly and there are many types of buyers. Here are four buyer types to consider in your selling strategy.

1. An outside third party;
2. Insiders, a group of individuals or a single insider;
3. Simply retiring and continue owning the business outright; and
4. Employee Stock Ownership Plan ("ESOP").

Selling to an Outside Third Party

By selling the stock or assets of your company to a third party, you/the company are selling to an unrelated party:

- Potentially a competitor, or
- Someone with industry experience/knowledge or to a true financial investor.

Based on our preliminary conversations, you have not expressed the partial sale (i.e., less than 100 percent ownership) of the company to third parties, so we have outlined the advantages/drawbacks of a *complete sale* to a third party.

Advantages
The main advantage to this type of buyer is you generally receive the greatest amount of cash proceeds at the closing date with potential earn outs/installment payments over a shorter timeframe. Other advantages are:

1. At the date of the transaction you have given up ownership and control of the company;
2. You are generally removed from any future obligations (prior obligations may remain, depending on the type of transaction); and/or
3. You may be offered an employment contract to assist with the new owners during the transition process.

If you are able to sell to a competitor, you may potentially receive the greatest purchase price, as economies of scale and other market pressures may make your business more valuable to a competitor over a financial investor or other buyers.

In an effort to reduce your credit risk from selling to this type of buyer and to limit the buyer's risk of not paying you the full purchase price, you should request the greatest amount of cash up front. If a buyer is in need of borrowing funds to buy you out, you may be required to carry some type of "seller note" to get to your agreed upon selling

(c) 2014 Lang Allan & Company CPA

price. The “seller note” may be required to be subordinated to the main creditor, in effect, placing you in a second or third position to be paid, if the new company becomes financially unstable.

At the date of sale, you may be asked to continue with the company for a “transition period,” to assist the new owners. During the transition process, you become an employee of the new company and continue to draw additional compensation; however, most likely at a lower rate of compensation than you are currently accustomed.

Drawbacks
The main drawback of selling to a third party is the potential transition period, if retained, and you are, therefore, employed by another person/entity.

During this period, you will actually report to the new owner, who may disagree or overrule your decision-making processes. As you have worked for yourself over the years, this may be a frustrating process for you. Additional drawbacks may include:

1. Additional and aggressive negotiating both from legal due diligence;
2. Representations and the final purchase price; and/or
3. Finding a true third party buyer without hindering current market/customer relations.

Other items
The sale to a third party may be either a stock or asset sale.

Selling to “Insiders”—A Group of Individuals or a Single Insider

By selling to insiders, you are in effect selling to employees of the company and/or family members.

Advantages
The main advantage of this type of buyer is generally the ease of the transaction and your retention of a greater control during the effective transition of ownership.

If you want to stay part of the Company in the short term, this would allow you to maintain control and decision making powers over a five- to seven-year time frame as you transition ownership. Other advantages include:

1. You continue to draw compensation under your current operations;
2. Other owners gradually begin to take on higher roles and responsibilities within the company;
3. The company’s operations are used to fund the buyout by the insiders; and
4. Your roles and responsibilities become less over a defined period of time.

Generally a stock sale transaction is structured whereby you sell a prescribed amount of shares over five to seven years at current, fair value of the company. The company, from its current operations would bonus additional salaries to the individuals identified in the transaction. Bonus funds are then used (and required via contractual obligations) to then buy stock back from you over time.

(c) 2014 Lang Allan & Company CPA

The goal of this type of transaction is that over the next five to seven years, the new owners acquiring 35-49 percent of your stock in the company; so, at the end of the transition period, the new owners should be able to:

1. Operate and manage the business; and
2. Have enough equity to obtain funding for the final purchase of your stock in the company at the then current fair market value.

Drawbacks
The main drawbacks to this type of buyer are generally:

1. Identifying employees with the financial assets to acquire your business, and
2. Identifying employees actually with the entrepreneurial spirit and knowledge to own and operate a business the size of the company.

Other drawbacks are closely tied to the above, and include

1. Significantly less cash to you at closing;
2. You becoming a creditor to the buying individuals/the company; and
3. Cash flow of the company usually indicates the gradual purchase of your stock.

Other items
As the majority stockholder of the company during this transaction, you will have a fiduciary responsibility to the minority stockholders. You will have to make decisions in the best interests of the stockholders, not just yourself, such as:

- The stock of company should be valued to ensure the employees are not receiving "compensation" for stock.
- The company should put in place employment agreements with the individuals entering in to the purchase of your stock, including salaries, bonus structure and then mandatory purchase of stock.
- In the contract process, we encourage you to enter into put and call options with the identified buyers. So, if a third party offers to buy the company, you can still control the decision process and/or the insiders have certain options as well.
- Related-Party Transactions – Installment sale may accelerate gains.

Simply Retiring and Continue Owning The Company Outright

In this situation, you simply retain ownership of the company; however, you "retire" from the company.

Advantages
The main advantages are that you maintain ownership of the company outright and continue to receive the excess cash flow of the company personally and individually. Another advantage is you can wait for a potential buyer to be identified at a later date.

Drawbacks
The main drawback of this situation is there is no "cash out" transaction. Other drawbacks include:

1. Identifying and developing a management team who will operate the business to maximize its cash flow for your return; and

(c) 2014 Lang Allan & Company CPA

2. Recognizing potential increased compensation costs to the management team to keep them motivated and driven for the success of the company;
3. Effectively reducing your potential cash flow for distributions to you as a retired owner; and/or
4. Maintaining a continued personal guarantee/obligations of the company.

Other items
For this strategy to be effective, you should be able to "walk away" and simply compensate individuals for reaching certain financial and operational milestones and/or measurements.

You must also be willing to let the new management team actually manage and operate the company on its own. They may come to you for advice. But, they may effectively "retire" you. Let them make the decisions and receive the benefits of their results.

Selling to an Employee Stock Ownership Plan ("ESOP")

In this situation, the company leaders would create a new entity (via a trust) that would qualify as a defined contribution employee retirement plan (i.e., "XYZ ESOP"), which would have a new tax identification number and year-end tax filing requirements/testing.

Because the ESOP is then a defined contribution employee plan, the company would be able to make contributions to it, up to 25 percent of the company's reported wages annually subject to certain limitations. The ESOP, acting as a new entity, could then buy back the stock from you personally with the cash available from its annual contribution to it. In addition, if a third-party lender was willing to lend money to the ESOP (usually guaranteed by the stock it holds in the operating company to the bank), the ESOP may have enough cash to buy out your shares of company stock.

Advantages
The main advantages recognized from selling to an ESOP are that the company:
1. Stays intact as is;
2. Gets a tax deduction for pension benefits and the ESOP then uses that cash to buy back stock from the selling stockholder;
3. Allows the selling stockholder to transition out of the company over time;
4. Rewards employees for their efforts and hard work by owning a piece of the operating company over time;
5. Allows the employees participating in the ESOP a tax-deferred "profit" of the operating entity;
6. Allows for deferred tax treatment in some instances for the selling stockholder; and
7. Creates an instant market for the operating company (i.e., a willing buyer).

Drawbacks

(c) 2014 Lang Allan & Company CPA

Similar to selling to an insider, the company leader must identify who will actually run the company at some point. Other disadvantages maybe:

1. If a non-leveraged ESOP is used, it will take several years before you can sell your stock outright;
2. The company's annual financial results will dictate how much cash is available to contribute to the ESOP;
3. The company must be valued annually to ensure that it (the ESOP) is paying fair market value for the stock it is acquiring; and/or
4. Certain employees may gain a higher "ownership" stake in the company, simply as a function of their payroll compared to total payroll.

Other items

Whereas the name "Employee Stock Ownership" is the formal name of the transaction, the employees themselves do not directly own shares in the stock that they can sell, assign, etc. to other thirds parties.

What the employees would own is a right to a distribution equal to their ownership interests the date they terminate their employment with the company.

Because a trust is being setup, a trustee (plan administrator) must be assigned who has fiduciary responsibilities to which he/she must act in the exclusive interest of the participants (not the seller's best interest). Also, a board of directors of the operating company usually makes the nomination/election of the trustee.

Be Aware

Consider your alternatives before making this big decision. You may want to consult with your legal counsel to make sure you understand your legal rights and responsibilities and before dissolving the company.

Once you are prepared to make a decision about your business, seek the guidance of a skilled exit-planning strategist to put the gears into motion and to move your company forward.

Contact **Adam Allan at 303-792-9445** if you would like to schedule a consultation to discuss your exit planning strategy and the options available to you.

(c) 2014 Lang Allan & Company CPA

Definitions

Economies of Scale: When more units of a good or a service can be produced on a larger scale, yet with (on average) less input costs, economies of scale are said to be achieved. (http://www.investopedia.com/articles/03/012703.asp)

Employee Stock Ownership Program (ESOP): A qualified, defined contribution, employee benefit (ERISA) plan designed to invest primarily in the stock of the sponsoring employer. ESOPs are "qualified" in the sense that the ESOP's sponsoring company, the selling shareholder and participants receive various tax benefits. ESOPs are often used as a corporate finance strategy and are also used to align the interests of a company's employees with those of the company's shareholders. (http://www.investopedia.com/terms/e/esop.asp)

Fiduciary Responsibility: A fiduciary is a legal or ethical relationship of trust between two or more parties. Typically, a fiduciary prudently takes care of money for another person. (http://en.wikipedia.org/wiki/Fiduciary)

Installment Sale: An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. (http://www.irs.gov/publications/p537/ar02.html)

Put and Call Options: Options are divided into two categories: calls and puts. Calls increase in value when the underlying security is going up, and they decrease in value when the underlying security declines in price. Puts increase in value when the underlying security is going down and decrease in value when it is going up. So depending on what you anticipate happening in the market, you can buy a call or a put and profit from that movement. (http://www.forbes.com/2006/08/23/investools-options-ge-in_wh_0823investools_inl.html)

Seller's Note: A seller note is a type of vendor take back financing used to bridge the gap between the purchase price and the financeable asset base of the target company. (http://www.divestopedia.com/definition/883/seller-note)

(c) 2014 Lang Allan & Company CPA
6130 Greenwood Plaza Blvd, Ste 130
Greenwood Village, CO 80111
info@langallancpa.com
langallancpa.com
t 303.792.9445
f 303.792.9449

move your company forward

Lang Allan & Company PC provides audit, review and compilation attest services, tax, financial accounting and management consulting services to small businesses and individuals. Our goal is to serve your needs in a professional, prompt, and courteous manner. We believe it is important for you to know we care about you and your future. We will always provide personalized services to businesses and their owners.

Our big firm experiences combined with small firm service helps to *Move Your Company Forward.*

- Financial Accounting
- Tax Planning
- Business Planning
- Accounting Staff Training
- Systems Design and Implementation
- Follow-up
- Payroll Tax Reporting and Compliance
- Financial & Estate Planning

Accounting Services

Our unique, individualized approach gives business owners, managers, decision-makers, and individuals the strategic advice essential to their success.

Tax Services

We help our clients achieve the right balance between personal and corporate taxation and make tax decisions that may reduce their liability.

Attest Services

Our professional services help organizations overcome the financial challenges they may face throughout their life cycle, setting us apart from traditional accounting firms.

Talk To Us

Find out how our depth of experience, technical expertise and proactive service can benefit you and your company.

Lang Allan & Company, CPAs
A Professional Corporation
6130 Greenwood Plaza Blvd, Ste 130
Greenwood Village, CO 80111
info@langallancpa.com
langallancpa.com
t 303.792.9445
f 303.792.9449

(c) 2014 Lang Allan & Company CPA