

Succession Planning For Business Owners



PRESENTED BY:

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Online Seminar

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Welcome to Succession Planning For Business Owners!

- This presentation will be available for replay from our website at SNSFE-law.com along with a PDF of the slides and separate audio file.
- A 5-question participant evaluation will be emailed to you.
- CPE candidates must prove interactivity by responding to the 2 identified poll questions via the Q&A tab in the lower right hand corner of the screen. Proof of attendance will be sent via email.

About SNSFE

- Established in 1960
- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
- From start-up to succession planning
- “AV” Peer Review Rated

About Larry Staat

- SNSFE partner
- 30 years experience
- Head of transactional practice groups with focus on counseling business owners and senior executives in matters affecting their businesses and personal estates
- Recognized as Illinois Leading Lawyer

Succession Planning For Business Owners

ORIENTATION

Balance Sheet of a Business Owner

Cash	\$ 100,000
Marketable Securities	\$ 500,000
Residence	\$1,000,000
Retirement Accounts	\$ 800,000
Business Real Estate	\$1,800,000
Business Interest	<u>\$5,000,000</u>
Total Assets	\$9,200,000
Real Estate Mortgage	<u>\$ 200,000</u>
Net Worth	<u><u>\$9,000,000</u></u>

2 Questions

1. How certain is the value?
2. How liquid is the value?

What makes the value certain?

- a. The current leader**
- b. What can happen to the current leader?**
 - i. Death**
 - ii. Disability**
 - iii. Distraction**
 - Family or health problems**
 - iv. Disinterest**
 - Retirement, new career**

What makes the value certain?

- c. The next leader
- d. Because he will continue to do what the current leader does

What makes the value liquid?

- a. The next owner**
- b. Because he has the cash**

**Succession plan helps answer
these questions.**

CPE Candidates:

Please respond to the following question by typing the answer A or B into the Q&A box.

Do you have a succession plan?

A. yes

B. no

Succession plan is a 2-part plan

- 1. Leadership succession**
- 2. Ownership succession**

2 succession plans

a. The plan

- i. Covers all 4 “Ds”
- ii. Expected timeline
 - Later

2 succession plans

b. Interim plan

i. Unexpected timeline
– Sooner than later

ii. Accelerate the plan

iii. Insurance for business
– Disability for buy-out
– Life for buy-out

Who cares?

- a. You
- b. Family
- c. Employees
- d. Creditors
 - Bank

EXPECTED TIMELINE PLAN

Succession plans vary

- a. By type of business**
- b. By number of owners**
- c. By number of leaders**

2 types of businesses

- 1. Personal goodwill**
- 2. Entity goodwill**

Personal goodwill business

- a. Personal reputation and relationships**
- b. Direct leader/customer interaction**
- c. Services**
 - Doctor, lawyer, accountant, architect, consultant, broker, investment advisor**

Personal goodwill business

d. Selling knowledge or know-how

e. Size

- **Smaller business cell**
- **Team needed to provide what the customer is seeking**

Personal goodwill business

- f. Non-balance sheet business**
 - i. Business requires few assets**
 - ii. Capital is not a material income-producing factor**

Personal goodwill business

g. Owner-operator

**h. If leader leaves, so do
customers**

Entity goodwill business

- a. Entity reputation and relationships**
- b. Less direct leader/customer interaction**
- c. Products**
 - Manufacturer, distributor, retailer, restaurant**

Entity goodwill business

d. Selling an object

e. Size

– Larger business cell

f. Balance sheet business

i. Business requires significant assets

ii. Capital is a material income-producing factor

Entity goodwill business

- g. Non-owner-operator**
- h. If leader leaves,
customers do not follow**

The idea is that the design of the succession plan is determined by the location of the business' goodwill.

- That's where the customers are
- Succession plan must protect the business' goodwill

2 types of succession plans

a. Personal goodwill

- i. Leader and owner are inseparable because leader holds the customers**
- ii. Plans for leadership succession and ownership succession are inseparable**
- iii. One plan**
 - Leader-owner succession plan**

2 types of succession plans

b. Entity goodwill

- i. Leader and owner are separable**
- ii. Plans for leadership succession and ownership succession are separable**
- iii. 2 plans**
 - Leadership succession plan**
 - Ownership succession plan**

LEADER-OWNER SUCCESSION PLAN

Example:

Small manufacturers representative

- a. Personal goodwill more than entity goodwill
- b. Revenue stream is rather predictable
- c. One owner
- d. Next leader is employee
- e. Buy-in by salary allocation

Income Statement

Revenue		\$1,000,000
A's salary		\$ 175,000
B's salary	\$125,000	\$ 175,000
Other expenses		<u>\$ 400,000</u>
Expenses		\$ 750,000
Profit		<u><u>\$ 250,000</u></u>

Compensation

	Salary	Profit	Total Comp
A	\$175,000	\$250,000	\$425,000
B	\$175,000		\$175,000
Total	\$350,000	\$250,000	\$600,000

Value of Business and Purchase Price

Profit	\$ 250,000			Annual amount over 5 yrs
Capitalization rate	<u>25%</u>			
Value of business	\$1,000,000	45%	\$450,000	\$ 90,000
Balance sheet equity	<u>- \$ 100,000</u>	45%	<u>- \$ 45,000</u>	<u>- \$ 9,000</u>
Goodwill	<u>\$ 900,000</u>	45%	<u>\$405,000</u>	<u>\$ 81,000</u>

Compensation After Buy-In

		Salary	Profit	Total Comp
A	55%	\$175,000	\$137,500	\$312,500
B	45%	\$175,000	\$112,500	\$287,500
Total		\$350,000	\$250,000	\$600,000

Compensation During Buy-In

	Before Buy-in	After Buy-in	During Buy-in				
			1	2	3	4	5
A	\$425,000	\$312,500	\$493,000	\$470,000	\$447,000	\$425,000	\$402,000
B	\$125,000	\$287,500	\$107,000	\$130,000	\$153,000	\$175,000	\$198,000
B's raise	\$ 50,000						
Total	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000

Value of Business and Purchase Price

Profit	\$ 250,000			Annual amount over 3 yrs
Capitalization rate	<u>25%</u>			
Value of business	\$1,000,000	55%	\$550,000	\$183,333
Balance sheet equity	<u>- \$ 100,000</u>	55%	<u>- \$ 55,000</u>	<u>- \$ 18,333</u>
Goodwill	<u>\$ 900,000</u>	55%	<u>\$495,000</u>	<u>\$165,000</u>

Compensation During Buy-Out

	Before Buy-out	After Buy-out	During Buy-out				
			1	2	3	4	5
A	\$312,500	\$ 0	\$183,333	\$183,333	\$183,333		
B	\$287,500	\$475,000	\$291,667	\$291,667	\$291,667	\$475,000	\$475,000
C		\$125,000	\$125,000	\$125,000	\$125,000	\$125,000	\$125,000
Total	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000

Succession plan documents

- 1. Employment agreement**
 - a. Salary allocation for buy-in**
 - b. Deferred compensation for buy-out**
- 2. Stock purchase agreement**
- 3. Shareholders agreement**

LEADER SUCCESSION PLAN

Who's the next leader?

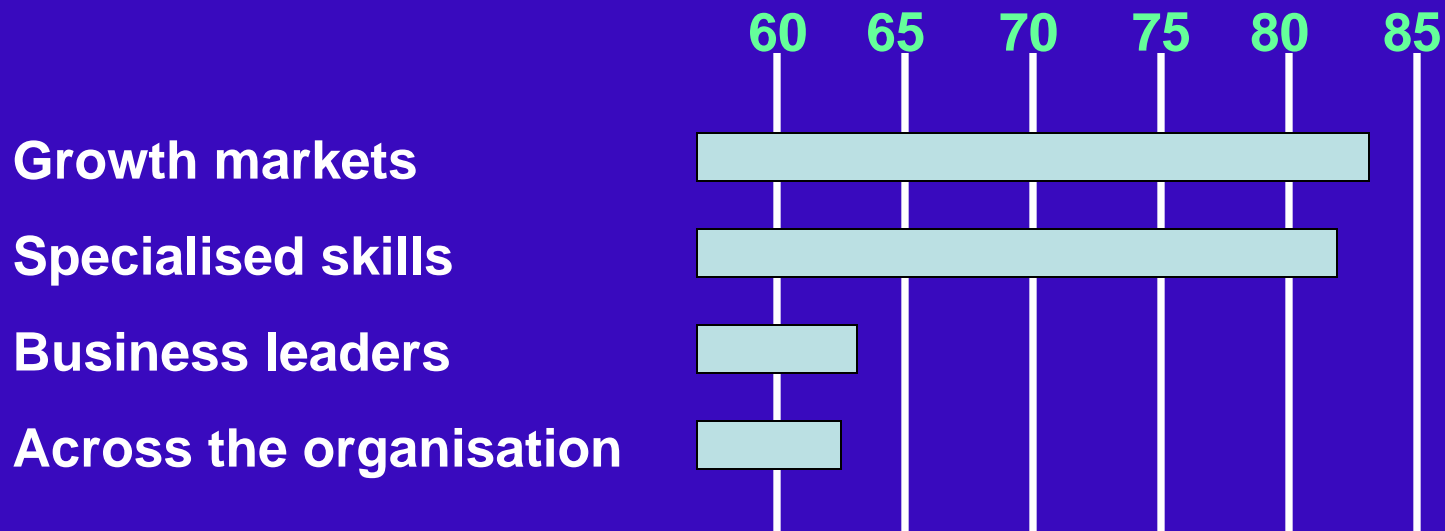
- a. The current leader and current owner must choose
- b. When?
 - Before the next leader is needed
 - Now

How to locate the next leader?

- a. Look inside
- b. Look outside
 - i. Someone known
 - Competitor
 - ii. Someone unknown
 - Headhunter

source: **The Economist, October 7th-13th 2006, The Battle for Brainpower**

Not enough to go round Talent shortages in organisations, %



source: **Corporate Executive Board, Corporate Leadership Council**

How to keep the next leader in place?

- a. Employment arrangement that keeps the next leader interested in the business**
 - i. Employment agreement**
 - 1) With attractive financial incentives**
 - a) Tied to personal performance**
 - b) Tied to business performance**
 - 2) With restrictive covenants**
 - a) Non-solicitation**
 - b) Non-interference**

How to keep the next leader in place?

ii. Deferred compensation

1) Qualified

- Profit sharing and 401(k)

2) Non-qualified

- a) Bonus deferral plan
- b) Stock appreciation rights (SAR)
- c) Phantom stock
- d) Supplemental executive retirement plan (SERP)

How to keep the next leader in place?

iii. Ownership

- 1) Minority interest with buy-back**
- 2) Stock option**

b. Continuing education

c. Good order to business

- Is your business attractive to an outsider?**

CPE Candidates:

Please respond to the following question by typing the answer A or B into the Q&A box.

Are you a business owner?

A. yes

B. no

OWNER SUCCESSION PLAN

Who's the next owner?

- a. The current owner should choose**
- b. When?**
 - Before the next owner is needed**
 - Now**

How to locate the next owner?

- a. Look inside**
 - i. Co-owner**
 - ii. Next leader**
 - iii. Employees - ESOP**

How to locate the next owner?

b. Look outside

- i. Strategic buyer**
 - Competitor, rollup buyer
- ii. Financial buyer**
 - Private equity
- iii. Business broker**

How to attract the next owner?

- a. Business must appear profitable and clean**
- b. Do the “due diligence” in advance**
 - i. Corporate formalities**
 - Good standing, required records
 - ii. Eliminate special arrangements**
 - Loans to insiders, employment of relatives

How to attract the next owner?

iii. Formalize vital relationships

- Make as permanent and transferable as possible
- 1) Employees
 - Restrictive covenants
- 2) Vendors
 - Supplier agreement
- 3) Customers
- 4) Licensors
 - Government and private

How to attract the next owner?

- iv. Formalize rights to vital assets
 - Make as permanent and transferable as possible
 - 1) Patents
 - 2) Name registration
 - 3) Copyrights
 - 4) Trade secrets

How to attract the next owner?

- v. Settle pending or potential claims against business**
 - 1) Lawsuits**
 - 2) ERISA compliance problems**
 - 3) Tax compliance problems**

What should be the deal with the next owner?

Goal --

Sell for the highest price for cash or marketable securities

Exception for family --

Arrangement which satisfies income needs and minimizes estate taxes

Minimize taxes

a. Income taxes

- i. Tax-treatment goals in sequence:
Defer, capital gain, ordinary income
- ii. Defer
 - Tax-free organizations or reorganizations
 - ESOP
- iii. Capital gain
 - Personal goodwill

Minimize taxes

b. Estate taxes

- i. Change ownership to discountable form for family succession plan
 - Minority stock
 - LLC
- ii. Gift ownership before value is apparent
 - Outright
 - GRAT – Retain income interest

CONCLUSION

Questions?

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Thank you!