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Navigating an Exit:
Advance Planning to Sell Your Family Business

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According to a 2022 study by PricewaterhouseCoopers, only one-third of family-owned businesses have a detailed exit plan in place. While most business owners have considered an informal exit plan somewhere during the course of building their businesses, a well-articulated and formalized exit plan has not been documented or vetted with other stakeholders in the business. While an informal back-of-the-envelope exit plan is fraught with peril, a well-considered and granular exit plan should take into account most of the inevitable twists and turns of a strategic business transaction that leads to success.

The beginning of the calendar year is an ideal time to put the following in motion, even if you are not planning an immediate exit. It's always best to be prepared when opportunity comes knocking at the door.

The process of executing a plan to transfer your business should not be haphazard or random. It should flow logically and predictably; following certain, well-defined steps.

A. Frame the Business Exit Strategically

Anyone who operates a successful and growing business will inevitably reach a point when they wish – or must – contemplate an exit from the business that he or she created. An exit plan is centered around a comprehensive roadmap to leave the business. The exit plan will include a thoughtful strategy that addresses financial, tax and legal matters, as well as the business owner's personal financial goals. An exit plan should also consider how to maximize the value of the business and how to minimize tax liability in completing the transition.

Adopting the mental toughness of a high performing company leader is a necessary component to begin contemplating an exit strategy, specifically (i) understanding fully the industry in which the business operates; (ii) getting ahead of the curve to identify strengths, weaknesses, opportunities and threats involving the industry; and (iii) educating oneself about the differences between families with operating businesses and post-liquidity families managing portfolio assets are critical elements in advance of drafting and executing a successful exit plan.

Collectively, the following are ideal exit strategies and any one of them should be at the heart of a well thought out business exit strategy:

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- **Pass the Baton.** Pass the business to another family member, which will include identifying competent and interested family members and training them over a prolonged period of time.

- **Sell the Business.** A third-party sale of the business will require a long-term and possibly complex plan to grow the business to a stage where the business becomes highly attractive to a potential buyer.

- **Managed Buyout.** A managed buyout may be the first option if the business owner does not have a qualified successor but wishes to continue the corporate culture.

- **Takeover or Phased Exit.** A phased exit will occur when a business owner does not wish to exit completely from the business but wishes to transition slowly to a new owner. The new owner takes on increasing managerial responsibility and the existing owner gradually sells its stake as he/she becomes more confident in the new owner's ability to continue the business.

A short checklist of objectives that an exit plan should accomplish will always include the following five (5) key elements:

- Maximize business value
- Exit the business on the owner's terms
- Realize the owner's personal financial goals
- Initiate proactive tax planning for the business
- Conclude a detailed and successful exit strategy

B. Plan Early

The best exit plans are thoughtfully planned out long before a business owner is ready to actually transfer the business. Business owners will develop a *strategic plan* – usually with the assistance of lawyers, accountants, financial planners and other trusted advisors – to specify their goals and values and clarify how they will achieve those goals. This strategic plan naturally takes some time, often years to develop.

The sale of a business that works best involves a planning structure in place for years. It's critical not to make the sale of a business a last-minute fire drill, although that is how it usually plays out. Everyone involved should know what will happen, approximately when it will happen, and be intimately familiar and in agreement with the ownership and governance structure of the business rather than making radical changes at the eleventh hour.

"If you don't know where you are going, you'll end up someplace else." is a maxim that Yogi Berra made famous, and it applies most certainly when planning to exit a private business at some point.

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C. Assemble an A-Team

Keeping the planning process as streamlined as possible is a good goal, but not at the expense of optimal planning. This is why a business owner needs to rely on advisers outside the immediate family. The core team will consist of tax, legal and business advisers who will focus on all aspects of the sale and potentially personal advisers who will focus on the impact of the sale on the business owner and her/his immediate family. Outside advisers family counselor may help to ensure there is clarity and agreement prior to an event. It's not uncommon to have conflicts occur, which can be mitigated through clear communications.

Business owners know that when friends, family and business mix, emotions often get in the way. When things get heated and messy, third-party professional advisors can help lower the temperature and bring the necessary pieces together.

D. Organize the Financial House

Preparing to sell the family business is not unlike preparing to sell the family home. Identify strengths and weaknesses and prepare accordingly, which can be accomplished by engaging a reputable accounting firm and auditing the last two years of financial statements. Know the numbers backward and forward and be prepared to speak about them.

The financial statements work in parallel with tax return information and are part of due diligence. For instance, the prospective buyer needs to know if credit agreements will be honored and whether creditors will be paid off as part of the sale.

- **Credit Agreements |** For example, a supplier may extend credit for raw materials.
- **Creditors** | This can include information about loans for business equipment, physical property, software and vehicles and can also include leases for property and equipment.
- **Accounts Receivable |** This information helps the potential buyer understand the cash flow of the business.

E. Prepare a Detailed Checklist

Selling a profitable business is a daunting task under the best conditions but is made all the more manageable by staying organized and focused on the details. An ideal way to stay on top of the myriad details is to develop a detailed checklist of everything that a business owner needs to focus on. Much of this will be included in a closing checklist as the closing date approaches but preparing a high-level checklist should include the following ten (10) items:

- Business licenses, contracts and agreements
- Corporate, business and tax documents
- Business owner discretionary earnings
- Intellectual property information
- Government notifications

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- Company assets
- Business permits
- Environmental audit
- Current inventory list
- Security information and technology systems

F. Take Advantage of Tax and Other Planning Opportunities

Strategic tax and estate planning may enable a business owner to transfer ownership in advance of a sale and minimize the family's future estate tax liability. These strategies are ideally completed well in advance of a sale, before there is a mark-to-market value for the business, which is why multi-year planning is so important.

A business owner will also want to focus on the key drivers of business value so she/he can perhaps manage it differently with a forthcoming sale in mind. Tax advisers can help to structure the sale to minimize taxes and spread tax liability over time. Some business owners prefer to retain a financial stake in the business. For example, electing to receive 80% of the value at closing plus another 20% earnout may benefit from continued business growth and/or cost-saving synergies.

Taking advantage of the current tax environment makes a lot of sense, especially qualifying for a reduced income tax rate by restructuring into a C corporation. Such a move could increase after-tax income to the business owner and potential buyers. Think about the sale of the business and its real estate separately. Real estate has unique value to a business, so pay attention to getting fairly compensated for the business operations and real estate separately. Another consideration is to hold on to the real estate with a long-term lease to the buyer, which creates ongoing cash flow and the option to sell the real estate at a future point.

G. Consider Adopting a Buy-Sell Agreement

Leaving aside the objective advantages of selling a business when the timing is right, a buy-sell agreement is always a good idea in the context of a privately held enterprise. A buy-sell agreement is a contract between the members of a limited liability company (LLC) that provides for the sale (or offer to sell) of a member's interest in the business to the other members or to the LLC when a specified event or events occur.

Common events triggering a buy-sell agreement include death, disability, retirement and divorce, but a buy-sell agreement also comes into play when a majority owner of a business is considering a sale to a third party.

A fundamental purpose of a buy-sell agreement for a family business is to restrict the owners' ability to freely transfer their interests to avoid unwanted owners. This is usually accomplished by limiting the situations in which an owner can dispose of his or her interest to the

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identifiable events specified in the agreement. Accordingly, the buy-sell agreement facilitates the creation of a market for the ownership interests in anticipation of a time when an owner may need or desire liquid assets.

When a triggering event occurs, the buy-sell agreement provides the entity or the other owners with certain requirements or options (e.g., a mandatory obligation to purchase the selling owner's interest or a right of first refusal), depending on the business owner's objectives. In other words, a buy-sell agreement establishes an exit strategy for the owners at the inception of the entity, which reduces the potential for conflict later when a triggering event occurs, such as the sale of the family business to a third party.

Buy- sell agreements and restrictions on transferability are useful in determining how a member's interest will be valued for transfer-tax purposes and the parties to the buy-sell agreement will be bound by the terms of the agreement. Possible methods for determining the value of an ownership interest (i.e., purchase/sale price) under a buy-sell agreement include: (1) a fixed price per unit; (2) requiring an independent appraisal; or (3) using a formula approach. At a minimum, a buy-sell agreement is a necessary component for any significant multi-owner small business irrespective of when the sale or transfer of a privately held enterprise occurs.

H. Focus on Closing

Under an ideal scenario, the business owner will have attracted several competitive offers for the business, the field of potential buyers will have been narrowed to a select few, and the parties will begin taking significant steps towards making a deal.

The first significant step towards closing is for the parties to negotiate a Letter of Intent (LOI). An LOI is a non-binding outline of the proposed transaction, including summaries of all key terms. If there are multiple buyers, the business owner may send each a preferred form of LOI, instruct the buyers to make any adjustments to the form that they see fit, and then weigh each buyer's LOI to determine the best offer. The LOI will typically contain an exclusivity provision, which means that once the buyer agrees, the business owner must cease its marketing efforts and deal with the buyer exclusively for a certain period of time, usually through completion of the due diligence phase.

Once the LOI is signed, the proposed buyer will continue its due diligence efforts to understand the finer details of the business and evaluate the risks of proceeding with the sale. What the buyer discovers during due diligence will influence its bargaining power and how it may seek to modify the transaction. If the business owner has adequately prepared for the sale, the due diligence process should not result in any surprises or material changes to the deal terms expressed in the LOI.

As this process continues, the parties will negotiate the form of the definitive agreements, including specific representations and warranties, indemnifications and closing conditions. Ideally, those terms were set forth specifically in the LOI so that any negotiations can be narrowed. Once definitive agreements are signed, there is typically a short period of time during which conditions to closing are satisfied or waived.

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I. Plan for the Post-Sale Future

Private businesses tend to be the binding agent that keeps some families and friends together. If this is the case, explore whether there is interest in establishing another vehicle they can work on together – a foundation or philanthropic entity, perhaps a donor-advised fund. The sale will create a big one-time liquidity event. If a family charitable vehicle is a consideration, it likely makes sense to do it the year of the sale in order to offset some of the significant tax liability it will create. A private business can also mask conflict among owners. A sale may bring these issues to the forefront, creating problems over perceptions of inequality. It's always best to address such matters ahead of time – with a counselor if necessary.

If the business owner intends to stay on with the business post-transaction, make sure to negotiate a solid employment contract at a fair market value. And mentally prepare for the idea that the owner will no longer be the ultimate decision-maker. It will be important to evaluate if the business owner can be successful in that environment.

J. Conclusions

Selling a business is a long and complex process. To make sure that you reach the best deal possible and encounter the least amount of angst along the way: (1) start early; (2) build a great team of financial, tax and legal advisors; (4) stay organized and on message; and (4) prepare the company for sale in a proactive and thoughtful manner.

Thank you for your attention and much success formalizing your exit strategy!

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