BUSINESS CONTINUATION PLANNING

STRATEGIES FOR THE FUTURE

THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

Costly Mistake

No Business Continuation Plan = Business Left to Chance

Family-owned businesses are the backbone of the American economy. Yet many small-business owners make a costly mistake: They have no business continuation plan. This leaves the future of their businesses to chance.

You've Worked Hard to Build a Successful Business

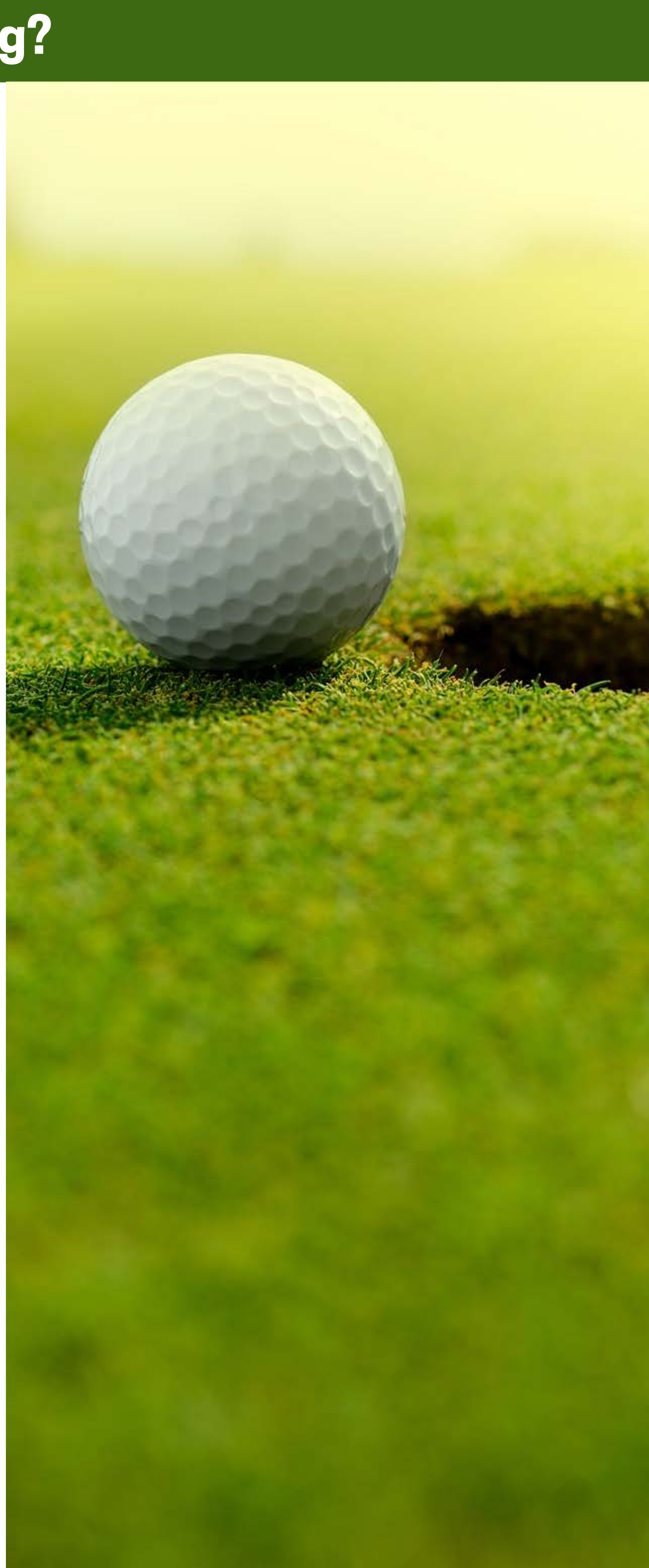
Would your business continue if you die or become disabled?

Will your business survive your retirement?

You've worked hard to build a successful business. Have you worked as hard to help your business continue should you die or become disabled? Will your business survive your retirement?

The fact is clear that continuation planning is one of the most important ingredients for a successful family business.

How is Your Business Doing?



Here are some questions to consider.

- Do you have a formal plan for continuing your business?
  - If you do, is your plan located where someone else could find it if you were to die unexpectedly?
- Have you selected a successor to take over your business?
  - Is that successor named in your written business continuation plan?
- Do you know the value of your business?
  - Just to be clear, I'm talking about a professional valuation here, not your personal estimate.
- Do you have a buy-sell agreement in place? And finally, if you do have a buy-sell agreement in place:
  - Have you set up a mechanism to fund it?

Elements of Business Continuation

1. Business Valuation

2. Succession Planning

3. Buy-Sell Agreement

With proper business continuation planning, you can help ensure that your business and the people whose incomes and lives depend on it will succeed when you're no longer at the helm.

There are three main elements of business continuation planning: business valuation, succession planning, and determining how your business will transfer to new ownership, typically accomplished through a buy-sell agreement. Let's look at each of these things individually.

1. Business Valuation

How much is your business worth?

- Cost approach
- Income approach
- Market approach

Most planning opportunities involve knowing what your business is worth. Whether we're talking about selling the business outright and investing the proceeds, using a buy-sell agreement, or transferring ownership to family members, knowing what your business is worth is critical to developing a successful plan.

For a more precise valuation, you will need to consult your accountant or a professional business appraiser. But for a rough estimate, you might use one of these three general approaches:

- the cost approach
- the income approach
- the market approach

- Book value
- Adjusted book value
- Liquidation value

Using the cost approach, you evaluate your assets and liabilities to determine the net worth of your business. Three types of analyses can be used.

First there's the **book value** approach. Generally speaking, the book value fairly represents the value of the underlying assets that the business owns, less its liabilities. This includes the business's inventory, the cash it has on hand, the receivables, and any other business assets. Liabilities comprise accounts payable, taxes payable, bank notes, and any other outstanding debts.

The **adjusted book value** approach takes into account many of the factors that the book value approach considers, but it adjusts for the assets that have risen or fallen in value.

The **liquidation value** is a method of valuation that does not consider the business as an ongoing company. It assumes the business would cease operating, sell its assets, and pay all its liabilities. Whatever is left would go to the owner. This approach is meaningful only in establishing an absolute bottom price for the company, below which the owner/founder would be better off liquidating the company rather than selling.

- Capitalization of earnings
- Discounted future earnings

The income approach assumes that your business's ability to earn income is the best indicator of its value. There are two main methods for determining the value of a business using this approach.

The real value of any business is its ability to produce cash flow. The **capitalization of earnings** formula determines the company's value based on its continuing ability to earn profits, rather than on the worth of the company's assets. This can be a fairly complicated way to determine the value of a business. Basically, you determine the average earnings over a particular period of time and divide the amount by a capitalization rate that would be widely accepted in that particular industry.

The **discounted future earnings** approach attempts to estimate the future earnings of the company and then discounts them back to the present to determine the value of the company. In order to estimate future earnings, this approach takes into account several items, including the past and present growth rate of the company.

- Compare company to similar enterprises that have sold recently

The market approach attempts to determine the value of a business by comparing the company to similar enterprises that have recently sold. Adjustments can be made to account for differences in size, risk, market position, and other factors.

Of course, this approach assumes that similar businesses have been sold and that some valid method for determining relative value can be used.

Worksheet

Average annual earnings[1]		$1,000,000
Capitalization rate[2]	÷	25%
Total capitalized earnings	=	$4,000,000
Fair market value of assets	+	$250,000
Total gross value of business	=	$4,250,000
Total liabilities	–	$1,500,000
Estimated net value of business	=	$2,750,000

1) Average after-tax earnings, including all compensation of owners.
2) Lower capitalization rate indicates lower business risk. Higher capitalization rate indicates higher business risk. Normal range is 10% (.10) to 30% (.30).

This hypothetical example is used for illustrative purposes only.

There are several methods of valuing a business. Let's use this sample valuation worksheet to estimate the net value of a hypothetical business.

Let's assume this business has $1 million in average annual earnings and a capitalization rate of 25 percent. The owner estimates the fair market value of the business's assets to be $250,000, and total liabilities equal $1.5 million. Based on these assumptions, this business would have an estimated net value of $2.75 million.

- Price satisfactory to a willing buyer and a willing seller
- Each party must have a reasonable grasp of the relevant facts involved in the transaction

In order for a business valuation to be considered “fair market value,” it must meet a couple of conditions.

First, the price must be satisfactory to a willing buyer and a willing seller. The seller cannot be under any compulsion to sell. Likewise, the buyer cannot be under any compulsion to buy. Also, each party must have a reasonable grasp of the relevant facts involved in the transaction.

2. Succession Planning

- Who will own your business?
- Who will manage it?
- Should you sell or liquidate?

Now let's look more closely at the future of your business. What plans have you made for your business after your retirement or death? Do you know what options are available?

There are a variety of issues to consider. For example: *Who will own your business once you're gone? Who will be responsible for managing it? Would it be better to sell or liquidate the business?*

Answering these questions now, rather than later, could make a world of difference for the continued success of your enterprise. Planning for the succession of your business will help benefit you, your survivors, and perhaps even your employees and clients — and it could pay big dividends later.

- Continuing
- Selling
- Liquidating
- Other options:
  - Venture capital
  - Business "angels"
  - IPOs

Many businesses are continued by a spouse, child, or other family member. If you have a family member who would make a suitable owner, this can be a great advantage. On the other hand, inexperience and lack of preparation may spell disaster. In some cases it may actually be better to sell your business to outsiders.

If selling your business makes sense, who are the potential buyers? Fortunately, there are a variety of candidates, including co-owners, key employees — perhaps even competitors. There are arrangements you can implement now to help ensure that funds are available to purchase your interest in the business. If neither continuation nor sale is likely, your business will probably face liquidation. If you haven't considered the effects of liquidation, this might be a good time to sit down with a professional to explore your options.

Other potential options for the continuation of your business after your departure include attracting venture capital or business "angels," or taking the business public through an initial public offering.

Continuing Your Business

Keeping the business in the family is important to many business owners. Do you want your family to take over the business? If so, consider these questions.

- *Are the members of your family able to assume an ownership role? Do they possess the maturity that owning a business usually requires? Have they been in close touch with your business, or have they had suitable experience outside the business?*
- *Are they willing to own your business?* Your spouse may choose to retire in the event of your death. Likewise, your children may have career plans of their own that you need to consider. Be sure the plans you make are compatible with the plans of your family.
- *Have you made appropriate plans for the continuation of your business by a family member?*

Liquidating Your Business

- Appropriate in many cases
- Often occurs due to lack of planning
- Consequences vary

The consequences of liquidation vary, and much depends on the size of your business, the type of business organization, and other factors. In many cases, liquidation is appropriate. However, liquidation may require your family to face several issues, such as a forced sale, income and estate taxes, and the loss of future income.

Liquidation happens all too frequently because business owners fail to plan in advance. If you haven't considered the effects of liquidation, we would be happy to sit down with you and discuss these matters at the complimentary consultation.

If liquidation is the most appropriate alternative, you and your family can plan for its effects. But don't let liquidation be the result of your inaction.

- Co-owners
- Key employees
- Competitors

If selling your business makes the most sense, who are the potential buyers? Fortunately, there are a variety of candidates.

For example, it may be appropriate to sell your business interest to a co-owner. This may depend on how your business is organized. For partnerships and closely held companies, this might be an ideal solution.

Depending on your circumstances, you may have key employees who could purchase your business interest. Like co-owners, they may have played a significant role in the operation of your business. In many cases this may be the preferred course of action.

Finally, you may want to consider outsiders, such as competing companies. Depending on your type of business, your competitors might be very interested in picking up your business and its share of the marketplace. Of these three options, selling an owner's share of the enterprise to co-owners is one of the most common methods of continuing a business in the event of one owner's death or retirement.

Case Study: Dr. Shultz

Dr. Schultz is entering the later years of his career, and his family has a history of heart disease. Because he is concerned about his long-term health, he wants to make sure that the dental practice will be taken care of in the event of his untimely death or a long-term disability.

He owns 65 percent of the practice and his partner owns 35 percent. Dr. Schultz's children are grown and have successful careers of their own, so no one in his family has an interest in taking over his portion of the business.

Dr. Schultz knows that his partner lacks the personal resources to buy out 65 percent of the business, but he does not want Mrs. Schultz to be burdened with deciding what to do with the business if something should happen to him.

What options are available to Dr. Schultz to address this situation?

3.. Buy-Sell Agreement

- Creates a market
- Establishes a price
- Provides cash for the buyout

A buy-sell agreement is a contract between the owners of a business that enables the surviving owners to buy out the interest of a deceased or disabled co-owner.

A properly designed buy-sell agreement creates a market for the deceased or disabled owner's business interest, establishes its price, and provides the cash that the surviving owners will use for the buyout.

- Sinking fund
- Cash
- Borrowed funds
- Life insurance or disability income insurance

Buy-sell agreements may sound like a great idea. But where does the money come from to buy out the interest of the deceased or disabled owner?
One funding option is a sinking fund. With this method, you set aside funds for the eventual purchase of the business interest. However, if the triggering event occurs too soon, you may face a shortage of funds.

If you prefer, you can hope that cash will be available when the need arises. But cash is not always available when you need it most.

The next alternative is to call the bank when the co-owner dies or is disabled and use borrowed funds to purchase the business interest. However, the absence of the co-owner may affect your ability to obtain credit, and this can be a very expensive way to fund a buy-sell agreement.

A final alternative is life insurance or disability income insurance. For many businesses, insurance provides a cost-effective alternative to fund a buy-sell agreement.

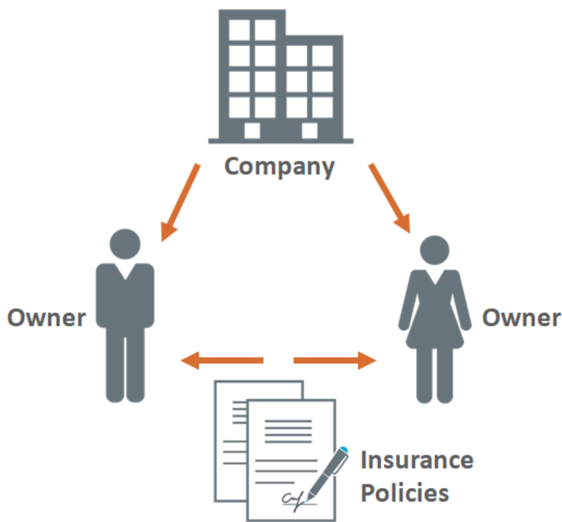
Your insurance needs are determined by your situation. The cost and availability of insurance can vary depending on factors such as age, health, and the type and amount of insurance purchased. Before implementing a strategy using life or disability income insurance, it would be prudent to make sure that the parties are insurable.

- Redemption buy-sell agreement
- Cross-purchase buy-sell agreement
- “Wait and see” buy-sell agreement

There are basically three types of buy-sell agreements: a redemption buy-sell agreement, a cross-purchase agreement, and a “wait and see” buy-sell agreement.

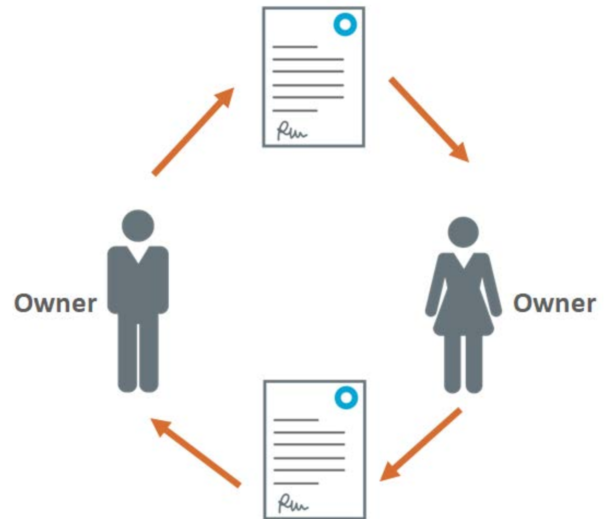
Under a redemption buy-sell agreement, the business entity agrees to purchase the interests of the individual owners. Under a cross-purchase buy-sell agreement, the individual owners all agree to purchase the interests of the other departing owners.

And finally, under a “wait and see” buy-sell agreement, the stockholders and the business agree that either the individual stockholders or the business will have the first option to buy the interests of the other owners, depending on which is most advantageous.



Using a redemption agreement to fund the buy-sell agreement, the business owns an insurance policy on each of the co-owners. If one of the co-owners dies or is disabled, the company will have the funds necessary to redeem that person's interest in the business.

The basic difference between the redemption agreement and the cross-purchase plan is ownership of the insurance policies. In the cross-purchase agreement, each business owner owns an insurance policy on the other owners. In the redemption agreement, the business owns an insurance policy on each of the owners.



This illustration shows how insurance can be used to fund a buy-sell agreement — in this case, a cross-purchase agreement.

As you can see, each owner individually purchases insurance on the other owner. If either of them dies prematurely or incurs a long-term disability, the funds will be there to purchase the other's business interest.

Three requirements:

- Genuine business arrangement
- Cannot pass to family members for less than full value
- “Arm’s length” transaction

Ensuring the continuation of your business with a properly drafted buy-sell agreement will provide more than just a mechanism for transferring the business should you die or become disabled. It also can save you thousands of dollars — and hours — by eliminating the costs, delays, and frustrations of IRS contests and litigation.

In order to accomplish these goals, however, the agreement must meet three requirements:

- First, it must be a genuine business arrangement.
- Second, it must not be a device for passing the business interest to family members for less than its full value.
- Finally, it must be comparable to similar arrangements entered into by other persons in an “arm’s length” transaction. That is, the arrangement must be made fairly, without special discounts or considerations — the same as if the parties did not share any sort of personal relationship.

Business Continuation Action Items

There are a number of steps you can start taking right away to make sure that your business continuation plans are in order:

- Develop a formal plan for continuing your business
- Select a successor to take over your business (I also suggest that you have a family conversation before you make any decisions.)
- Have a formal valuation determined for your business
- Put a buy-sell agreement in place
- Set up a funding method for your buy-sell agreement

Where Do You Go from Here?

Where do you go from here?

Are you confident in the preparations you have made for your business and your personal financial goals?

Are you on track? Could you be doing better?

Of course, there is no assurance that working with a financial professional will improve investment results. But by focusing on your overall financial objectives, a financial professional can provide education, identify strategies for taking control of many financial situations, and help you consider options that could have a substantial effect on your long-term financial situation.

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