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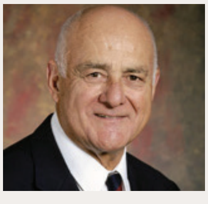
Employee owners, on the other hand, have a different attitude about their company, their jobs and responsibilities that make them work more effectively as an ownership team.

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



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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 of 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 estates 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'

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Presenting a menu of services is a great way to present the option of an ongoing financial advice relationship to new clients. When you first acquire the new client, you are able to establish an advice relationship immediately and set the stage for what the client can expect from you in an advice relationship, as well as the benefits he or she will get out of it.

How do you move forward with an existing client base? While the menu of services would likely also be a good option for your existing client base, having a discussion with existing clients may be a more viable option for some. Following is a sample script of an advice relationship discussion — a template to at least get you started.

Advice Relationship Discussion

(Sample Script)

I'd like to visit with you about the way we can work together as we move ahead. The reason is that I have a good portion of my clients asking for more services, asking more questions, and bringing me more complex situations. While I'm complimented by these requests, there are only so many hours in the week. I'm finding that their lives have evolved to being more complex, and therefore, my practice needs to evolve to provide these services.

I want to determine what level of service interests you and matches your situation. We have three options: a service model based on work we have already done, a foundation advice relationship for the basics, or a comprehensive advice relationship that integrates all aspects of your financial world and drives us to reach your goals. Most people at your level of wealth and complexity engage in a comprehensive relationship where we cover the following topics (show the menu of services). The decision is yours. In any case, you will remain part of our practice. Fortunately, I have an excellent team who will respond to those clients who have service requests. Clients in an advice relationship will continue to work with me and meet with me. We will have a defined service model and experience during the year.

I have found that clients who work with me in an advice relationship consider me the CFO of their household and the guardian of their financial future. With me, you are benefiting from literally thousands of client meetings, in which I have seen both smart and not-so-smart decisions regarding finances. My value to you is that I bring both knowledge and discipline to your financial situation to help you reach your goals. Most people will make a fortune in their lifetime. Without an advisor, few have anything to show for it in the end. Working in an advice relationship will mean that you will have something to show for it, and that money will be your servant, not your master.

How would you like to move forward?

The right advice at the right time can make a tremendous difference in the financial health and personal future of a client. By leading your clients through an ongoing financial advice relationship, you will be offering them a higher caliber of service and a more direct route to achieving their goals. As the advisor, you are the source of knowledge and possess the experience and expertise to offer financial advice to your clients. Make the leap and evolve your practice into one that will mutually benefit both you and your clients.

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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.