Four Ways to Leave Your Business

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You will either sell to an outsider, sell to your managers, pass your business to your family or liquidate your operation someday.

At some point you will leave your business. The ways you can leave your business is either through a sale to an outside entity, selling to your management team, passing your business to your family or liquidation. Although there are various iterations on how you can use each of these four methods, there are basically only four ways of getting out of your business.

When we start our business, we rarely think about an exit strategy up front. However, this may be the most important business decision you will make. Most of us when we build a business want to see our creation go past our working career. However, we don't make plans for this and reality is most successful businesses will not last for five years after the founder leaves.

After running a business for a few years most of us think the value of our business is going to take us through retirement. However, we don't factor the effect of taxes in this analysis. We also don't sit back and think about how we can make our business transition and still provide us full value for the business.

Our initial conversation with our Clients concentrates on strategies that help us move from working for our businesses to having our business work for us. The first area that must be tackled is the fact that we will eventually leave our business and the second decision that needs to be made is what of the four ways we can leave is most attractive for us.

Working on these questions earlier than later will increase the options that we have available. In the planning that we do for our Clients, we concentrate on increasing options. We find that early work on options will provide more chances to live your dreams in the future. Thinking about your preferred way of leaving your business allows you the time to leisurely plan for the transition that may be years ahead. When it gets time to leave your business, we know that these plans are not just the financial considerations. There also are emotional and management transition training and decisions that need to be done.

Know the value of your business

The first step that we suggest with our Customers is to know the value of their business on an after tax basis. Later we will discuss corporate structure and how the different organizational forms can have a dramatic effect on the value of your business. But, for know, understand that when looking at the value of your business, you can't look at just how much money you will get in gross sales. You must consider the effect of taxes and the economy on the ultimate value of your business.

You also should remember that your ultimate business value will depend on how you will leave your business. If your probably successor organization is a public company, you can expect a high value for your business. However, if the successor is your children, then a much lower value is what you need to plan on. In either case, you should have an idea of what the value of your business is on the open market. The only way to get this information is to have a formal valuation done on your business.

The person doing the valuation should have a good grasp on your specific industry. Although a general business valuation expert can give you an idea of general rules of thumbs a comparables for your business value, a specialist from your industry will understand the hidden value in your balance sheet. This industry knowledge helps you understand what your business is worth to others in your industry.

After knowing what sort of money you could expect for the sale of your business, it's then important to subtract any liabilities you have. Finally, after you subtract the liabilities you then have to factor what the tax burden will be on the sale of your business. Most people we see back off from the sale of their business is not on the gross monies received, but a shock at how much Uncle Sam wants to take. Taxes will often force you to rethink your strategy for leaving your business. It's better to know what this bite is up front.

Once you have a value for your business, it's important to take two more steps. The first is taking an independent look at how saleable your business may be and the second is what sort of change in business value can you expect over the coming years. First, lets take a look at the salability of your business.

Although your small business might have a great cash flow and a very strong balance sheet, you might find that the business is based on the founders personality. A good example of this situation is smaller construction companies. There are many construction companies that will do four or five million dollars per year and have profits of $500,000 per year. However, these companies are only as good as their last bids. Also, the personality of the owner of the company drives the value of the company.

These companies will often be valuable to managers of the company, but not to an outsider. As a result, there needs to be a significant discount applied to the value of these companies. The owner can't expect to get full cash flow values of a sale to an outsider. They need to understand that these values will be diminished by their potential buyers ability to finance an acquisition.

The second area that must be considered after a valuation is complete is what is the possible ranges of future values when it gets time to leave your business. For this calculation we suggest that you use a range of growth rates. For a rapidly growing business, you will want to use multiple growth rates over the life of your business. For example, you might be growing at 25% per year. You should think about how long you want to grow at this rate and think about financing of your growth if you continue at this rate. Also, understand that if you had 25% compounded growth for twenty-one years and your business value would have doubled seven times.

This means that if your business is worth $500,000 today and you expect to have a 25% compounded growth rate for 21 years, your business will grow to a value of $64,000,000 over that period of time. Obviously, there are very few businesses that will show that sort of value growth. So, it's important to realize that most businesses will have valuations that may grow rapidly for a period of time, but will eventually fall into a range of values that are sustainable for the future.

You now have moved towards having an idea of how much your business is worth and to whom. This means we need to start considering the four ways to leave your business and what some of the ramifications of these decisions might be.

Selling to an outsider, the most popular decision

Many people who own a business when asked, will say they want to sell the business to a third party. You've worked hard for many years and it's time to cash in on that hard work. As with all business decisions you make, this one has multiple ramifications on economic, emotional and philosophic areas of your life. We want to consider each of these and help you become ready for this road if it's the one you choose.

Since you have a business valuation, you have an understanding of what your business is worth to a third party. The first thing you should probably consider is that your business is most likely worth more to your competitors than to any other people who might want to purchase your business. Your competitors assumably can have cost savings that an outsider from your industry would have.

Also, understand that most people who purchase businesses purchase multiple businesses. You on the other hand, have not probably had a great deal of experience in selling your business. Even though you may have bought many businesses yourself, you probably have not had a great deal of experience in selling businesses. For this reason, you can be at a great disadvantage in the sales process. However, if you're fortunate, you will find yourself in a position where there are more buyers than sellers for your company. This is why it's important to understand the basic question about salability of your company before you start the process.

The business broker question

Many people in the sales process will first try to sell their business without the help of a professional broker. In my opinion a broker will usually provide far more than their fee in value. Your potential buyer is going to want to know why you are selling your business. To maximize the value of your business for sale, you must have good story. You also have to find a compelling way to sell your story. Your broker can deliver this information to a buyer in a manner that will give credibility to your story.

When hiring a broker, you want to get someone who will add value to your sale. Most of the time, this person will again be someone who has industry specific knowledge about your business and industry. A quality broker will recast your financial statements showing all the cash flow your potential buyer will have. From this cash flow statement, you will develop a multiple of cash flows to ask as a purchase price.

One of the ways your cash flow will look better is through what is known as add backs. These are expenses that your business presently has, but a new owner would not be incurring. If you are selling a competitor and they would not need to use your physical facility, one of the add backs you could put in your cash flow statement would be the reduction of rent expense the potential new purchaser would have.

For this reason, many times, your worst competitor from across town can afford to pay more for your business than anyone else. They also are the people who can justify paying for your business in the shortest possible time. So, when it comes time to leave your business and you are considering selling to an outsider, consider that competitor you can't stand as the most probable buyer.

Be psychologically ready to leave your business

One of the great lies when buying a business is telling the old owner that they are much more valuable than the business itself. Although this may be true, the purchaser of the business wants the sales and assets of the business, not usually the person who built the business in the first place.

Many times the purchaser of your business will say something like "you know, we like your business. However, we value you even more than this wonderful business you have bought. In fact, we are willing to pay you this large amount of money for you to stay and continue running your business just as you have in the past. All we want is the cash flow from the business that you are now going to create for us." If you hear a variation on this statement, understand the purchaser is trying to get you to sell your business to them.

People who purchase businesses on a regular basis understand that there are always fewer sellers than buyers. For this reason, they know they have to "sell" you on selling your business to them. Many owners of businesses have not thought about what they want to do after they leave their business. For this reason, the purchaser of your business knows that in many cases, if they don't have a compelling story for the continued participation of the ex owner in the business, they will have a lower chance of making the purchase.

Even if the new owner is serious about having you stay with the business, it's important to start thinking about your life after you leave the business. The sad fact is that most business owners have been asked to leave the businesses they have created within twenty-four months after the completion of the sale. The new owners have purchased and paid you for your business. They now want the opportunity to run your business their way. Many times, your philosophies will be very different and you will find some "irreconcilable differences" that pop up between you and the new owner.

So, in the process of looking at the sale of your business, it's crucial that you look at how you will spend your time after you leave your business. You will find that the phone will stop ringing and those in your industry that used to call will stop calling. Not because they don't like you, just because you are now off the radar screen.

We spend a lot of time with our Clients who are going to sell their business to help them understand that life after selling their business will be different. This means we want them to have an understanding before

they sell that they will have to find meaningful ways of filling their time. There is only so much golf that you can play before you need to start finding some way to fill your time. Thinking about this before you leave your business will help you spend your time in a manner that gives you pleasure.

Ways of selling your business

Now that you know you want to sell your business and have identified what you will do after the sale, it's time to start thinking about the different ways you can get paid for your business.
The two ways businesses are sold is either through an asset sale or through a stock sale. Of the two, the stock sale is usually more advantageous to the seller, but not as advantageous to the buyer. For this reason, most business sales are done as an asset sale.

However, there is an exception to this rule. If you happen to be lucky enough to have the type of company that a public company would be interested in, then you can hopefully structure a stock swap. Under this scenario you would trade your stock for stock in the company that is going to acquire you. The IRS allows you to make this swap and not pay any current taxes. However, when you sell the stock, you would then have to report capital gains on the original basis in your stock. For example, if you have a basis in your company of $200,000 and you are able to sell your company for $1,000,000 you would normally have to pay taxes on the $800,000 in gain you would have. However, if you do a stock swap, then you could defer the gain as long as you help the acquiring companies stock.

However, in using this strategy there is a large risk. That is you have no control over the value of the new companies stock. So, for no reason of your own, the value of this stock could decline by as much as 99% in value. So, if you sold your company for $1,000,000 and you kept the stock, your value could become useless and there would be nothing you could do about it.

On the upside though when doing a stock swap, there is the opportunity to get a much higher multiple for the value of your business. Let's say that your target buyer is a publicly traded company. Let's also say that this company trades a multiple of 25 times earnings. That means that if your company made a 10% profit on $1,000,000 in sales, the value of your stock to the purchasing company would be an increase of $2,500,000 in their total stock price. So, if the purchasing company purchased your company for $1,250,000, they would be getting your company for a 50% discount.

On the other hand, you also have some companies that are privately held and the most they can pay is $500,000 or five times earnings for your company. By having the public company purchase you for $1,250,000 you are improving your sales price by 150%. For this bonus in your sales price, you are taking a large risk in the market volatility of the purchasing company. However, if you have a plan of attack on how to diversify your stock quickly, you can make the risk smaller by having the time frame for diversification short.

This means you must have a strategy for diversifying your investment quickly after selling your company. Most of the time, when you sell your company through a stock swap, you will have your stock restricted for a period of time. When you have restricted stock, there are rules about when and how much of your stock you can sell. It's very important to have these restrictions lifted as quickly as possible. The longer your restrictions stay in place, the more risk you will have with the market volatility of the purchasing company. Market volatility you will have absolutely no control over.

The asset sale

Not many buyers are willing to do a stock sale for two reasons. The first is that they would be purchasing your hidden and contingent liabilities. This means that the new owner would have all the liabilities your company had incurred over the years. Liabilities that no one may know about for many, many years. The second reason would be because on a stock sale, they would be inheriting your depreciation and amortization schedule. If, on the other hand, they did an asset sale, they would be able to depreciate almost the entire purchase price of the business. This can give the buyer an annual write off for their taxes of a number that can be as much as ten times higher than by doing a stock purchase.

For this reason, most of the time you will be negotiating an asset sale and not a stock sale for your business. So, when negotiating an asset sale, it's important to find ways for the potential buyer to pay more for your business. Most of the time the people doing an asset sale will also be closely held businesses.

They understand the value of cash flow and it's your job to show them how they can purchase their business and improve their own cash flow very quickly.

You do this through finding all the hidden costs in your business that the new buyer won't have to incur. Every time you find a dollar of this cost, you will get between three and five dollars in return. For example, if you have a car provided for you through the business and the new owner won't have that expense, you can probably get a multiplier of about three times added to the value of the sales price of your business.

The reason this works is because the new owner will most likely be looking to pay for your purchase in 2.5 to 5 years. So, every time you show them a savings they will have, then you are adding to the ultimate price you can expect to get for your business.

Also, understand that you will need to work closely with your broker to help them see all the ways you can add cash flow for a purchaser. We will later have a conversation on how to read and understand your cash flow statement. It's absolutely crucial that you as an owner of your business understand how the cash flows through your business. You need to know this for two reasons, first, your business is providing you with living costs you will need to replace when you leave your business and second, you will be getting extra money in your sales price every time you can document these savings for the new owner.

The advisors you will need

When selling your business, it's important to have your team of advisors ready well before you actually start the sales process. The different expertise your account, lawyer, financial planner and business broker will bring to the table is very important. As in every business transaction, managing taxes can mean the difference between having enough or not enough money to live on. There are various advanced tax strategies that can be used with the sale of your business than can increase the net amount of money you will have to spend by as much as 100%. However, for much of these strategies to be used, they must be put in place before the sales process starts.

Also, you will want to look at your advisory team that you presently use. If your accountant, lawyer and financial planner don't have experience in buying and selling businesses, then you will want to bring in expertise in this area. It's important for you to be able to evaluate whether your professionals are good in this area. Most advisors will tell their Clients they have experience in all areas. However, the amount and sophistication of their experience can mean a great deal when it gets time to leave your business. Talk to other Clients they have worked with and find out whether in fact, you need other outside advice. If your professionals are good and don't have experience, they will suggest people who specialize in this area.

I can't over emphasize how important it is to have good advice at this point in your business career. Remember, the buyer is the pro. You need help in combating the professional buyer with advisors who have been to the table many, many times. Having a good advisor team in place can mean the difference between a successful and mediocre sale for you.

Finally, when selling to an outsider there is almost always only one rule. What can you do to maximize the value of your sale? Or, how can I increase the amount of money I'm getting from the sale of my business. You have worked hard your entire life getting ready for this day; make sure you get the most that you can. The goal when selling to an outsider is maximizing your sales price.

Selling to your management team

Many organizations are very difficult to sell to an outsider. There are also many business owners who have built a business and want to see the business continue in a similar fashion to their present operations where their key people are rewarded with ownership for loyal service. Both of these are excellent reasons for passing your business to your management team.

The obvious problem with selling to your management team is the amount of money you can expect from the sale of your business. In most instances, you will not get as much money from your management team for your business as you could get from an outside organization. However, for a large number of businesses, selling to your managers is the only way to get more than liquidation value from your business.

How marketable is your business?
One of the first questions you might want to ask when your start thinking about leaving your business is how marketable is my business? For example, many professional service companies or smaller construction companies are only as good as the owner of the company. When you take the owner out of the mix, then the company has very little if any value. If your business falls into this category, then you must start to think about developing a second generation of management that has the interest and ability to take over your company.

The second group of people who want to sell to their managers might be those who have started a business and want to stay involved. They might not want to have a full time involvement, but one of a manager emeritus. If you sell to an outsider, your role within the business you created will most likely radically change. However, if you have a plan to pass to your managers, you will likely be able to structure a deal where you can stay involved in your business for the time frame and under conditions that work for you.

Under both scenarios you will first want to look at and understand first if someone would want to purchase your business and second, if not, how can you get more than liquidation value from your business when it's time to leave. Again, if you can find a business broker who understands your business, they can give you some good advice about how saleable your business is. Once your have this information, you can then start making decisions about which direction you want to pursue when it comes time to leave your business.

Valuation of your business to your managers
Although your business might have very high values to an outsider, the value to your managers in most cases will not be nearly as high. The reason for this is the ability of your managers to pay for your business. When outsiders look at your business, they have cash flows they can count on for part of the payment for your business. However, your managers only have any equity they can put into the business plus the cash flows the business produces. So, in most instances, your present management staff will not have the money or the resources for you to get full economic value from your business. However, if your business is one of those that are difficult to sell to an outsider in the first place, you must find ways to get value out of your business as you are running it.

We will cover some specific strategies you might want to pursue later in this book. However, as a first step, it makes sense to think about how I will leave my business. If the answer is I want to or have to sell to managers, then you must start thinking about ways of getting some of the value of your business in your pocket today.

Most businesses can't afford to do a 100% leveraged buyout on them. For this reason you will most likely be able to get only 50% to 75% of the value of your business. Remember that your managers will be purchasing your business shares with after tax dollars in most instances. For this reason, they will need to earn significantly more than the amount of money they agree to pay you. For this reason, you will want to get a large portion of your payment in a manner that will allow them to deduct the money that flows through to you.

This can be in the form of a deferred compensation arrangement or by using some advanced purchase options such as an ESOP type program. Both of these allow for using pre-tax dollars to purchase your business values. However, both of them also involve risk on your part that your new management team has the skills to successfully run your business.

Test your manager's skills
Well before you plan to leave your business you must test the abilities of your managers to run your business successfully without you being there. At first, you may just want to start delegating responsibilities to your supervisors and managers to see how they handle the responsibility. As the years progress, you will want to give them harder and more serious tests.

One of the ways we suggest you begin this test is by leaving your operation for longer and longer periods without leaving a number where you can be found. You might want to start off with one or two days. However, about four or five years before you plan to leave your company, you will want to extend these

time periods. Eventually, you will want to leave for three months and not have any contact with your people. Hopefully, before that time you have built enough trust with your management staff where you and they feel comfortable with you leaving for an extended period of time.

You must communicate your plans to your management staff. If your preferred method of leaving your company is through a management buyout, then you must tell your managers this is your plan. You just might find out that your managers either want to pursue this avenue or have absolutely no interest. In either case, you will want to know where they stand well before you plan to leave your company.

After communicating your plan and having the plan accepted by your management team, you will then want to institute a program that will help your management team become effective and efficient at taking over your responsibilities. Testing your managers along the way will give you a sense whether they have the abilities to actually run the company. If you find they don't have the ability to run the company, then you must let them know. If you also believe that extra training will not get them to the point of running the company, then you must also not only let your present management team know, but find managers who can ultimately run your company.

Tie your managers to the company

You will want to make sure your managers are going to stay with you during the testing and training process to actually take over the company. In today's environment, many people don't have the patience to wait for many years for their turn to come. So, you will want to develop some ideas and programs to let your mangers know that you are serious and that you will share with them along the way.

One of the best ways of slowing managers leaving is having programs in place that make it expensive for them to leave. Publicly traded companies use stock options to keep their employees at home.   Smaller companies don't have that option. However, you can have compensation programs that are designed to have a deferred mechanism to them. Bonus plans can be tied to performance and will not come due or be vested for a period of years after. This may not keep your managers from leaving the company, but it will cause them to think once or twice before moving on.

If you implement a deferred payment program of some sort, it's important that you communicate to your people why you are doing this. Also, on a regular basis you will want to let your mangers know what the values of these programs are. You also will want them to know how much they are vested in today and how much depends on them staying with the company. Having these programs in place will not guarantee your key people will stick around, but it will help you communicate the value you place in their services.

It's time to leave

You now have put your succession plans in place and it's time to actually start the process of leaving your company. Most of the time you will be taking a note back from your managers for the purchase of your business. This means at least some of your future economic security will be based on the ability of your managers to successfully run the company and pay off your note. Because of this you will want to pursue options that will make it more likely that they will pay off your note before you fade into the future.

One of the most effective ways of doing this is by having you vote their stock until you are paid off. This gives you the opportunity to force actions on your managers should they not stay current with you on agreed payments. This can also be structured if you decide to use the ESOP as an exit strategy. In both cases you can control the company even though you may not own it anymore.
Remember, your managers will most likely be much younger than you. You are depending on the money you will receive from your managers for part of your life-style expenses. Anything and everything you can do to make sure you are getting your money on a timely basis is fair and equitable.

You will also want to find ways for your managers to pay you in a tax efficient manner. Since you will most likely be selling stock in the company, you will have favorable tax treatment on this portion of your sale. You may also agree to take a certain amount of the payment of the company in the form of deferred compensation. This means your managers would get a tax deduction for your payments and you would pay ordinary income taxes on the money that you receive. Although this is not the preferred method of getting

money out of your business, many times it is what makes the deal make sense for both parties.

It's important for you to look at both sides of the deal when selling to your management staff. You will have an advantage in most cases. For this reason, you want to make sure that two or three years down the road your managers don't look back and feel like they were taken advantage of. You will want them to hire and use their own advisors so they have an independent picture of what they are getting themselves into.

Finally, when selling your business to your managers it's important that they have a lot to lose if they don't make the business work. In most instances the only asset they will have that is of any value is their home. If this is true, I believe that it's very important for them to take a second mortgage and give you a lien on their homes until your note is paid off. You want them to get up in the morning and worry about making the business work just as you have for the years you owned and ran the business. Ownership not only comes with advantages but also should come with financial worries that have real consequences if it doesn't work out.

What advisors do you need?
Having your managers take over your business is an option that will work very well for many people. As with all the choices you will have in this book, the earlier you start looking at your options, the better choices you will have.

In the beginning stages of thinking about transferring ownership to your management team, you might want to work with some organizational development people to help you develop a training program that will make your managers able to take over your business. There are specialists who can help you develop programs that not only provide the training for your people, but institute little tests along the way to make sure they are able to handle the work.

As you get closer to actually making the business transfer you will again want to work with your team of attorneys, accountants and financial planners who understand the intricacies of transferring ownership of your business to your management team. You will want your advisory team to understand the uses of all the methods of ownership transfers. You will especially want them to understand ESOP's and whether this method is appropriate for you to use.

ESOP's for the proper companies can provide ownership transfer opportunities where the owner gets tax preferential treatment on the money they receive and the new owners are able to deduct the payments for money they send out. As you can imagine this can be the best of both worlds. However, not every company is a good ESOP candidate and not every management team wants to be involved in ESOP's. For this reason, you will want to have your advisory team tell you both the good and bad points of putting together an ESOP program.

You will also want your managers to engage a separate group of advisors from you. Although the sale of your business to your managers should not an adversarial process, you want to make sure your managers are getting independent advice that supports what they want to do. This will help insure that when you strike your deal, the deal with stay in place and everyone can feel good about it for a long time to come.
Selling or passing your business to your family.

The third option of passing your business is through having family take over your operation. In many cases, this is the most satisfying way of having your business continue and leave a legacy for what you have established. Also, in many industries, this may be the best way for you to structure your retirement plans. However, if you decide this is the road you decide to go down, then you should be aware there are some significant challenges along the way. If you are a second or third generation now, you have experienced some of the challenges. If you have started your own business and dream about having your children join you, then there are steps you will need to make to have a successful transition.

Preparing your children
The first step after making this decision is to let your children know you would like them to join you in the business. Many parents make the mistake of never letting their children know what they would like them to do as far as the business is concerned. I also think it's important to let your children know that even

though you would like to have them join you in your enterprise, you don't expect that this is the only option they have available.

If your business is in the second generation and you are hoping to have it move towards a third generation, then you will most likely have had some history of making the generational transfer. If this was a positive experience the first time around, remember what made it positive. If there were some negatives around passing the business, then make sure you examine what could have gone better and then make the appropriate adjustments in your mind.

It's a good idea to also include your spouse in the conversation about children joining you in business. Many times the entrepreneur of the family will want their children involved, but the spouse does not think having the children involved in the business is a good idea. Having clarity around this topic is important because you will want to have your children receive a message from both parents this is congruent with your hoped for end result.

Expose your children to the business

Once you have let your children know that having them involved is a good thing, then it's important to have your children exposed to the business. This means while they are in junior high school and high school they have the opportunity to participate in the business. This can be in the form of summer jobs or working on the weekends. It might even just mean going to the office with their parents when you work at some odd times.

Many family businesses never get to the stage of having the business pass on because the children don't know what the business does. If you want your children to join you in business, then it's important for them to know what and how the business operates.

Make sure your children are exposed to the positive things about your business. As you eat dinner with your family, it's easy to just complain about all of the bad things that happen to you during the day. However, if this is the only thing your children hear, then they will develop a negative view of the business and will not want to spend their time there. If instead, you also let your children know about the good things in the business, then there is a very good chance that they will develop positive feelings about the business and what it can develop.

I encourage you to not only talk about the positives of what you do, but the freedom that owning your own business can provide. Most entrepreneurs work very hard on their business. By the time they can start to have more discretionary time, their children have come to dislike the business because of all the time you spend at it. It's important for you to communicate how the hard work you have put in is now paying off in the form of allowing you to spend time doing the things at work that you enjoy doing.

Selling predictability

If you are a first generation business, then your children have seen the hard work. The second generation will often have a much easier time making the business go. This is because you have developed a sense of predictability in your business. This means that you have regular Customers who purchase items for your business on a regular basis.

It's important to let your children know that you not only have some predictability, but with good planning the business can provide a good income for you and them for a long-time to come. The reason you want your children to join you in business is because you want to not only continue doing what you enjoy, but you also believe that the business can provide a standard of living and enjoyment for your family for many years to come.

If you are a second-generation owner, then your children have grown up in a business that has had regular Customers for their lifetime. You also are looking at a business that has been going for between thirty and forty years. It's important for you to have a clear understanding for how the business can prosper for another twenty to thirty years and provide a good living for your children that you want them to join the business.

How many mouths can the business feed?
The final area you will want to look at when deciding whether you want your children to join you is how many mouths can the business feed? The business is providing an adequate living for you and your family that is now in the business. The question you must ask is, how many additional family members can the business provide for?

If the answer you come up with is not everyone, then it's important to communicate that to your children and let them know that not everyone is going to welcome to join the business. In fact, it will be highly unlikely that all of your children will have an interest in joining the business. For those children it becomes important to let them know that other options are fine for them and you.

Having additional generations join the family business will often mean finding ways to expand the business to not only accommodate the life-style needs of the younger generations, but to provide interesting and challenging jobs for your children in the company. The way this usually happens is through an expansion of the business that will allow more senior managers.

How do your children join the business?
You now have children who are interested in the business and you have a business that you think can work for many years in the future. The next question becomes how do you train and bring your children into your organization?

I think this is the crucial question and decision process that needs to be developed for successful generational transfers of business operations. Among the questions you will want to ask are:

- Will you require outside work experience for your children to join the business?
- What sort of educational requirements are the children required to have?
- At what level will the children join the company?
- How successful must they be in their other jobs before being allowed to join the family business?
- What equalization strategies do you want to have with your children who decide not to join the business?
- What sort of pay structures do you want to have with your children as compared to other employees in the company?

I believe that these questions need to be answered fully and in writing for you and your children to understand what the rules of the game are going to be. Companies that have successful generational succession plans will take a great deal of time thinking about and answering the above questions.

Your children will need to know that they can be successful outside the family business. You also need to know this for your retirement security to be firmly in place. You will only want to have children join you in your business when you and they both know they have had successes outside your business. If you are in the second or third generation, the becomes even more important as there will be cousins and siblings who also might have an interest in having their children join the business.

The other area that is crucially important to have written strategies is pay structures in place for your family. You will want to make sure your children are paid on a market rate for the work they do. Families will usually overpay or underpay children for the work they do in the family business. Both are just as damaging. Children who are overpaid will often not be respected by other employees in the company. Children who are underpaid will be unappreciated and will often feel like second-class citizens in the company.
Under both circumstances, it's important for your children to know that they are being paid what they would be worth on the open market. This also allows them to understand that they have options and if the family business does not provide them with the type of work environment they want, then they can move to another employment situation and have a good understanding for what their potential compensation might look like.

Your Present employees
As you are starting to get your children ready to join your business, it's important to look at how the

transition plans come across to the non-family members of your company. You will want to communicate your intentions and let your non-family members know what the transition will mean for them.

We find that most employees will understand that if communicated properly, having family members join the business is a good thing. This is especially true for a first generation business. Job security is important to most employees. Knowing that you have a succession plan in place and are starting to work towards this plan is important. You, as the business owner will want to talk about this with your people, letting them know that you are thinking about what will happen to the business in the future.

Having your present employees understand your succession plans will not only give them an idea about what you want to see done with the business, but will also let them know that you are thinking long-term. The best job security you can provide your people is to have a succession plan in place that keeps the business with your family. As long as your next generation is able to run the business well, your present employees should be excited about having another generation come aboard.

Training the next generation
Your present employees in most cases will be instrumental in helping your children learn the business. These folks can make the transition happen smoothly or have it happen with pain. I always spend some time talking with the junior generation in a business letting them know how important the current employees are and how they can help them get a leg up on the learning curve.

Showing the current employees respect is crucial to having the next generation accepted as the successors to the present CEO. If the children of the owner do not show respect to your present employees, there will most likely be a fight about who works for whom. This can only cause the business and you stress.

After getting your children to understand the importance of your present staff you will want to work with your present management team to put together a training program for your children. I suggest having a plan where your children are introduced to different areas of your business. As they work through the business, you can decide what their core competency is and then help slot your children into long-term jobs that will be effective for both them and the company.

Having your management help craft the training and introductory program for your children will give them ownership in the training process. In many cases your managers can become mentors to your children, teaching them the nuances of their jobs that can pay huge dividends down the road.

Bridging the management gap
In many cases you will want to start winding down the intense day-to-day involvement in your business before your children are ready and able to take over the business. Having a gap management program in place is important for this to happen.

If you have some senior managers who are ten years younger than you and fifteen years older than your children, it's often a great way to have someone run the day to day operations of the company while your children learn the ropes and gain the experience necessary to actually take over the operation. With these managers you will want to have a different conversation to help get your company ready for the next generation.

Putting together the gap management program
Let's say you are 50 years old and your children are around 25 and are thinking of joining the company. You believe it will take about ten years for your children to gain enough experience to take over the job of CEO of your company. However, you are not willing to continue working as hard as you've been going for the last twenty-five years.

You also have a senior manager who has been with you for fifteen years and has been doing an outstanding job during this period of time. This manager is also now about 45 years old. You believe the manager would be able to run the company on a day-to-day basis and you could start to take some more time off.

This senior manager also knows that you have children who are about to join the company. If the manager is good, your competition are also interested in having the manager join their company. You want to make sure this manager stays around and gives you the time off until your children are ready to take over the reins of the company.

The first thing I suggest doing is having a conversation with your manager outlining what your plans for succession are with the company. You will need to let them know how important they are in the succession plans and what their actual role in the succession is. You might want to make this manager your chief operating officer and have them take over day-to-day operations of your company. You will also want to have them take an interest in the company and be compensated on the performance the company has.

The management phantom stock program

You will not want your manager to have actual stock ownership in the company. However, you will want them to feel like an owner and make decisions as if they were a manager.

One of the best ways of accomplishing this is through a phantom stock program. This is where you award your manager a certain number of shares of the company. The shares you award your manager is not actual shares in the company, but it is a bonus plan that gets more valuable as the company becomes more valuable.

For example, if the company hits certain sales and profit goals, you may award your manager a certain bonus, say $10,000 for the performance of the company. But, because the bonus is phantom stock, they will not actually receive the bonus at the time of the award. They will however be able to redeem this bonus at a later time and the growth of the bonus will be tied to the performance of the company.

So, let's say the companies value increases by ten percent per year. Ten years from now, the manager's value in the original stock grant would have grown to about $26,000. When the manager retires, they would then be entitled to cash in their phantom stock and would be paid out at retirement.

The beauty of this program is that you not only tie the value of the bonus to the increased value of your company, but you can also tie the vesting or ownership rights to the values to certain performance and time frames. So, if in our example we have a ten year vesting for the phantom stock and the grant is $10,000 per year, your manger would be leaving your company with $150,000 bonus at the end of ten years.

This means that for a competitor to hire away your manager, they will have to come up with this additional money in addition to the salary and benefits you are providing your key manager.

Now, not only have you told your key manager how important they are to the company, but you have given them a tangible reward for outstanding performance that allows you your ultimate goal of having your business available when your children are able to take it over and run the operation.

Test your children

Now that you have put together your management gap program, you will need to make sure that your children are ready and able to take over the company. The only way this can be accomplished is through a progressive testing program, giving your children more and more responsibility.

As with passing the business to your managers, you must test your children to make sure they have the ability to run the company after you leave. In many cases you will be dependent on their success for your financial well being later in life. It's important that you have confidence that your finances will be well taken care of after you leave your business.

You will want to work with your children and managers to progressively give your children more responsibility for key areas of the company. This can be difficult in two ways. First, it's just plain hard to give up authority for tasks in your company. The second is family dynamics. Many children and parents have developed poor communication skills over the years for corrective actions that need to be taken. However, in the workplace, corrective actions need to be taken on a regular basis.

You as a parent will need to let your children make mistakes and your children will need to hear your constructive comments on an employer employee basis. Having your management team involved in this process can be a huge help. Many times your children will hear how to do things better from your managers than from you. So, if you have a bridge management system put in place, you will then be able to use your managers to help you develop strategies to teach your children management lessons they will need to learn.

Also, having your children work in an outside organization will give them an understanding for how the business world works. When they come to work for you in your organization they will not only bring new and fresh ideas with them, but will have had some experience of making mistakes and having them corrected by others.

So, as you plan the transition of management in your company and your children are part of that transition make sure you first have a system in place for training your children and second a system that will allow them to have more responsibility. When mistakes happen, make sure you children learn from those mistakes by knowing what needs to be done next time that situation arises.

Finally, when you delegate a task to your children, make sure that delegation stays with the child. Your employees will want you to get involved in situations where your children are responsible. It's important to make sure you don't take the power of supervision from your children. If you do this by solving problems that are supposed to be solved at other places in your organization you are giving your people the message that you are still in control. If, on the on the other hand you make the person who has the problem work though it with their supervisor, (your child) then you will showing confidence in your children and helping them gain the authority they will need in becoming successful managers.

The mechanics of succession

You have decided that you will have your children take over the company. You also have a training program and they are well entrenched in the company and working out well. Now, it's time to start thinking about how you can actually transfer ownership of the company to your children with the least tax effect.

To do this you will want to look at what current tax law allows and take another look at what your own financial needs are. If you have accumulated enough assets outside the business and have reached the point of financial independence, then the decisions will be pretty easy. If, on the other hand, you do not have adequate assets outside the business, then you will need to have the business provide income for you for a period of time after you formally leave the company.

The goal in doing a business transition is to first take care of your personal financial needs and then look at economically feasible ways of passing the business to your children. If you don't work in the order suggested above, you could put yourself in the uncomfortable position of having to go back to your children at a later date and ask for more money. Most parents that we work with do not want that to happen.

The personal financial analysis

In the next chapter we will cover financial planning in depth. When doing the planning for having your children take over the company, first you must understand what your personal financial needs are. This would start with what we call the liability analysis. In other words, what are your cash needs on an annual basis. This needs analysis should be done taking into account any additional spending you may have for more travel or additional medical expenses down the road.

Remember, our goal in working with our business is to have our business work for us. This is certainly true in the realm of financial support that comes from the business. Many times owners and especially founders will have underpaid themselves for years to get their business off the ground. Also, many times when it comes time for passing the business to the next generation your business is just starting to provide you with the financial rewards you were hoping would come your way.

You may find that you have not put away enough money for the future and you will need to find some ways to provide income for you in the future. The two ways this can be done is through the business purchase or through a deferred compensation program for continued income in later years after you formally stop working.

The psychological aspect of leaving your business

You will not only want to examine if you have enough money to leave the business, but will also want to know what's next in your life. You have spent the last xx years building and running your business. Probably a great deal of your social interaction will has through your business contacts.

The unfortunate thing about leaving your business is that most of the business contacts you have built during the years will disappear. Many of the people we work with report that after they leave their business, they find that the phone stops ringing.

The more you have been involved in having your business provide your social support, the more dramatic this change in your social status could be. In effect, the day you stop coming to the office, will be the day that many of your peers will stop calling. It's not because they don't like you any less, it's just that you have fallen off the radar screen and they don't think to call. Also, their life is busy and unless you can add value to other people's lives they will tend to stop calling.

So, when it's time to leave your business, make sure that you have other activities that will fill your time. You have spent years using your brain to make your business grow. Before you move on, make sure you have some ways to keep yourself involved and active. For some people this will mean doing volunteer work, for others it might involve starting a new operation and for still others it might involve going back to school to start a whole new career.

It doesn't matter what you decide to do as long as you have something in mind that will help you keep involved in active. This way you will develop new contacts and friends that will help you maintain the social contacts that we all need and want.

Ownership issues

You have now worked through your cash needs and psychological needs for passing your business on. Now, it's time to actually start planning for the transfer or ownership and control of the business. Unfortunately, Uncle Sam waits to become a large partner in this part of your business transition unless it's done properly. For this reason, I suggest that you become familiar with several discounted ownership transfer strategies that are available for closely held businesses. This includes family limited partnership, stock reclassifications and minority share discounts. All of these programs allow you to pass ownership to your children for less than full fair market values.

The type of transfer that you will use will depend on the financial needs that your business will need to provide for you. If you have no financial needs from the business, then you will be able to use any discounted method of transfer you want to use. If, you need to have some financial needs continue to be met by the business after you leave, then you will want to control over the company, but not necessarily ownership.

Most of the time we find that owners of the business will have continuing financial needs so we want to use structures that allow ownership to be passed for estate tax purposes, but the senior family members will still want to maintain control over the company for a period of time. For this sort of arrangement we will often use either the Family Limited Partnership or the use of voting and non-voting stock in the Sub Chapter S Corporation. (We will be covering different corporate structures later in the book.)

The key to using both of these corporate structures is to know that you will control the business through either voting stock or being the general partner in the partnership. Both of these arrangements allow you to hire and fire management and make key decisions in your company. This is important because your financial future is still tied to your business. You will want to make sure that your security is just that, secure. The best way to accomplish this is through control over your company. Having control over your company does not mean having to make the day-to-day decisions about what is happening in your company. What it does mean is that you are involved in setting direction and working with your management staff to make appropriate long-term decisions for where the company is going.

When deciding which structure for passing your business is appropriate for you, it's important to bring your advisors into the loop. Again, if your advisors are not specialists in helping you design which mechanism

works best for you, ask them for a referral to a professional who specializes in this sort of work.

Who should own stock

Now that you have decided that you are going to pass stock to your children, you next need to decide who should own that stock. I believe that it's very important for ownership of the company to be passed to your children who are going to work in the company. I think that it's very important to have the stock be restricted and it only to be allowed be owned by those who are actively involved in the company.

Later we will cover ways to equalize your assets between your children. Most of the parents we work with want to make sure all of their children are treated equally. We encourage our Clients not to use the business to equalize assets passed to their children.

The reason we don't want to see this happen is because all businesses need cash to operate and grow. We find that children in the business will want to retain the cash for growth and children outside the business will want dividends to be paid. Most smaller companies can't afford to have both done. To make sure that you don't have this sort of fight between your children it's important to make sure that only family members in the business get to own stock in the business.

The family council

When your preferred choice to pass ownership of the business is to your children, we like to see a family council established as the structure to talk and plan for this transition. The family council would include both spouses and all children who are over fourteen years old. At these meetings, discussions are held about what is going on in the business and what everyone's long-term plans are for their involvement in the business.

When your children are young, you will not expect them to have a very active conversation in the business, but you can start to teach them about confidentiality and how the business works. This also gives you an opportunity to talk about the good things that are going on in your business and things that you are excited about. As your children get older, you will be able to include them in more in depth conversations about business operations, philosophies and your thoughts about how to integrate the business with family wealth issues.

When your children are in their twenties you may find that some of your children are involved in your business and some of your children are not involved in the business. Your family council meetings will change to not only talk about the business, but family wealth issues as well. One of the mistakes we see families make on a regular basis is not talking about family wealth issues. If you have a successful business and want to treat your children fairly, this conversation needs to come up. Typically as your children move into their twenties, you will be moving into your fifties. Although you may not want to make any serious estate planning decisions at this point, you will want to start thinking about what your options are.

My belief is that the more open you are about your plans, the better your family can communicate. The family council is a great place to discuss not only company ownership issues but your reasons for making the decisions that you are making. You will hopefully set time aside for an open communication period where everyone in your family will be encouraged and allowed to participate in letting others know their feelings about not only the family business but the family in general.

If you are involved in a second generation business and would like to move the business to a third generation, then you will not only be dealing with your own family, but in many cases siblings and cousins. The family council in this situation may just be involved in business issues. These conversations should cover requirements for participating in the family business as well as control and ownership issues.
In the third generation it becomes even more important for family members to know that the business is not a money machine. It is a structure that can provide a good living and satisfaction, but it will need to be nurtured and grown to continue being successful. The family council in this stage of the business allows the senior members of the family and their spouses to set a course for the continued success of the business and their own personal financial security.

Many times you will want to use an outside facilitator for this stage of the formation of the family council.

With the different family dynamics that are often present, it's important to make sure different viewpoints are accounted for and the needs to the different factions of the family are given credence and voice. Having a professional will help you with the successful transition of the business and hopefully keep everyone speaking to each other.

Liquidation

The last way you can leave your business is through liquidation of the business. Most of us don't want to leave our business this way, but there is the chance that this is in fact the way many businesses are closed. Liquidation can be a positive event if the proper planning is done. If not, liquidation can be very unpleasant and in fact, end in bankruptcy proceedings.

If you have decided this is the way you want to exit your business, then you must make plans to have your business provide extra income while you run it for retirement purposes. Very few businesses will have enough value in liquidation to provide for a comfortable retirement for the owners of the company.
Planned liquidation as a way to leave your company

If you are the type of business where there is no ready market of buyers for your company and you don't have and do not want to develop managers who can take over the company, then at some point you will want to liquidate your company. Many construction companies, small professional service companies and smaller retail stores will fall into this category.

These companies can have very successful runs and provide the owners of these companies a very nice income while they are being run. However, when it comes time for the owner to leave the business they will not have a buyer available that will be able to pay them a reasonable amount of money for their business. For these types of business it's very important that you have a strategy for putting money away every year for retirement purposes.

When liquidation is the planned way for you to leave your company, then you must do a financial plan to find out how much outside assets you will need to reach financial independence. Financial independence is defined as having enough assets outside the company where you would not have to work anymore. Working with a qualified planner will help you develop this number. Remember, when you are developing this analysis, you will want to err on the side of conservatism. It's better to have more money when it's time to leave your business than fall short.

After you have completed a financial plan to find out how much money is needed to leave your business, you can then start to develop a plan that will help you get there. One of the best methods of putting away a lot of money is using a qualified retirement plan. Later in this book we will got through your options for retirement plans. For the present time, understand that if you can have the government help you save for your retirement, then this is what you want to do
.
Once you have reached financial independence, then the time you continue running your company is up to you. Again, as with moving out of your career under any scenario make sure you know what's next for you in your life. Running a small company and then liquidating the company will leave a void in your life. If you have any idea of where you want to go and how you would like to spend your time then you will be happier than leaving with no plan.

The other side of liquidation, bankruptcy

The other group of people who end up liquidating their company are those who run across severe financial hardships in their business. These are the people who will have to consider bankruptcy as an option for them to get from under the debts their company has produced. None of us want to be in this position, but there is a portion of the population who ends up here and will need some help along the way.

There are two types of bankruptcy, the first is Chapter Eleven where you will try to reorganize your company and come out with an operating company that can stand on it's own two feet. Many companies who choose this route do have a plan for coming out of bankruptcy. Others are buying time to find a buyer who can help them pay off some of their creditors.

The second type of bankruptcy is Chapter Seven. This is where the business is liquidated and suppliers of the business split on a discounted basis bills that are owed to them. Under Chapter Seven, the owner of the business will often have some severe problems with creditors who have secured the money that has been loaned to the business.

If you think that there is any chance that you will end up in either of these situations, it's imperative that you get help from advisors who work in this area on a regular basis. However, it's also important that when you choose an advisor to help you through this situation you don't choose an advisor who will put you in bankruptcy because it's a way for them to increase their fees.

Well before you think you might need the help of a bankruptcy expert start investigating what your options are. As with all planning opportunities, the more you know about your options and the farther out in time you have to make a decision the better your chances for making a decision that is good for you and your family. If you have to liquidate your company through bankruptcy, then knowing the rules and having the proper amount of time to plan is crucial in making a bad situation tolerable.

Conclusion

As you can see under all four ways of leaving your business there are many subsets of how you can leave your business. However, when you break it all down, there are only four ways to leave your business.

Planning for your preferred method of business transition can improve your bottom line considerably. If you want to sell to an outsider you can position your business for maximum sales prices. If you want to pass the business to your management staff or children, then you can plan to become financially independent before you actually start transferring stock. Finally, if you think that liquidation is the way for you to go, you can make plans that you are financially independent well in advance of the actual time you will leave your company.

The key under each of these scenarios is having enough time to put together the other plans that you need to employ. We will continue hitting on the theme that early planning will allow you more choices along the way. We find that with our Clients, the more choices we can provide, the better our Clients feel about the final choice they will make.

Finally, understand that there is no rule that if you are leaning towards one way of leaving your business that it precludes you from using any other exit strategy. Taking the time to learn what your options are will make the actual leaving of your business that more pleasurable.

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