A Better Way:

Business Succession Planning: Funding the Plan [1]

By G. Timothy Leighton [2]

There are two basic sources of funding your business succession plan. Either the seller funds the transition plan, or the buyer does. How you fund the plan will affect the price, the terms, and the subsequent involvement of the selling owner.

Some owners adopt formal or informal succession plans. Many owners who write and sign buy-sell agreements neglect or forget to fund such agreements, either in whole or in part. As is true with many business issues, those who plan ahead can typically achieve the desired result with lower costs than those who react at a time of crisis, emergency or opportunity.

When the selling owner elects to fund the succession plan, the choices typically range from insurance policies to external lines of credit to internal sinking funds. Sometimes the business transfer results from the death or disability of an owner. If the other owners, or the business, has paid life insurance and/or disability insurance premiums, then the insurance company would be expected to deliver insurance policy proceeds that would fund the deal. Of course, there are administrative, mortality and morbidity costs associated with insurance, so this option can be pricy. Sometimes business owners establish lines of credit that they can tap to fund the buy-out. Others put a portion of revenue and/or profits into reserve, building an internal "sinking fund" to fund the deal. Any of these options involves a burden on current business cash flow to fund the future result.

A creative alternative involves establishment of an Employee Stock Ownership Plan (ESOP). This approach allows the existing enterprise to set aside funds with the dual purpose of funding retirement for key people and also funding the entrepreneur's exit strategy. Changes in tax, labor and other laws make this pursuit challenging and potentially expensive.

The major alternative to seller-structured financing is for the purchaser to line up funding. Naturally, the simplist approach would be for the buyer to pay the price at closing. Under this approach, after closing, the seller receives no further money or information on the business from the successive owner. If the buyer cannot deliver the full price from its own resources, then the buyer would need debt or equity or blended financing from either the seller or a third party.

When financing is involved, the traditional approach is for the buyer to line up investors and/or lenders. If this effort yields sufficient funds for the buyer to pay the full purchase price to the seller at closing, then again, the seller would receive no further money or information from the buyer after closing, and the seller would receive full price. A buyer might offer a reduced price in exchange for seller getting an immediate capital influx up. This line of thinking would

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[1] ***Important note***: *This information is designed to provide a general overview with regard to the subject matter covered. The author and publisher and host are not providing legal, accounting, financial planning or specific advice to your situation. You should consult with the professional advisors of your choice for specific advice.*

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reflect the costs of financing, such as application fees and interest. A prudent lender would require reasonable cash flow expectations from the successor enterprise. And the parties would need to determine how to collateralize the deal so the capital provider would have adequate security.

In response to a buyer's suggestion for a price reduction under this set of circumstances, a seller might well think that since the buyer has control over terms, or at least the seller does not have control over terms, there should not be a price adjustment. Yet, if the enterprise has sat on the market for some period of time, or the seller is convinced of the buyer's necessary costs of arranging the transaction, then the seller might indeed concede to a lower price.

The logical alternative to third party financing would be seller-held financing. Typically a buyer would pay a portion of the purchase price in cash. Then the seller would hold the balance in the form of a promissory note. A purchaser typically likes this arrangement because of the expectation that seller terms and conditions are typically more favorable and/or flexible than what a third party lender would impose. Parties recognize that a motivated seller will agree to such terms. Often this arrangement does not require underwriting or placement fees that institutional lenders tend to impose.

However, a savvy seller may require a premium rate or other compensation to cover risk. Naturally, such a deal requires sufficient collateral. That savvy seller may also derive tax benefits by structuring the deal to qualify for perks inside the income tax code. The most typical example is the installment sale that defers recognition of some capital gains during each year of the agreement.

Sometimes, a seller retains an equity interest in the enterprise. This approach is commonly used when the purchaser has a short-term need for cash and would prefer to give value to the seller through future payments of dividends or liquidation proceeds. Yet, this method of payment works primarily if the seller believes that the purchaser will add value to the subject business after the closing. For example, a "retiring" seller who does not have a particular need for cash and has extreme confidence in his successor may be amenable to this arrangement. That same seller might take a consulting or advising role with the succeeding business, perhaps for a defined period of months of years, and receive payment from the buyer of a consulting fee. This fee might also be the funding of a non-compete agreement.

Caution is in order for the seller, since the seller's retained interest will likely be one of a minority shareholder. Therefore, to avoid the negative aspects of being a minority shareholder in an entity having no public market for its securities, the seller should consider requiring that the purchaser grant to the seller mandatory buyout terms, a forced cash distribution formula, and other important provisions in a shareholder agreement.

Yet another blended alternative can involve a contingent price method of payment. In this arrangement, the buyer tenders a portion of the purchase price at closing, and a yet-to-be identified balance is to be paid upon the happening of one or more contingent events. The contingent price method of payment is often used when the parties cannot agree on the weight afforded to the historical data or if some uncertainties as to value exist (because of pending litigation, for example). The actual purchase price may be contingent on the future performance of the business after an agreed period of time has lapsed or upon the outcome of the litigation.

When the goal is to preserve the value of the business when you are no longer in business, then the business owner needs to plan for how to fund the transfer to the new owner.

The alternative is to recognize that failing to plan is the equivalent of planning to fail. Said more positively, planning how to fund the transition should maximize the sales proceeds and minimize the succession cost. To manage the impact on estate and/or gift taxes as well as potential capital gains benefits, wise entrepreneurs involve their professional advisors early in the planning process.