

Conquering the Mergers, Acquisitions and Business Succession Processes

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Some Family Business Statistics

- Family businesses comprise 80 to 90 percent of all business enterprises in North America (Family Business Review, Summer 1996)
- Family owned businesses account for 60% of total U.S. employment, 78% of all new jobs, and 65% of wages paid (Financial Planning, November 1999)
- There are 1.2 million husband and wife teams running companies (NFIB 2003)
- 35 percent of Fortune 500 companies are family firms
- Only 40 % of family-owned businesses survive to the second generation, 12 % to the third, and 3 % to the fourth

Some Family Business Statistics *continued*

- Nearly 40% of family businesses in America will be passing the reigns to the next generation over the next five years
(BusinessWeek, August 11, 2003)
- Of CEOs due to retire in 5 years, 55% have not yet chosen their replacement (Arthur Anderson/Mass Mutual, 2003)
- 25% of senior generation family business shareholders have not completed any estate planning other than writing a will, 80% want the business to stay in the family, and 20% are not confident of the next generation's commitment to the business

Most Family Businesses Lack...

- Having a written strategic plan
 - ✓ Recent polls show only 37% of businesses have implemented a strategic plan
- Buy/sell agreements
- Formal redemption plans
- Formal company-share valuations
- Hold board meetings
- Hold family meetings
- Establish policies for employing family members
- Selection of a successor

Attributes of Successful Transitions

- Leader into the next generation: is it clear?
- Accountability vs. entitlement
- Outside counsel respected (non-family)
- Business focus v. family focus
- Professional organization
- Conflict resolution/decision making process thought about in advance of conflict

Attributes of Successful Transitions *continued*

- Financial metrics understood
- Clear definition of roles
- Opportunity for ownership available to non-family employees
- Recognize challenges to transition plans

Results of Poor Succession Planning

- Not building a business with transferable value
- Not creating sufficient personal liquidity and net worth to fund lifestyles
- Not tending to family needs and interests
- Quick decisions without careful deliberation
- High employee turnover
- Reduction in productivity
- Client Service Issues
- Succession by unqualified candidates

Successor Candidate

- Identify successors early on
- Identify several possible candidates
- Consider incentive plans
 - ✓ “golden handcuffs”

Transferring Ownership of Business Interests

- Distinct from transferring management responsibilities
- Failure to plan can result in the transfer of business based on state inheritance laws
- Results can be devastating – taxes, ability for business to survive

Transfer Options

- Ownership can be transferred slowly or all at once; during life or after death
- Transfer options can include either a sale, gift, or combination of both
- Determining appropriate value for transferred interest
 - ✓ IRS requires appraisal from certified valuation analyst in many cases

Selling Options

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Redemption:

- Corporation reacquiring its own stock
 - ✓ Trying to fund transfer of interest with least amount of income tax
 - ✓ Important when business is to stay within family
 - ✓ Stock can be redeemed from estate to pay for taxes and administrative costs upon death

Cross Purchase:

- Owners enter into agreement to purchase each other's interest on the occasion of certain events
 - ✓ Attractive option for unrelated owners
 - ✓ Agreement often provides formula to determine price
 - ✓ Often funded with insurance purchased by each owner on the lives of the others

Checklist: Selling Options

- ✓ Determine source of funds to make acquisition
- ✓ Provides comfort to have agreement in place and can be accomplished with little interruption

Installment Sale

- Permit sales proceeds to be collected over time, delaying payment of income taxes
 - ✓ Consider private annuity or self-canceling installment note (SCIN)
 - ✓ Annuity-purchaser agrees to provide lifetime annuity payment to seller based on life expectancy

- Self-canceling installment note
 - ✓ Similar to other installment obligations except one additional feature
 - ✓ If seller dies before maturity, any further obligation is forgiven
 - ✓ In contract to annuity, purchaser entitled to deduction for interest portion of payment

- Employee Stock Ownership Plan
 - ✓ Excellent vehicle to give employees ownership in business
 - ✓ Provides benefit to employees on a tax-deductible basis
 - ✓ ESOP permitted to own stock of employer corporation

ESOP: Advantages

- ESOP cannot discriminate
- Corporation can transfer cash to ESOP to use to purchase stock
- Corporation obtains income tax deduction
- Upon sale of stock to ESOP, no taxable gain recognized to the extent proceeds are reinvested (C Corp)
- Gain recognized when “replacement securities” are sold
- To qualify, ESOP must own at least 30% of outstanding stock of employer corporation

Income Tax Considerations of Sale

- C-Corporation vs. Pass-Through Entity
- Stock Sale vs. Asset Sale

C-Corporation vs. Pass-Through Entity

- C-Corporation
 - ✓ Two levels of tax (for sale of assets)
- Pass-through Entity
 - ✓ One level of tax

C-Corporation | Stock Sale vs. Asset Sale

- Stock sale better for seller (one level of tax)
- Asset sale better for buyer (step-up in basis and release of liabilities)
- Consider allocation of sales price for asset sale (i.e. Goodwill)
 - ✓ Martin Ice Cream Co. (1998) 110 TC 189
 - ✓ Covenant not to compete is ordinary income for seller

C-Corporation | Other Considerations

- Tax-free reorganization under Sec. 368 (sell stock for stock in another corporation)
- Liquidation of C-corp same effect as sale of assets
- Sec. 1244 loss may be available for sale of small corporation stock (same for S-corp)
- Sec. 382 issues when more than 50% change by a 5% shareholder in a loss corporation

S-Corporation | Sec. 338(h)(10) Election

- Treat as asset sale for tax purposes but as stock sale from a legal point of view
- Beneficial when there are difficult assets to transfer ownership
- Buyer must be a corporation

Sell to Family | Concerns

- Successor competency
- Usually little cash up front
- Generally low value
- Family issues, nepotism
- Legacy
- Better control of timing
- Discounts are valuable
- Estate planning potential
- Family unity is successful
- Family discord
- Capital gains

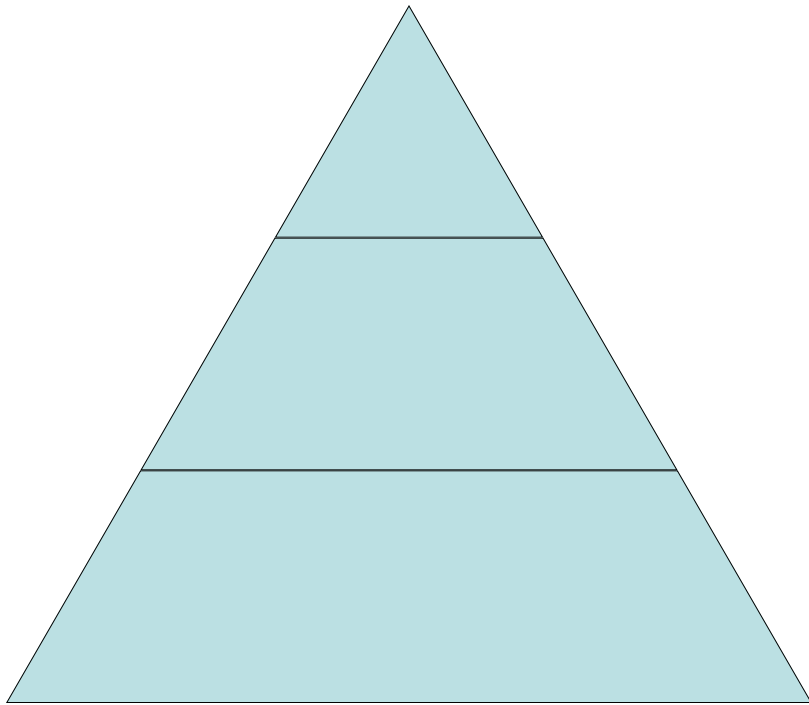
Sell to Key Management

- Usually little cash
- Low net worth of successors
- Competency issues, training issues
- Usually lower sales price
- Legacy is left
- Capital gains
- Retain key management
- Cash out excess assets

Sell to Competitors

- Ready market (potentially)
- Better price
- Cash up front
- Business familiarity
- Excess asset issues
- Disclosure of info issues
- Economies of scale
- Faster exiting
- Effect on employees
- No legacy
- Tax effects

Sell to Private Equity/Venture Capital Firms



- Value tied to uncontrollable future
- Capital gains
- Tight scrutiny from purchasers
- Ready market of buyer
- Better price
- Cash and stock
- Employment agreements

Go Public

- Tough to do
- Expensive
- Better price
- Regulatory oversight (Glass walls)

Preparing the Business for Sale

- Strategically position for sale
- Develop the marketing strategy
- Prepare marketing materials
- Identify list of prospective buyers

Preparing the Business for Sale

- Develop valuation and build justification
- Organize company's records and data
- Prepare portfolio including financial information for prospective buyers

Valuation

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Valuation Approaches

1. Asset Approach

- ✓ Book Value
 - $\text{Net Assets} - \text{Liabilities} = \text{Book Value}$
- ✓ Adjusted Book Value
 - $\text{Assets at CMV} - \text{Liabilities} = \text{Adjusted Book Value}$
- ✓ Liquidation Value
 - $\text{Assets at CMV} - \text{Liabilities} - \text{Liquidation Costs}$

Valuation Approaches

2. Special Industry Approach

- ✓ Multiple EBITDA
- ✓ Multiple of Gross Revenues

Boost Your Company's Value

- Work yourself out of a job
- Empower your employees and build “bench”
- Improve your internal systems
- Create high NPS
- Clean up dirty laundry
- Build specialization, differentiate