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SUCCESSION PLANNING

THOUGHT LEADER FORUM

Minimizing conflict Maximizing return

As baby boomers reach retirement age, many are turning over the keys to their businesses. Some will hand them to a family member or a key employee, while others will seek an outside sale. Whatever the route, succession planning can be complicated at best and financially disastrous at worst. Four thought leaders recently got together to discuss the strategies to make the transition as seamless as possible. At the table were Jeff Bird from Lane Powell, Linette Dobbins of McGee Wealth Management, Sherri Noxel from Oregon State University's Austin Family Business Program, and Michael Lortz from Geffen Mesher. Maureen McGrain for the Portland Business Journal moderated the discussion.

Maureen McGrain: When there's not a family member taking over the business, how do you start succession planning?

Linette Dobbins: There are three aspects to consider: financial, legal and psychological. Anybody who starts a business should start with the end in mind. Consider what kind of value you are building in that business along the way, and what kind of team you are building that could take over. You bring someone in who is going to help build the business for that transition. Warrants may work well. You're setting the price today, but having them prove themselves first and funding that with a different compensation plan.

Sherri Noxel: Having a conversation with the family about the pending business transition goals will help prevent conflict and regret after the sale. Preparing the family for new opportunities that may emerge from finding an outside buyer will help continue the legacy beyond an operating business. Sometimes this means the next generation will exit the legacy business and start a new venture. This is often viewed as a business failure when in fact continuing the entrepreneurial culture into the next generation continues to benefit the family and the community.

Jeff Bird: The first question to ask is what are your goals and objectives? It may be to get as much money from the sale as you possibly can. Secondarily, some business owners want to create a legacy, so they're more mindful of a buyer who would treat their employees well, grow their business and continue the legacy. You've also got to consider what you need for retirement.

Michael Lortz: There's normally some tension between those. Most of the time, the largest sale price is probably not going to come from an internal sale to employees. Yet, often owners are very concerned about the wellbeing of employees. You have to plan to see whether or not you can accomplish both objectives.

Dobbins: That's the three-legged stool: You need current cash flow, investment assets pre-tax and after-tax funds and then money out of your business at some point. Whether you grow this other part independently so you can exit your business without having to feel like you have to get every single dime out of it is really important. Taxes are a big issue.

McGrain: How do you minimize taxes in a transition?

Lortz: There's the income tax piece of things, and there's the estate tax piece of things. You certainly don't let the tax consequences govern your decisions, but they should influence and inform them. What is the ultimate goal? Once you've decided what those bigger picture things are, there are a host of different strategies to pick from and consider.

Bird: I tell clients to plan for the event at least three to four years before the business transition because there are so many front-end loaded things that need to take place, and tax planning is one of them. For example, if you're a C Corp, and you want to convert to an S Corp because of the tax advantages, that takes time.

Lortz: There is the equity versus asset sale that people always talk about. Generally speaking, an equity sale is

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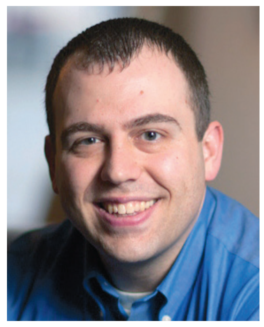
A. JEFFERY BIRD
SHAREHOLDER, LANE POWELL

Jeff has more than 25 years of experience assisting clients with complex business transactions. He has developed a niche practice in helping business owners plan for and execute business transition and succession plans. Jeff is a Certified Exit Planning Advisor through the Exit Planning Institute. He has been recognized by The Best Lawyers in America®, Super Lawyers® magazine and The Legal 500 for his M&A work. Jeff serves as Board Member and Vice President on the Northwest Chapter of the National Association of Corporate Directors and Chairs the Portland Advisory Board for the Northwest Chapter of the National Association of Corporate Directors.

SHERRI NOXEL, PHD
DIRECTOR, AUSTIN FAMILY BUSINESS PROGRAM, COLLEGE OF BUSINESS, OREGON STATE UNIVERSITY

Dr. Noxel designs educational programs and networking opportunities for Oregon's multigenerational businesses. She has received the Family Firm Institute's (FFI) Advanced Certificate in Family Business Advising, teaches the family business management course at OSU and serves on the board of the Family Enterprise Research Conference. The Austin Family Business Program has received FFI's Interdisciplinary Award, an international recognition of exemplary success in the delivery of education to family businesses.

Sherri's doctorate in Higher Education Leadership from Ohio State University supports her academic interest in the college experience of next generation family business owners.



MICHAEL LORTZ
SHAREHOLDER, GEFFEN MESHER

Michael Lortz, CPA, LEED AP is an experienced tax and accounting professional with significant experience working with family owned and other privately held businesses. Some of the projects Michael routinely works on include advising clients on the purchase or sale of businesses, assisting business owners with ownership transition planning, analyzing a company's entity structure with an eye toward tax and liability concerns, and participating in strategic planning conversations related to business expansion. He is a frequent speaker regarding tax updates and business transition planning. When he's not working with clients, Michael enjoys spending time with his wife and 5 children as well as serving as a board member or volunteer for a variety of non-profit organizations.

LINETTE DOBBINS
PRESIDENT & CCO, MCGEE WEALTH MANAGEMENT, CO-BRANCH MANAGER, RJFS

Since 1988, Linette Dobbins, CFP® has been a driving force behind the success of McGee Wealth Management, helping develop the business into one of Oregon's leading wealth management firms. As President and Chief Compliance Officer, Linette helps define and implement the firm's vision.

Linette demonstrates a talent for translating complex financial issues into simple, understandable concepts, and creating action plans to help meet clients' individual goals. Linette thrives on helping small businesses and multi-generational families manage and transfer their wealth.

Linette exemplifies the concept of contribution of time and talent to organizations such as the Circle of Giving that benefits women's health research at Oregon Health & Science University. Linette is a contributing speaker for several different organizations in the area.

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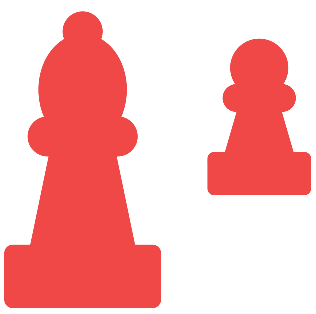
going to produce the best tax benefits to the seller. Sometimes it's similar to the results of an asset sale, but it's rarely worse. In some cases, an asset sale could be a lot worse for a seller. If your business is a C Corp and sells its assets for a gain, the corporation pays corporate tax on those gains. Then when it distributes that money to the shareholders, there's a dividend that is also subject to tax. That's the classic double-tax scenario that people talk about with C Corps. On the other hand, some businesses are organized as partnerships or LLCs, and many times an equity sale or an asset sale could produce similar results. So an equity sale versus an asset sale depends on the entity structure. And a significant factor is what the buyer wants because the buyer may insist on a particular deal structure, depending on if there are liabilities they're trying to avoid or if there are contracts that would be difficult to assign.

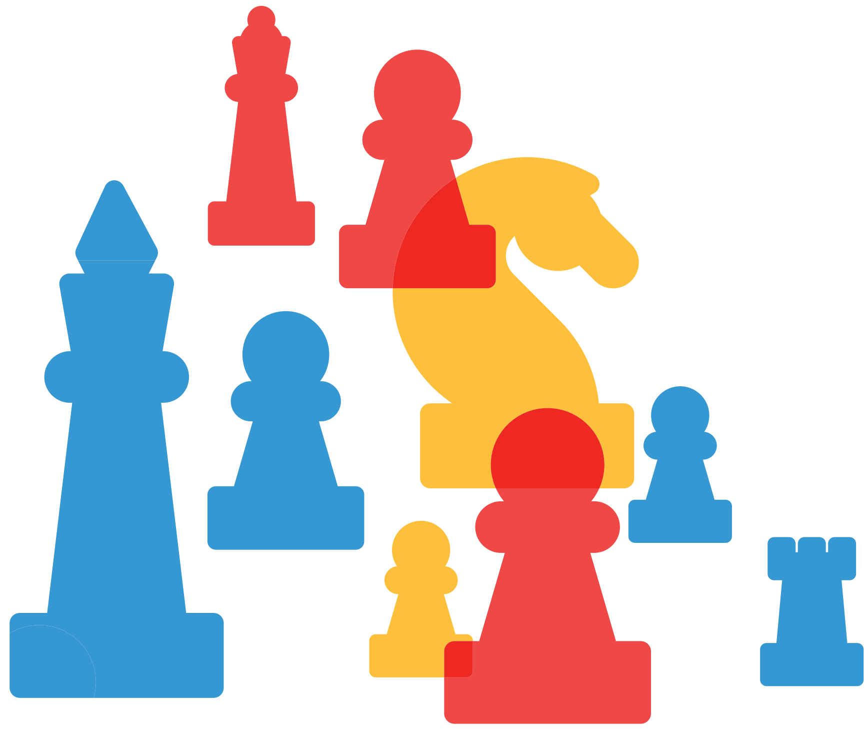
Dobbins: Depending on estate planning goals and other assets of the client and their cash flows, a charitable remainder trust might be appropriate for business owners to shelter some of that tax and get income throughout their life.



Bird: Buyers want to buy assets so they can limit liability. Sellers want to sell stock because all of the liabilities in the company get transferred to the buyer as a result of owning the stock. If a seller is stuck with an asset transaction, which often they are (because a buyer will often refuse to buy stock), there are ways to address and minimize taxes through the allocation of the purchase price, which is typically a negotiated decision between buyer and seller. How the purchase price is allocated can have a significant tax impact.

McGrain: How do you advise business owners who are passing the business on to a family member?

Bird: That's probably the most difficult succession transfer there is. Emotions always enter the picture and questions of fairness inevitably surface. I advocate adopting a family business charter early on in the evolution of the family business to help set expectations and minimize conflict. It's a document that sets forth the values and mission of the business, how family members can participate in the business, what's expected, and what the guidelines are for becoming an owner in the business. Sometimes you're expected to have a college degree and demonstrate interest by working in the business during summers. Sometimes you're expected to work outside the family business for a number of years. Whatever your values and guidelines are for participation, you can put it in a family business charter. The children will grow up with it, so when the time comes and one of the kids enters the business while the another one doesn't, they understand what the consequences of those choices are.



Noxel: Just as goals and objectives were important in a non-family transition they are even more important in a family transition. Owners should have conversations with all family members about the business at least annually. Waiting for the family business leader to retire and then looking to turn the intact business over to the smartest, or closest or most dedicated child puts the business at risk.

Lortz: Most of the time when people come to us to discuss transition issues, those kids are now adults, and they haven't grown up with a charter. Normally if we're talking about a transition from the first generation to the second, the owner hasn't been thinking along those lines. Frankly, they're usually shocked the business has done so well. Nowadays, these issues are often complicated by multiple marriages as well.

Noxel: The definition of family is changing and that affects how assets are passed on. The family charter can define who is family. Assets may be only passed along through the bloodline, for example. In a blended family, there can be new talent.

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The key is to lay it all out in a document and communicate that because transitions are hard enough in a nuclear family and can become quite contentious when it's a blended family.

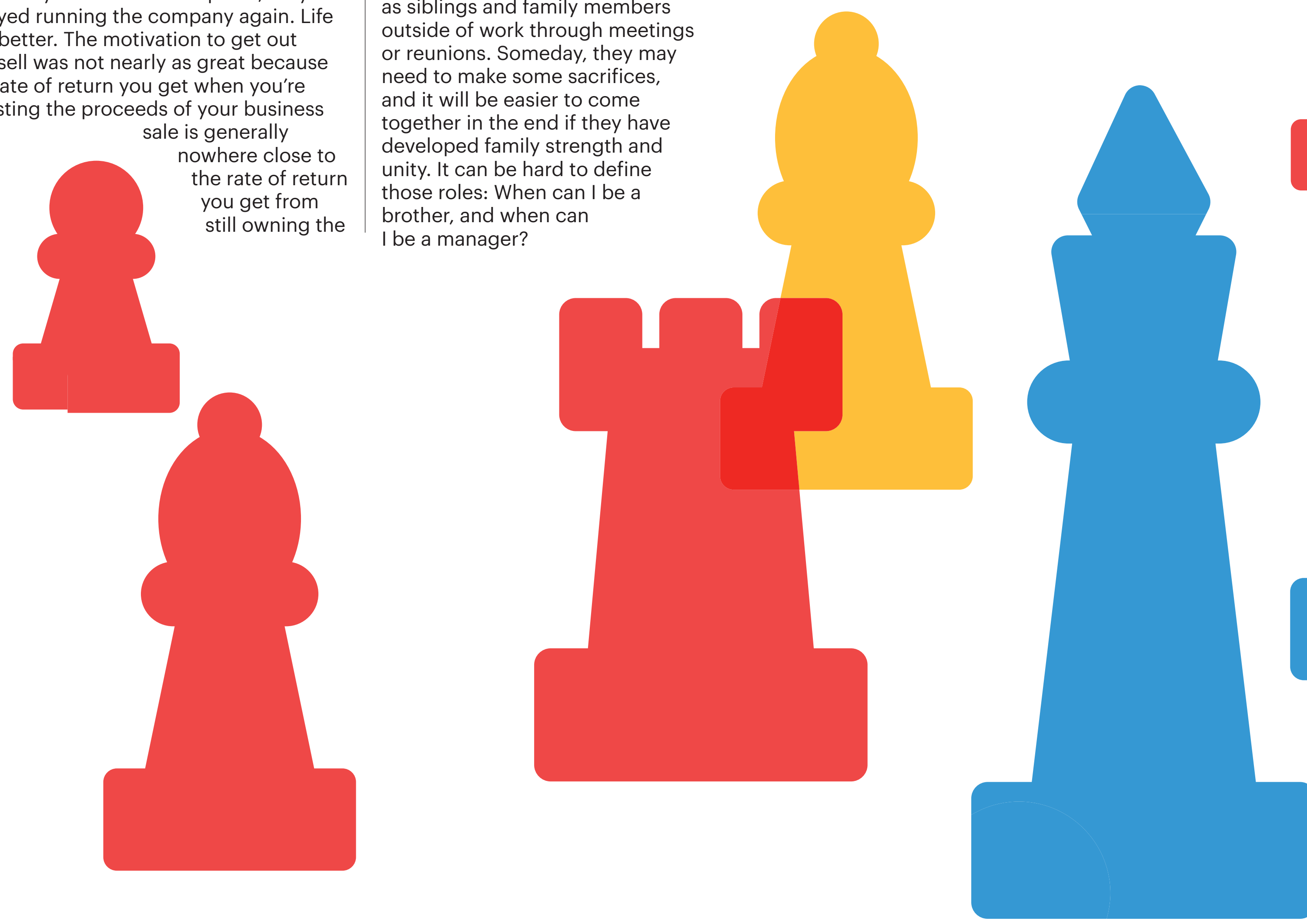
Dobbins: I am this example. We have three generations in our firm. My brother is not in the business. My mom and I have been working for 29 years together. I didn't always know this was my life's passion. You work through those things with coaches and counseling. You also have to consider transitioning from the tax aspect. For me to buy more shares of the company with after-tax dollars, and for her paying capital gains tax in Oregon, I add it up to be about 87 percent. Some business transition advisers have told my mom, 'You should just die with it.' There are gifting strategies. We've used the warrants early on. There's this issue of equalizing the estate when some kids work in the business and some don't, so how do you equalize that? Do you do that in your estate planning? You can equalize using other assets such as real estate and investments, or utilizing life insurance. There is also the psychological aspect. There is the founder of the business who refuses to leave. How does that affect the business and the next generation trying to transition? You get people working into their 80s, and then the next generation is getting closer to the retirement age. Are they going to buy your shares out knowing that they're not going to see a profit on them because they're paying you for the next 10-15 years?

Lortz: When there are two children and one doesn't work in the business, there are a few options to consider. First, one child may own the business, but there may also be real estate that is rented to the business that the other child owns. Second, in order to equalize an estate, life insurance can be obtained so that the child not working in the business ends up with cash that is roughly the equivalent to the business value. Third, for larger businesses with significant value, there may be an opportunity for that child to get involved in the family's philanthropy work. In terms of estate planning, there are a lot of reasons it makes sense to transition businesses to the next generation while the owner is still alive. President Trump could do away with the estate tax. But regardless, for our Oregon and Washington clients, we have very significant state estate taxes.

Bird: Communication is huge. Many businesses operate on the assumption that the children will work in the business, but they don't talk. They get to the point where they start to transition, and guess what? Jane isn't interested in owning the business. Jane has other dreams to pursue, and she has shown interest in the business in the past just to appease Mom and Dad. The founder has spent all this time and energy based on a false assumption, and has prepared for this, and now, it's not going to happen. Even worse is if Jane takes over the business out of guilt. Her heart isn't in it, and the business is not going to thrive. Secondly, you need to create a transferrable business. The founder can't be the person who has all the contact with the major customers. Some founders are control freaks. They don't create the level of management that needs to be there to sustain the business when the owner disappears. Lastly, how do you transfer control? Do you do it in one transaction or do you do it in stages to demonstrate that the family member is going to be a good manager?

Noxel: Letting go is an important part of stewardship of a family company. Recognizing that the next generation will most likely run the company differently to remain successful is the core of family business succession. The next generation will have to innovate to thrive but their challenge will be honoring the founder's legacy and values while leveraging the family's assets to grow.

Lortz: Creating a transferrable business is pertinent to increasing the value of the business regardless of whether it's going to the next generation or to an outside party. We've had clients motivated to sell the business because they aren't having fun anymore. They have many responsibilities that they shouldn't do and need a management team that shoulders those responsibilities. If they don't, it will negatively impact the value of their business. We have seen some situations where the owners were motivated to hire a management team to increase the value of the business and sell it, but found that when they had the team in place, they enjoyed running the company again. Life was better. The motivation to get out and sell was not nearly as great because the rate of return you get when you're investing the proceeds of your business sale is generally nowhere close to the rate of return you get from still owning the business.



Dobbins: You need to be working toward retirement readiness. Most entrepreneurs' identities are wrapped up in what they do. They need to create the financial plan but also a vision for what life looks like beyond the business and what role they want to play. Exiting the business doesn't mean you have to disappear. In fact, most people want you to stay on for a period of one to five years to be a mentor and help transfer the relationships. If you're that control freak, there's work to be done on your part to give up control and trust other people. To me, transition to the next generation is like raising a kid. You give them little bits of responsibilities along the way so they're growing their confidence and skill set and then they can fly on their own.

Lortz: Some families have an approach that the younger generation has to earn it. That is important if the organization is large enough with key employees and good managers already in place. How do those key employees feel about this? Are they going to view this transfer of the business merely as nepotism? If your values are such that the next generation needs to work their way up, that can go a long way to showing those key employees that this person is good at what they do and they've earned it.

Bird: That's something that can go in a family business charter. How do you earn it? When you're in high school, you get a part-time job at the loading dock so you learn about distribution. When you're home from college for the summer, you have a lower supervisory position. Clearly set forth what the expectations are and how you earn it.

Noxel: The key is governance, particularly if it's a big family with a large second generation inheriting the business. It is important to address their responsibilities as potential owners and set forth appropriate roles. It is also critical that families also develop their connections as siblings and family members outside of work through meetings or reunions. Someday, they may need to make some sacrifices, and it will be easier to come together in the end if they have developed family strength and unity. It can be hard to define those roles: When can I be a brother, and when can I be a manager? Define those roles so that everyone has the confidence and clarity to move forward.

McGrain: What succession readiness training do you suggest for employees who are not family members?

Bird: More important than training is to instill ownership thinking. One way to start to do that is to adopt a bonus plan tied to profitability or an equity plan where you use stock options. I prefer phantom stock. Use some type of compensation plan so that they see if the business is successful, they share in that.

Dobbins: The owner of the firm should start being quiet in meetings and let the management team make decisions, solve problems and take over projects. You can see how they're making those decisions and if they can think like an owner. Also, when you're that founding entrepreneur, what it took to build that business may not be the same skill set that it takes to take it to the next level. You have to pay attention to what the business needs today and who's going to fit those different roles.

McGrain: How do you go about finding a qualified buyer for an outside sale?

Dobbins: You want to have your ducks in a row with your professional advisers. The mergers and acquisitions people is the final step. If you're not quite sure and just want a valuation, the CPA or attorney can help do that. There are people who specialize in certain industries that are great resources for getting you ready. As for financing options, there are different ways to structure that. Sometimes there's a portion of cash and a portion of stock that you can redeem later when you make sure the transition is complete so you still have skin in the game to make that transition successful. There's also bank financing or private equity financing to get those funds on those sales when it's a non-family member or even with a family member. You can go seek financing versus the owner carrying the contract.

Lortz: I'd actually like to start with what not to do. You see this too often: A business owner who's been working very hard for many years suddenly gets a phone call from someone saying, 'I know someone who wants to buy your business. Let me send you this document to sign, which will allow me to represent you in selling your business. I have a great buyer, and they're going to pay you a great price.' If you're a business owner and happen to be at a weak point and owning the business has taken its toll, that can sound like an amazing out. What they ought to do is immediately forward that document to their attorney. That is a horrible way to start the business transition process. There are lots of reputable folks who can help examine the business to see if it's in a good position to be sold.

Bird: Broadly speaking, you have two types of businesses. You have Main Street and you have Wall Street. With Main Street,

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it's really tough to find an investment banker who's going to shop that business because there's just not enough money in it. Those folks are left to deal with people who will help connect buyers and sellers for a finder's fee. With the bigger businesses, $10-$20 million and above, you can get investment bankers involved who understand M&A, who understand the market, know what the trends are, and can provide the advice you need and have the contacts to find buyers and shop your business.

Lortz: There are some industries where there are people who specialize in selling just those types of businesses, even if they're a relatively small size. In some industries, the buyer is almost always a national brand. Depending on the industry, there might be a logical outcome.

McGrain: What other red flags should business owners look for when entertaining offers?

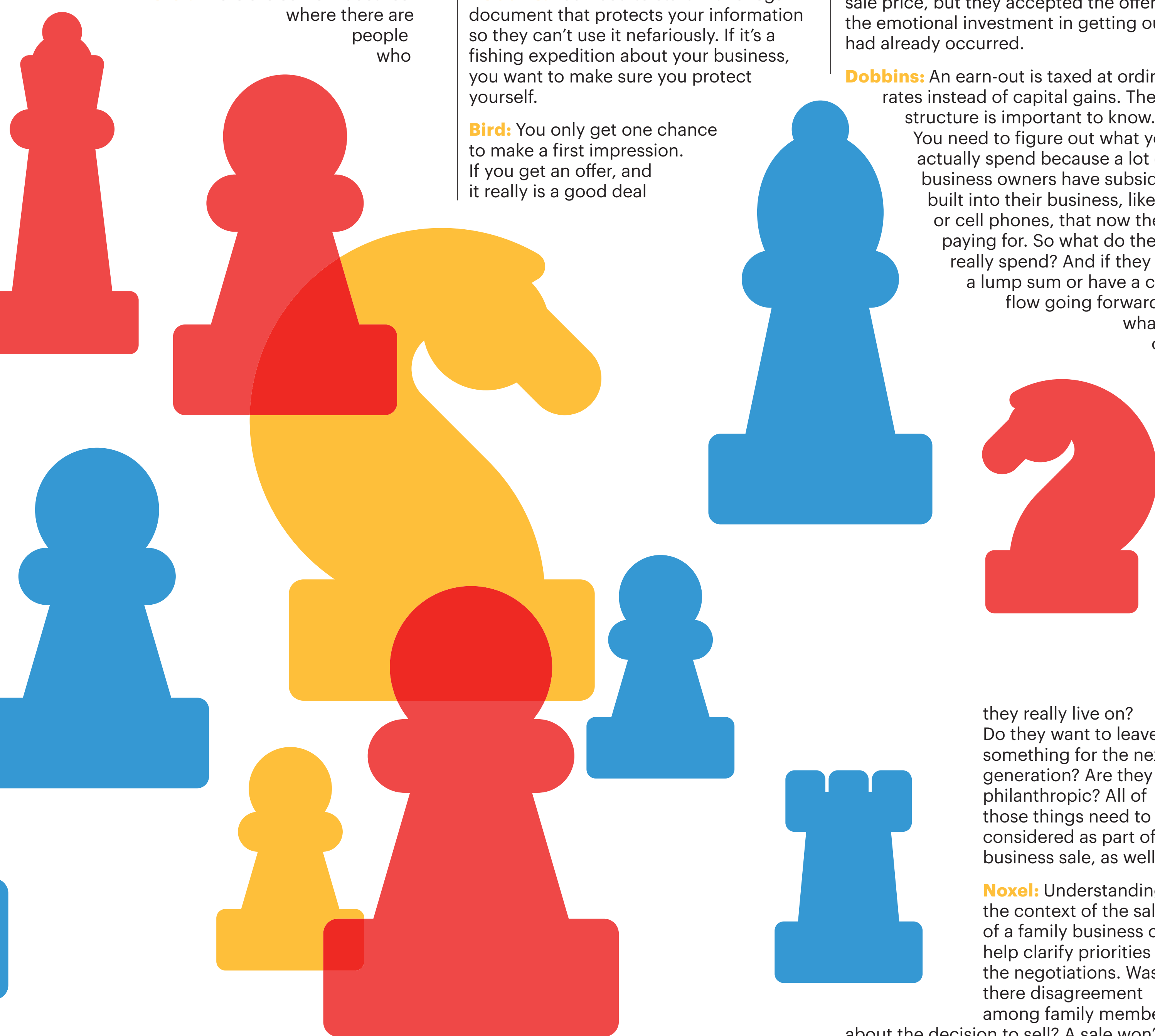
Bird: One red flag is the unsolicited offer when you're not looking to sell. Someone knocks on your door and says, 'I'll pay you $10 million for your business.' And because they haven't done any planning, the business owner will say, 'Wow, that seems like a good number. I had no idea it was worth that much.' That's problem No. 1: They don't know what their business is worth. They get led down the primrose path where a large number is dangled out there, and they start to engage with that buyer. They get swept away in the process and the prospect of making a lot of money. Usually going down that route leaves money on the table or worse, squanders a lot of time and resources on a transaction that falls apart.

Dobbins: You need to start with a legal document that protects your information so they can't use it nefariously. If it's a fishing expedition about your business, you want to make sure you protect yourself.

Bird: You only get one chance to make a first impression. If you get an offer, and it really is a good deal but you haven't prepared and your financial statements and books and records are not up to the standards the buyer would expect, the buyer is going to think, this business is not well run and the confidence level will plummet. It's the same thing with contingent liabilities or where you've misclassified your employees. Now there's this huge withholding liability that has been created and not paid. A buyer is likely going to walk away.

Lortz: It's a delicate dance in terms of information sharing and confidentiality. We had a client who was approached with an unsolicited offer. It was at a time when the ownership group was frustrated, and they were dangled a $65 million offer. The potential buyer had not even seen the financial statements yet. They were in the same industry, so it took quite a while before financial information was shared because both sides were quite concerned about each other as a competitor. Once that information was shared, the offer turned into a $35 million offer along with an opportunity to receive more if the company performed well, which is called an earn-out. It was a dramatic decrease in sale price, but they accepted the offer as the emotional investment in getting out had already occurred.

Dobbins: An earn-out is taxed at ordinary rates instead of capital gains. The structure is important to know. You need to figure out what you actually spend because a lot of business owners have subsidies built into their business, like cars or cell phones, that now they're paying for. So what do they really spend? And if they get a lump sum or have a cash flow going forward, what can they really live on? Do they want to leave something for the next generation? Are they philanthropic? All of those things need to be considered as part of that business sale, as well.



Noxel: Understanding the context of the sale of a family business can help clarify priorities in the negotiations. Was there disagreement among family members about the decision to sell? A sale won't necessarily eliminate future conflict and may divide the family more deeply. Was the family united in understanding that a knowledgeable buyer may be best for the long-term success of the business? Employee provisions may weigh more heavily. Sale earnings for a united family will be more easily leveraged to finance new family ventures, philanthropic activities or family office investments.

Lortz: If we have a client considering a sale of their business, we can prepare a quality of earnings report where we do similar due diligence to what a buyer's accountant might do. The buyer's accountants will end up looking for adjustments to the financial statements to normalize earnings and essentially look for ways to reduce the net income of the company. If we can identify those potential adjustments in advance, it can help our client get to a more reasonable net income number on which to base a valuation.

Bird: One thing I advise clients to do is deal with the big deal breaker issues up front. If you don't, you may get so swept up in the transaction and start thinking what retirement is going to look like as the transaction gets close to closing, that you cave on extremely important issues. For example, if there's an earn-out provision, one of the threshold questions should be how will the business be operated during the earn-out period? If you don't put it in the contract, the buyer will have great leeway to run the business how the buyer wants and the seller will likely lose out.

Dobbins: Investing in your professionals ahead of the game offers a bigger return at the end. It looks like an expense at first, but look at it as an investment because they can save you time and money. Even if the cost ends up in walking away from the deal, that can be a blessing, too.

Bird: You also should develop a contingency plan that sets forth in writing what should happen to the business if the owner should die unexpectedly. Without that document, often times everybody is left to guess what should happen to the business and how it should be operated during the transition period. In the contingency plan, you set forth how the business is to be transitioned. Maybe you provide for stay bonuses for key employees, so you don't lose them during this vulnerable time.

Dobbins: A buy-sell agreement should have a contingency plan in case of disaster. It can be funded or unfunded. Typically it's funded with a life insurance policy. Life insurance can solve many of those issues. If you're selling to the next generation either on a stock purchase plan or if it's in the family, you can use some of those gifting rules. Oregon and Washington don't have a gift tax; they have an estate tax. We have a family that owns a mobile home park, worth about $10 million, and it's in Oregon. All three are Washington residents, so they weighed the gifting versus the estate tax. When you gift it out, you lose the capital gains step up in basis, so for them, the estate tax may be less than the capital gains tax. So you really need to weigh that if you're going to gift the business to the next generation or dying with it. It's not one size fits all.

Bird: A covenant not to compete can be very important in transitioning the business. For example, you have key management in place that are essential to the business, and one of the conditions the buyer has is to keep those key employees working in the business post sale. After all the documents are negotiated, key management now understands they're an essential component to the sale. So now they have leverage. If you don't put in place properly enforceable covenants not to compete, you can be subject to the holdup by the key employee who now demands a very large bonus as a condition to staying with the business, and you have to pay to make the deal go through. Covenants not to compete are very difficult to enforce if you don't do it correctly and at the proper time.

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