DEFINING THE PROBLEM

- How to plan for the transition of the ownership and management of a business consistent with the personal and professional goals of the principals (equity owners) and the business plan of the Company
A Company and its principals have to be prepared for:

- An unanticipated death or disability of an equity owner
- A change in the position of the business within the marketplace
- An unanticipated offer to sell or merge
TRANSITION DEFINED

- **INTERNAL TRANSITION** – buyout of the equity interests of equity owners by the other equity owners or by the Company

- **EXTERNAL TRANSITION** – buyout by a third party as a sale of substantially all of the assets of the Company or by merger or acquisition

- **The Transition Process** involves:
  - the definition of the personal and professional goals of the equity owners
  - the development of a long term business plan for the Company
  - the valuation of the Company
  - an agreement upon what happens to the equity interests of the principals upon the occurrence of certain events and how the purchase of equity interests will be funded
  - positioning the Company for a possible External Transition
PARTICIPANTS IN THE PROCESS

- Senior management / equity owners
- Company CPA
- Corporate counsel
- Individual counsel / Individual CPA
- Estate planning attorneys for principals
- Insurance/financial planning professionals
- Business valuation professionals
VALUATION

- Use of valuation to define value upon the occurrence of one of the “Triggering Events” (death, disability or retirement of a principal, or involuntary transfer)

- Need outside valuation by qualified third party business appraiser coordinated through Company CPA (business appraisers, investment brokers)

- Define fair market value of the Company as a going concern

- Valuation factors
  - Balance sheet
  - Income
  - Goodwill
FUNDING THE PURCHASE OF EQUITY INTERESTS

- **Insurance**
  - Life insurance to fund buyout upon death of a principal
  - Disability buyout insurance
  - Long-term disability insurance
  - “Keyman” insurance

- **Payment from “Available Cash”**

- **Cash flow from operations in accordance with general accounting principles reduced by such amount as the Company deems reasonably necessary to meet the anticipated expenditures and liabilities of the Company, including (i) loans to principals who are creditors of the Company, (ii) distributions to principals to cover tax liabilities related to owning equity interests in the Company, and (iii) reserves for replacement of capital improvements for which adequate provision has not otherwise been made**
DEVELOPING A PLAN FOR TRANSITION

- Reduce to writing the personal and professional goals of the principals. How long does each want to work? How much income will each require during retirement?
- Develop long-term business plan
- Valuation of the Company
- Determine whether or not a principal may convey all or a portion of his or her equity interest to “outsiders”
DEVELOPING A PLAN FOR TRANSITION

- Determine what will happen to the equity of a principal in the event of his/her death
  - Entity purchase or cross purchase?
  - Mandatory or optional?
  - How will the purchase of the equity interest be funded?
  - What are the payment terms?

- Determine what will happen upon the disability of a principal
  - Entity purchase or purchase by equity owners?
  - Mandatory or optional?
  - How will the purchase of the equity interest be funded?
  - What are the payment terms?
DEVELOPING A PLAN FOR TRANSITION

- Determine what will happen if the equity interest is subject to an “involuntary transfer” - the bankruptcy of a principal, divorce of a principal, or equity interest subject to levy on execution
  - Entity purchase or purchase by equity owners?
  - Mandatory or optional?
  - Payment from available cash over a period of time

- Determine what will happen upon retirement of a principal?
  - Entity purchase or purchase by equity owners?
  - Mandatory or optional?
  - Payment from available cash over period of time
DEVELOPING A PLAN FOR TRANSITION

- “Tag-along” and “Drag-along” provisions
- Prepare and sign a Buyout Agreement including the terms of the agreements of the principals on these issues
VOTING AGREEMENTS

- Agreements among equity holders to vote their respective equity interests with respect to certain decisions and actions

- Purposes
  - to provide for orderly transition
  - to protect the interests of the equity holders as the transition proceeds

- Agreement to vote for election of directors and/or officers
VOTING AGREEMENTS

“Supermajority” Provisions – Define what actions will require more than a majority (typically two-thirds) to take certain actions

- issue additional equity interests
- asset sale by the Company
- merger transaction
- financing and incurring substantial debt
- hiring and compensation of upper management
- approval of annual budgets or capital spending plans
- acquire any other business entity or line of business
- dissolve the entity
POSITIONING THE COMPANY FOR AN EXTERNAL TRANSITION

- Business plan
- Valuation
- Voting agreements
- Buyout Agreement
- Covenants not to compete
- Retention of the upper management team who are not equity owners
  - Stock options / equity based compensation
  - Profit sharing
  - Bonus plans
  - Severance and change in control agreements
ESTATE PLANNING ISSUE

FOR PRINCIPALS

- Coordination with estate planning attorney and

- Financial planner

- Importance of accurate valuation of Company

- Equity interests for estate purposes

- Coordination of business planning, transition planning and personal estate planning is critical – the S Corporation example