LOOKING AHEAD – 2015
Are You Ready For the "D's"

Strategic Issues in the Apparatus Service Industry in 2015 and Beyond.

by: Pete Smith
C&S Associates, Birmingham, Alabama

STOP: If you meet any of the following criteria, you don't need to read any further.

1. You are a business owner or partner that wants to leave the emotional and financial costs of succession decisions to your spouse and family.
2. You have complete trust that your business partners will treat your family fairly in the event of succession.
3. You have complete trust that your family members will divide the ownership and control of the business as you would want.
4. You are an employee of a privately held company and are aware of the Succession Plan in the event of an unanticipated death or disability of the owner.
5. You are going to live forever.

Much of my 35 year career working with owners of apparatus service businesses has involved succession issues and problems.

Whether your objective is to sell the business to an unrelated party or transfer your ownership interest to current stakeholders, a Succession Plan is just common sense. Stakeholders include spouses, family, partners, key employees or anyone that has or may have an ownership interest in your corporation, LLC, or partnership.

Even if you have a previously prepared Succession Plan in place, there are three questions to ask:

1. Does the plan meet your current goals? Plans should be reviewed at least every few years.
2. Does it cover all the appropriate triggering events listed below?
3. Have you used all the tools needed to achieve your goals for ownership and control?

Case Study

In the separate text boxes below is an illustrative Case Study. It combines the key elements of two client assignments completed over the past few years where I quarterbacked the design of the Succession Plan.

TRIGGERING EVENTS – All the "D"s

Develop a good Succession Plan before the need for the succession occurs, while all parties involved are in an amicable and cooperative mood. No one knows when or who will cause the first trigger event.

After a triggering event where no plan exists, most situations become adversarial; amicability becomes hostility. Cooperation ceases and costs skyrocket as emotions override sound business thinking. **IT'S ALL ABOUT THE MONEY!** In the end, there are often estrangements between ex-partners, ex-spouses, family members, and other stakeholders in the business. No one believes that the outcome was satisfactory for them.

Most Succession Plans only deal with death, disability and sometimes reciprocal buy out arrangements. There are a host of events, the D's, which can trigger the need for succession.[i]

The "D's"

- Departures
- Discharge
- Death
- Divorce
- Disability
- Default
- Disqualification
- Disaffection
- Disagreement
- Disclosure
- Dispute Resolution
- Dilution
- Dividends
- Distributions
- Drag-along (tag-along) rights
- Double Entities
- Differential Pricing
- Don't Compete Agreements
- Donate
- Distributions after a trigger event

SUCCESSION GOALS

Every owner must clearly define his or her succession goals: primarily the goals for eventual equity ownership, the future benefit stream (cash flow), future voting rights and the gain or losses from disposition of the business sometime in the future. Other goals may also be defined.

It is critical to understand that these goals may be separated from each other using the tools described in the paragraphs to follow. Mark Zuckerberg, CEO of Facebook, does not own the majority of the outstanding stock, but he does control a majority voting interest in Facebook, a company with a total market value of $225 billion -with a “b”. (For a perspective, General Motors has a market value of about $60 billion.)

In addition to being separable, future changes in these goals can be set up in the Succession Plan. While a majority of the voting control can be assigned today to one party, future control can be designated to another party or generation.

My Client’s Goals

“To be positioned to pass the Company to my son if he wants it while treating my Spouse and other children equitably”

RELEVANT FACTS

Every client is different. For related party Succession Planning, every stakeholder and potential stakeholder, including key employees, should be considered. Information gathered about each stakeholder may include: extent of current ownership, family relationship, age, health, financial resources, marital status, management experience, technical ability, and willingness to be included in the succession.

Relevant facts about the company also need to be considered including future business outlook, projected cash flow, and major legal, tax, regulatory, or environmental issues. Counsel should review the corporate charter, by-laws, minutes and any buy-sell agreements for any prior alienation issues which might restrict changes of ownership.

Case Facts

Father (Client): CEO, 100% owner, Baby Boomer, bad health. Owns and leases real estate to the Company. Reasonable salary.

Father's Spouse: Works in Company office. No interest in owning or running business. Will need income from sale of business and lease to maintain comparable life style in the event of the Father's passing.

Son: Late 20's. Has worked at Company for relatively short time, left an unrelated career position, college degree. No significant financial resources – some remaining student debts. Intends to get married to new girlfriend shortly. Has child from prior marriage. Girlfriend has no prior children. Not sure at this time if he wants to take over business permanently.

Two Siblings of the Son (both over 18): Not working in business, no interest in active participation.

Company: Small business, reasonable profits and net cash flow, no significant legal, regulatory, tax, or environment risks. No major market or technological threats, reasonable expectations of continued future business. No alienation issues.

SUCCESSION TOOLS:

There are numerous tools that can be used to design a Succession Plan to meet the client's goals. Understanding and using the tools properly is the key to achieving the succession goals. To be clear, a KISS (Keep It Simple, Stupid) strategy is important. Only a couple of tools may be necessary; however, our purpose is to demonstrate the breadth of possibilities.

- Will: The most important tool in the toolbox. It continues to astound me how many owners do not have a basic Will. Please, you really do not want some probate judge deciding on the disposition of your assets, specifically your interest in your company.
- Trusts: Trusts are legal entities that are very useful for directing the use and eventual disposition of assets and related income.
- Buy-Sell Agreements: Agreements between equity stakeholders or potential stakeholders: absolutely a "must have" for equal partnerships. Establishes terms and conditions, usually with an appraised value or pre-determined valuation formula or methodology.

- Options: A contractual right to buy (a Call) or sell (a Put) some identified ownership interest at some future time or for some future period, at some pre-determined value, either at a specific price or using a pre-determined valuation formula or methodology.

- Pre-Nuptial and Nuptial Agreements: Allows for directed disposition of assets, including business interests, and defines future support in the event of a divorce. Note: 50% of all marriages today end in divorce.

- Employment Agreements: May reduce risk of key stakeholders leaving the employment of the company. Usually used in conjunction with the next tool.

- Non-Compete Agreements: Should reduce risk of stakeholders going into a competing business.

- Life Insurance and Annuities: Used for several reasons: such as buying out stakeholders, paying off debts, or replacing lower profits from loss of key personnel. Life insurance is integral to many Succession Plans.

- Disability insurance: Used to substitute for part or all of the continued expense to the company for an owner's disability or to purchase an equity interest over time.

- Real Estate Leases: Lease terms and conditions, including purchase options, are critical in the long term, but are often overlooked in the Succession Planning stage.

- Corporate Structure: Changing the corporate structure at the time of succession may have control and tax advantages. Splitting a company into two or more companies might be used to balance control between siblings. Removing the real estate from a company into another entity at the time of succession may make sense for future tax considerations.

- Capital Structure: In addition to common stock, there are other forms of equity in a company, although many of them have restrictions too numerous to detail here. Other equity forms might include preferred stock, convertible preferred stock, warrants, options, and other classes of stock. Generally these are used by larger companies.

- Non-Voting Interest: Within every type of business formation, i.e., corporation, LLC or partnership, there is the capability to create non-voting equity or assignment of voting rights, such as the Facebook example. Creating and using a non-voting interest can be a powerful tool for many situations such as gifting, selling partial interest, and allocating assets - but not voting rights - among family members

Other tools include, but are not limited to: profit sharing programs, debt guarantees, ESOP’s, REIT’s, and unrelated owner’s assets,

There are ample tools available to achieve most reasonable goals regarding ownership and voting interest.

BUSINESS VALUATION

A Business Valuation is an important cornerstone for every Succession Plan.

The Business Valuation supplies three things:

1. The current value on which to build the Succession Plan,
2. A methodology with which future valuations can be based when a triggering event occurs,
3. Highlights the strengths and weaknesses of the company from a succession perspective which is usually different from the perspective of day to day operations. These insights often provide guidance to the owner to improve the value of the business in the future.

THE MECHANICS

The professionals involved in setting up your Succession Plan are the mechanics that help you use the above tools properly. These professionals include your accountant, attorney, tax professional, life insurance agent, business appraiser, and banker.

Someone will also need to oversee the design of the Succession Plan and quarterback the implementation. Owners can do the design and quarterbacking. But with the myriad of tools available, it is strongly recommended that you use an experienced Succession Planner as the quarterback.

The costs for these professionals are not inexpensive. However, every professional that has done clean-up work in a situation where no plan exists, will vouch that these upfront costs for a Succession Plan, both financially and emotionally, are but a fraction of the costs that are incurred after a succession event is triggered where there is no Succession Plan in place. Is it fair to leave the emotional decisions and financial costs to your family and other stakeholders?

How We Designed the Client's Succession Plan

Created a Trust for the benefit of the Son's current child and his future biological children with the Son as Trustee.

The Trust purchased from the Father and his Spouse an option for a very nominal amount that, for a set period of years, the Trust could purchase the common stock of the Company. The value of the stock was set at 1.4 times the accounting (not tax) book value. The "1.4" was based upon a Fair Market Value Business Appraisal performed in association with setting up the Succession Plan. Terms included a long payoff period at a minimal fixed interest rate.

Lease was rewritten between the Company and the Father: specifying a five year term, three - five year options, price increases at the end of each term to be the lessor of 1) the cumulative change in the cost of living index, 2) the then fair market lease value of equivalent properties, or 3) 20%.

Lease also specified that in addition to the Company paying taxes, insurance, utilities, and normal maintenance, the Company would also be responsible for maintaining the roof, structure and all utility connections in a useable condition.

The Company accepted responsibility for all future leasehold improvements, all future liabilities related to the real estate and all environmental liabilities, past, present and future.

The Wills of the Father and his Spouse were revised such that the estate would be shared equally among the three children after the demise of both the Father and Spouse.

ANALYSIS OF THE SUCCESSION PLAN

After each professional has done their part in the design of the Succession Plan and the documents are in draft form, it is good practice to get the group together to review everything before the documents are signed. As a team, they should check for whether the Client's goals are met, whether there is the proper assignment of future risks, what points may need to be covered in the future, and assure the different parts fit together logically and legally.

Analysis of Client's Succession Plan in the Event of Father's Death

The son could decide not to exercise the option if he did not like the industry or the amount of debt in the Company, the price was too high, or any other reason.

The Trust protected the assets should the Son get divorced in the future.

The Spouse would get the income from the sale of the Company and the lease during her lifetime. The three siblings would receive the income after her passing.

The long term lease and renewal options protected the Son and the Company from predatory lease increases from the Spouse or other siblings.

The multiple of book value was a good method to set a future price as it included an automatic check and balance. If the Father took out too much, the value would be lower allowing the Son to purchase the business at a discounted price, thus depriving the Spouse and Siblings from future income. If the Father built up the book value too much, the price might not be attractive to the Son.

No provision was set up for eventual disposition of the business should the Son decide to not exercise the option, a weakness that the Father understood and accepted.

No life insurance was included on the Son as a key employee, a situation that could be remedied in the future.

Creation of the Trust and the legal provisions were left to the Attorney, as they should be. Nevertheless, the team felt that as a group, more time should have been spent defining the Trustee duties and other business provisions related to the Trust such as under what circumstances the Company could be sold.

RESULTS

The results of your Succession Plan may not be realized for many years. Don’t wait until you reach age 50, 55, 60 or whatever age you think is appropriate to set up a Succession Plan. The appropriate time is now regardless of your age. We are not promised tomorrow. Unfortunately, I have been involved with too many clients where a pre-mature death, unforeseen divorce, or disaffected partner has triggered a succession long before the owner thought it might happen. The results were the best that we could piece together, but a far cry from what could have been done with some pre-trigger Succession Planning.

Case Results

The Father passed away within a couple of years. The Son exercised the option. The income from the lease and the payments on the purchase of the business by the Trust are going to the Spouse.

The Book Multiple Valuation formula worked smoothly.

The Professionals involved agreed that the succession was very smooth, and less costly, than most unplanned business successions.

The Company has since grown and prospered.

TO DISCUSS YOUR SUCCESSION

My thanks to the hundreds of clients I have served over the last 35 years. I look forward to serving them again as well as numerous new clients over the next decade.

To confidentially discuss your succession issues, please call me at 205-837-4845. There is no charge for the initial call. I will also be attending the EASA Convention in San Antonio and staying at the Grand Hyatt Hotel adjacent to the Convention Center. I would be pleased to meet you privately.

I have prepared two questionnaires to help initiate a good discussion. They may be found at:

- http://www.emailmeform.com/builder/form/mr5TcsC2RffdG for Business Valuation,
- http://www.emailmeform.com/builder/form/Opu487J20rbh6A for Succession Planning.

They can be printed out for your private use only, or completed and submitted to me. All submitted information will be kept confidential.

Hopefully you have found the information in this newsletter valuable. I only send one issue of "Looking Ahead" each year. If a major economic or geopolitical event were to occur, I might send an addendum, but never more than two mailings a year. To be added to the mailing list for this free newsletter, please send me an email. If you wish to be removed from this mailing list, please send me a reply email from the email address that received this newsletter. Put the word REMOVE in the subject line.

Please send any questions or comments regarding this newsletter to the email address below.

Pete Smith

Pete Smith

- Member National Association of Certified Valuation Analysts (NACVA)
- Accredited in Business Appraisal Review (ABAR)
- 35 years of experience working with owners of apparatus service companies

Email Address:petesmith@value-a-business.com
Website: http://www.value-a-business.com
Office: (205) 987-5315, Cell: (205) 837-4845

[i] Mercer, Z. Christopher *Buy-Sell Agreements for Baby Boomer Business Owners*, Peabody Publishing, 2013