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FINANCIAL CONSIDERATIONS WHEN OWNING AND SELLING A BUSINESS

BY DAVID G. ADISHIAN*

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I. BEFORE SELLING A BUSINESS

When clients tell me they would like to start a business, they are often surprised when I ask them if they have also considered a plan for when they decide to sell it. This line of thinking is typical among most business owners who assume that eventually they will be able to sell their business for a significant profit. However, these new owners get so caught up in growing the business that they do not plan for its sale, which requires just as much planning, ideas and teamwork.

Owners considering selling their business need to make sure they have a team of advisors long before the sale. This team of an attorney, financial advisor, investment banker, and tax professional should have a significant amount of expertise in the selling process and be integrated and communicating from the moment the first business plan is developed. This ensures that the plan to sell incorporates all of the business owner's financial objectives and that the seller progresses into the next segment of his career financially equipped.

Consider the following guidelines when advising business owners throughout the different stages of the ownership.

Start of business:

- Choose the best entity. When the business is sold, the type of entity the business holds affects the tax treatment and financing sources the owner can use (*e.g.*, Subchapter S facilitates assets sales and may provide tax benefits to the owner in early years when the business may lose money, but it limits the type of shareholders in the company).
- Reward employees. Motivate and retain employees through the use of equity. The tax benefits and equity value to employees is always

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better the earlier they receive the equity.

At least one year before the sale:

- Resolve outstanding problems. Get rid of bad debt issues on the balance sheet and settle litigations or any other disputes.
- Target potential buyers. A great way for your clients to meet buyers is by attending industry networking events. It is common for buyers to have background knowledge and/or experience in their prospective industries.
- Control Profits. The value of a company is heavily determined on profitability; therefore it is advisable to show a steady growth of earnings. When owners pay themselves an extra million close to the sale of the business, it could cost them up to ten times that much in the purchase price.

At least six months before the sale:

- Organize company records. Prospective buyers like to see that the company was run well and information is readily available.
- Consider the owner's future role in the company after the sale. Often an emotional issue, a business owner's continued involvement after the sale of his company can lead to financial implications when trying to sell stocks from the acquisition company. Additionally, the owner needs to be prepared to relinquish control of the company.
- Substitute income. Once the owner sells the business, he will need to substitute his salary income with portfolio income, especially if bound to a non-compete agreement.
- Agreements of non-competes. These agreements are strictly enforced by a court in the circumstance of a business sale. Thus, it is important to realize the buyer will want to defend the value of the business, while the seller needs to maintain the future use of his skills with another business.
- Decide between payment of stock or cash. Cash is often the first choice, but not always an option. The seller must be protected from the innate risk in having a concentrated position in someone else's stock.
- Consider liquidity of buyer's stock. If other companies were acquired by the same buyer, meaning that other shareholders could be selling the buyer's stock, this could juristically affect the seller's personal liquidity.
- Do not overlook stock sales limitations. Be aware of after-sale restrictions and limitations regarding when the seller can actually sell the acquired stock.

II. WHAT IS THE BUSINESS WORTH?

When valuing a business, there are a number of components that must be considered; however, there is no set formula as each acquisition is unique. The following components are the most common: comparable companies' trading prices and acquisitions; strategic value of business to non-financial buyers such as competitors and companies seeking to enter a new market; current impact the sales would have on the buyer's earnings per share; and the cost of debt financing.

Lastly, consider the questions the buyer will have: Who is the customer? How large is the market? Does the current owner still need to be involved? And, is the product protectable?

III. AFTER SELLING A BUSINESS

The sale is over. You and your client should continue to solidify long-term plans important to his wealth and that of future generations. There are many components to consider in this evaluation, including income replacement, wealth preservation, tax efficiency, liquidity management and concentrated stock positions.

A. Secure Long-Term Financial Security

Sellers often have a hard time transitioning from building to preserving wealth. For example, they are often unenthusiastic about conservative asset classes with low returns. Additionally, they are concerned about maintaining the lifestyle they had when they owned the business. Below are focus points to discuss with your client for long-term financial security:

- Evaluate your client's position. How liquid are the assets? Does he still have a salaried position? Obviously, these issues would have been dealt with during the pre-sale; now is the time to execute the end result. For example, a client with a concentrated stock position would have an increased risk profile. In this case, the assets left over must be invested conservatively and diversified from the concentrated equity position.
- Manage concentrated stock positions. When no restrictions apply to the stock, the holder is free to start selling soon after the sale. However, most of the time, there will be restrictions on the sale of stocks so that multiple strategies will need to be planned to control risk. For example, your clients may have become employees of the acquiring company and may only be able to sell their stock during certain trading windows. In this case, they would want to use a 10b5-1 plan.[1] These plans were created to defend insiders from claims of insider trading and provide for an efficient sale of stock, helping to quickly diversify your client's portfolio.

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[1] SEC Rule 10b5-1, 17 CFR § 240.1065-1 (2000).

- Balance the new portfolio. The most important aspect of after-sale planning is asset allocation. Some of the toughest conversations involve the client's personal fondness for a particular asset class - for example, securities in their former sector - because that is what they know. Clients commonly underestimate their ability to take on risk and misjudge the diversification of their asset allocation. Windfall investors now have more diversification options to consider. They can now qualify for hedge funds and invest in private equity and other non-publicly traded investments that can help balance return and decrease volatility.
- Replace income. After the sale, your client may have reduced compensation and/or reduced company-paid benefits. Replacing income without exhausting principal is imperative to build into the plan. Income-producing investments, such as bonds, and various strategies for managing single stock positions are used here. If your client needs cash before he is allowed to sell stock from the acquiring company, financing tactics can be discussed. Below are a few options for income-producing investments:
    - Municipal Bonds: Use this strategy when your client wants less risk and exemption from paying federal taxes. These bonds are issued by states, cities and counties and often carry a lower interest rate than riskier, taxable bonds.
    - Certificate of Deposit (CD): Use this strategy when your client wants to reduce risk. Although CDs are more liquid than other vehicles, they are not completely liquid because many have penalties for withdrawals prior to maturity. They are insured by the FDIC[2] or NCUA[3] depending on whether they are issued by a bank or credit union. CDs come with a fixed interest rate and mature in three months, six months, or one to five years.
    - Laddered Portfolio: Use this strategy when your clients need a steady flow of income or are unsure when they may need extra cash. This tactic employs investing in several similar securities with different maturity dates so your client is never more than a year away from maturity. For example, if your client has $500,000 to invest in CDs you would invest $100,000 in one, two, three, four and five year CDs. Keep in mind that there is a risk if CDs and other deposits exceed the FDIC limit at a particular bank.
    - Charitable remainder trust (CRT): Use this strategy to generate income while reducing taxes and capital gains. With this tactic your client obtains an income tax deduction and a lifelong payment stream. When your

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[2] Federal Deposit Insurance Corporation (FDIC), http://www.fdic.gov/.

[3] National Credit Union Administration (NCUA), http://www.ncua.gov/.

client and his surviving spouse pass away, the CRT will go to the charities specified.

IV. MAINTAIN EMOTIONAL STABILITY

Your clients go through a whirlwind of emotions after selling a business, most commonly experienced is their unwillingness to sell off the acquired stock from their old company. You can help your clients by working with them to help them see the stock they received as something to be sold and diversified.

Similarly, past owners seem to want to keep a measure of control over the business and may want to sign employment contracts that include non-compete agreements. It usually takes one year for sellers to detach from the business and pursue other opportunities.

However, if your clients seem worn out from the business world, you may want to suggest that they get involved in philanthropic activities in which they may devote the talent, time and resources they would normally expend to their business. The 2007 Merrill Lynch/Capgemini World Wealth Report noted "a growing trend toward strategic, 'investment-like' giving aimed at maximizing societal return on investment."[4] Philanthropists are now giving their charities the same kind of disciplined scrutiny they devote to stocks and bonds.[5] These donors are consulting with their financial advisors to develop strategies designed to realize the maximum potential of their charitable dollars.[6] Charitable giving is one of the best ways for former business owners to feel that they are using their hard-won expertise.

V. BENEFIT FROM INSIGHTS OF TRUSTED ADVISORS

Most of the strategies discussed bring together a client's tax, legal and financial advisors. Given that each client's needs, goals and financial situation are unique, these professionals should consider each client on a case-by-case basis and recommend the solutions that are best suited to him or her. This collaborative approach will help to ensure comprehensive planning with an eye towards the client's dreams and aspirations.

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[4] Merrill Lynch & Capgemini, World Wealth Report 2007 at 22, *available at* http://www.capgemini.com/resources/thought_leadership/world_wealth_report_2007/.

[5] *Id.*

[6] *Id.*