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Business Exit Strategies Each Offer Plus, Minus

By Marcel J. Bernier

Choosing the right business exit strategy may be the most important decision a business owner will make with respect to his or her business. If the business owner makes a good decision, he or she will be able to realize the economic value of the business. If the business owner makes a bad decision, he or she may never fully realize the economic value of the business.

Marcel J. Bernier

There are a number of ways for a business owner to exit a business. Each way has advantages and disadvantages. The best exit strategy depends on the particular facts and circumstances of the business and the business owner.

The most common business exit strategies are to:

- Sell an ownership interest to employees or other owners of the business;
- Sell to a strategic buyer such as a competitor of the business; or
- Sell to a financial buyer such as a private equity group.

Less common exit strategies include selling or transferring the business to family members; a sale to an Employee Stock Ownership Plan (ESOP); or an initial public offering.

A sale to employees or other owners of the business has the advantage of allowing the culture and management of the business to continue after the sale in a manner that is consistent with the culture and management before the sale. Another possible advantage is that it may allow for, or require that, the selling business owner continue in an employment or a management role for a period of time after the closing. This exit strategy is frequently used for professional service firms such as accounting, architecture, engineering, law and medical firms. It is also used for businesses that are large enough to provide cash flow to support the purchase from a retiring owner.

A disadvantage of selling to employees or other owners of the business is that the purchase price is often paid over time and whether or not all of the payments are made is largely dependent on the success of the business after the sale. If the business performs poorly after the sale, the selling owner may not receive all of the payments he or she is due, and therefore may not receive full value for the business. An additional risk of selling to employees is that the employees may or may not successfully make the transition from being employees to being managers.

ILLUSTRATION/MARIA PAZOS

A "strategic buyer" is generally a company in the same business or a related business. A strategic buyer expects to gain one or more strategic advantages from buying the selling business. Such advantages may include increasing the strategic buyer's revenue by selling products of the buyer to customers of the selling business; selling the products of the selling business to customers of the buyer; reducing compensation and benefits expenses by eliminating employees who perform overlapping functions; or reducing rent expenses by eliminating one or more locations and consolidating operations. An advantage of selling a business to a strategic buyer is that the buyer may be willing to pay a higher price to the seller because of these possible strategic advantages.

Disadvantages of selling to a strategic buyer may include changes to the culture

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and operations of the selling business that the strategic buyer may make to accomplish its strategic objectives. These changes may include reducing the number of employees and reducing the compensation and benefits of employees, including senior management.

A financial buyer is interested in buying a business as an investment. A financial buyer generally does not manage the business on a day-to-day basis, but actively manages the managers. A private equity group is an example of a financial buyer.

A possible advantage of selling to a financial buyer is that the existing senior management may be allowed to continue as senior management, subject to the supervision of the buyer. The financial buyer is likely to be in a better position to pay the entire purchase price at the closing than employees or other owners who are purchasing equity from a selling owner. Also, the financial buyer is more likely to permit or require the selling owner to retain a minority equity interest in the business so the financial buyer and the selling owner have a shared interest in increasing the value of the business.

Financial buyers are generally only interested in businesses that already have significant operating profits. Financial buyers are more likely than internal buyers to make changes to significantly increase the revenues or significantly decrease the expenses of the business to increase profitability and generate the returns expected by the financial buyers and to sell the business for a profit.

A business may be sold or transferred by gift to one or more descendents of the owner or owners. Whether the transfer is structured as a sale or a gift depends on a variety of factors, including the net worth and financial needs of the owner and the spouse of the owner, the possible impact of estate and gift taxes on the owner, the level of interest of the owner in continuing to work in the business, the ability and work experience of the descendents and the number of descendents in each family who are and are not working in the business. The documents such as bylaws or operating agreements of the entity should be reviewed for possible revisions before such a sale or transfer to achieve the desired voting and governance structure after the transaction.

An ESOP is a qualified retirement plan that invests in the stock of an employer company through a qualified employee stock ownership trust. The trust purchases all or part of the business for the benefit of the employees. The trustee of the trust makes decisions with respect to voting the stock owned by the trust.

There are significant income tax advantages with respect to an ESOP. The ESOP generally allows the earnings of the company to be used to purchase the shares of stock of the company using pretax dollars because the contributions by the company to the ESOP are tax deductible. If the company is a subchapter C corporation and the ESOP owns at least 30 percent of the stock on the date of the sale, the selling shareholders can defer income tax on the sale to the ESOP if they invest the proceeds from the sale in marketable securities of United States public companies. If the company is a subchapter S corporation, the earnings with respect to the shares of stock owned by ESOP will not be subject to federal income taxes.

There are also disadvantages to an ESOP. The ESOP must purchase shares of stock for their appraised fair market value based on the earnings of the company without regard to any strategic premium that might be paid by a buyer due to gaining a strategic advantage. The cost of creating and administering the ESOP may outweigh the benefits of the ESOP for a company with minimal profits or less than 20 employees.

It is important for a business owner to determine his or her objectives and take these objectives into account in determining the best business exit strategy. A business owner should consult with his or her professional advisors for assistance in determining the best exit strategy. ■

Marcel Bernier is a partner in the Hartford office of Murtha Cullina LLP. For over 25 years, he has devoted the majority of his time to advising businesses and business owners with respect to business agreements, business exit strategies and business transactions. Reach him at mbernier@murthalaw.com or (860) 240-6087.