Case study: Using compensatory devices in succession planning

Unique aspects of closely held partnership exit strategies

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Earlier articles in this series explained the uses of certain compensatory devices in succession planning. In most cases, these devices will be part of an overall plan. This last article in the series sets forth a hypothetical case study to illustrate how several compensatory tools can be combined to achieve owners' goals for a business transition.

Case study facts

Joe Smith is an engineer who, in 1980, began N. Gin Company (NGC) with two friends, Tracy and Sam. The friends originally contracted to design certain machine parts for other companies. Over the past 30 years, Joe, Tracy and Sam have grown the business to not only design parts, but also to machine those parts and sell them to customers. NGC is an S corporation that now employs 150 individuals and has annual sales of $20 million. Joe, Tracy and Sam still work at the company, and each owns one-third of the business. Joe is already 60 years old, and the owners realize they need to position the company for their eventual exits, which will likely occur over the next 10 years.

Although Joe, Tracy and Sam currently serve as the president, chief financial officer and chief engineer, respectively, they have historically taken relatively modest salaries of $200,000 each, plus distributions to cover their individual income tax liabilities on the business income. In addition, each has made contributions to the company's qualified retirement plan

over the past 30 years, based on their salary levels. They built the business from the ground up and have chosen to pay themselves only what they needed to maintain their lifestyles and to leave as much as possible invested in the growth of the business. Since all three are owners, the company growth ultimately benefits them directly. Based on their knowledge of the market, the owners believe the business is worth approximately $20 million.

The owners have several concerns to address in their business succession plan. First, from a timing perspective, the owners are not yet ready to step completely away from ownership or management. Joe, Tracy and Sam agree they need to have other managers ready to take over before they fully exit, and they have identified potential successors at the company. While these individuals will likely be ready to run the day-to-day operations by the time the current owners leave, Joe, Tracy and Sam know they will not be willing or able to purchase the company in full to also replace them as owners. Joe, Tracy and Sam believe that their combined ownership and management is what helped them grow the business so successfully. Throughout the business' life, each decision they made as managers affected the business value, which directly affected their personal net worth. Therefore Joe, Tracy and Sam want to find a way for the successor managers to have some equity interest in the company.

In addition, Joe, Tracy and Sam have enjoyed being close friends and co-owners together, and the whole company feels like their extended family. Before completely exiting from the company, Joe, Tracy and Sam want to have a plan in place that makes them feel comfortable that the employees will be taken care of after they leave. The owners want to ensure as few interruptions as possible to company operations, and they think a gradual exit will be more reassuring to employees.

Coordination of goals

One benefit of beginning succession planning before an actual exit from the business is that all of the owners' goals can be considered together to choose a plan that includes them all. If, for example, Joe wants out as soon as possible, Tracy and Sam may use company cash to redeem Joe's interest. The redemption would solve the current need, but Tracy and Sam may have limited their exit options because the company would not be as cash-rich, and they would need to sell 100 percent of the business at once later, so they would have to find a party that could afford the purchase price.

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This example is not meant to imply that the redemption of an owner's interest is never a good fit. For example, a corporate redemption is valuable when only 10 percent of the ownership needs to be liquidated, and the other owners plan to remain for several years. In the case of NGC, though, because the owners may all leave within a relatively short time period, it is better to consider all owners' exits at once to design the best plan.

Another consideration when owners do not plan to leave at the same time is the need for a coordinated buy-sell agreement. Depending upon what percentage of ownership exits at once, the price received by the exiting owners may or may not be discounted for representing a minority interest (or lack of control) in the company. If individual owner exits are not coordinated to account for this factor, some owners may end up receiving much less for seemingly equal ownership shares. For example, imagine Tracy and Sam leave first, and they own two-thirds of the company. If they sell to the same buyer, that buyer would own the majority of the company. Later, when Joe wants to sell his interest, he would likely not get the same price per share for his one-third interest, even if no other facts have changed, because the purchaser of his interest would not receive control of the company.

A buy-sell agreement may provide a formula that will be used to calculate what owners receive for their interests at different points in time, for example. Buy-sell agreements may have provisions restricting timing or methods of ownership exit, as well. As long as these factors are considered early in the process, the three owners could enter a buy-sell agreement that mitigates some of the issues that may arise in staggered ownership exits.

Joe, Tracy and Sam have a few major goals, as identified above. First, management needs a compensation package with a component aligned with the equity value of the company. Second, Joe, Tracy and Sam need to identify potential buyers for any remaining equity not provided to management. Third, employees need to somehow benefit, or at least not be harmed, in the transition. If these goals are addressed separately, any potential solution could inhibit the ability to meet the other goals.

For example, if management equity incentives are considered first, successor managers may be granted stock options that allow them to purchase a percentage of the company. Assume that even though the successor managers do not want to purchase the entire business, stock options are of interest to them and they purchase 15 percent of the company over the next five years. The management incentive goal has been met. However, Joe, Tracy and Sam are now ready to sell the other 85 percent of the company, and management is still unwilling to purchase their remaining interests. Since it may be unlikely that an outside party will only want 85 percent of the company, any outside sale could potentially jeopardize the management incentive structure already implemented. Selling 85 percent of the company to an employee stock ownership plan (ESOP) is an option, but an 85 percent-owned S corporation may not be the best structure, because the ESOP will receive 85 percent of the S corporation distributions made to the owners to cover income taxes associated with business income. Without a tax liability at the ESOP level, the company will have to devote efforts to finding the best use of all of that cash in the ESOP, whereas options for using the cash inside the company may be more attractive.

Alternatively, if the issue of finding a buyer for the equity is viewed separately, an outside party sale may be the best option. Assume a strategic buyer is willing to pay $25 million for 100 percent of the company. Because Joe, Tracy and Sam think the chance of receiving a premium like that will not come along again, they sell 100 percent of the company over two years. That outside buyer may now reduce the workforce, and some employees could lose their jobs.

An optimal succession plan should be considered over time, and all goals should be considered together. Using Joe's, Tracy's and Sam's goals, a plan can be designed that meets them all, and adjustments can be made periodically if those goals change.

NGC succession plan

When all goals are considered together, Joe, Tracy and Sam may decide an ESOP combined with stock appreciation rights for management is the best option. The ESOP solves the concerns over employee well-being and finding a buyer for the equity. However, since shares are generally allocated within an ESOP by percentage of compensation, management may get ownership through the ESOP, but not quite at the level the owners think they should have. Stock appreciation rights can solve that problem because they can be given only to the upper-level managers to give them increased incentive. In addition, although the payment is tied to equity value, the rights do not represent actual ownership. Thus, the entity remains 100 percent ESOP-owned and does not have to make tax distributions. Lastly, the ESOP allows owners to gradually exit as they wish. The gradual exit is desired because the owners are not ready to completely leave the company. In addition, successor managers and employees will have comfort that the owners still have a financial interest in the company and, thus, an interest in the succession plan working well for the company.

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S corporations with ESOPs need to pass a "broadly held" ownership test based on the allocation of ESOP ownership to make sure ownership is not concentrated in the hands of a few people. Because synthetic equity components may effectively dilute other ownership, such components must be included in the test. The test details are complicated and beyond the scope of this article, but any S corporation considering an ESOP should ensure this test is passed prior to implementation. In the current example, NGC would need to include the stock appreciation rights in its test.

Joe, Tracy and Sam have received relatively low salaries in the past, and their succession plan is generous to successor managers and employees. Outside of the ESOP and stock appreciation rights, they would like their succession plan to provide them with additional compensation. Thus, Joe, Tracy and Sam enter into an agreement with NGC for them each to be paid an additional $100,000 per year for 10 years, beginning with the first year after each owner's exit. This agreement provides each owner with another $1 million over time and bolsters their retirement account balances. In addition, the nonqualified deferred compensation agreement creates a liability for NGC that will slightly reduce the price the ESOP pays for the stock. Joe, Tracy and Sam realize this transforms what would otherwise be capital gain income from the sale of the stock into ordinary income from the payments under the nonqualified deferred compensation agreement. In addition, they realize they will not benefit from the company's tax deductions for the deferred payments since they will not be owners when the tax deductions are allowable to the company. However, the owners feel that the deferred compensation payments will provide them enough additional annual income to maintain their lifestyles while fully reinvesting their stock sale proceeds to earn a return.

Next steps

Depending on the plan chosen, certain steps need to be taken before a succession plan is fully implemented. In the case of NGC, the creation of an ESOP will involve a corporate obligation to fund the plan. Although an ESOP sounds attractive to the owners in theory, a feasibility analysis should be completed to ensure the corporation can afford the plan and to select the best terms for the ESOP.

Implementing a succession plan usually involves several service providers. During the planning process, at a minimum, accountants and attorneys for the corporation and owners usually participate to help the business and owners understand their options and decide on a plan that meets their goals. In addition, the owners' financial planner may be involved to make sure the tax and legal considerations are coordinated with the owners' estate planning needs.

Once a plan is chosen, the same service providers would likely help the parties understand which terms are negotiable and advise them on the consequences of various negotiated terms. At this stage, other service providers may also get involved. For example, since NGC is using an ESOP, an external trustee may be chosen to represent the ESOP, and a third-party administrator may be involved to assist with plan design and execution.

In addition, an ESOP is required to get an independent appraisal of the fair market value of the company stock because the ESOP cannot pay more than this value. For purposes of feasibility planning, Joe, Tracy and Sam may want to obtain a preliminary appraisal of the estimated value of the stock. Then, a full appraisal would be needed at the time of the transaction for confirmation of fair market value as of the transaction date. The ESOP will also be required to get appraisals at least annually for reporting purposes, as well as for stock transactions that occur during the year.

Dynamic planning

Joe, Tracy and Sam agree to the above plan when they believe they still have 10 years before all three of them will have fully exited from management and ownership of the company. Most likely, the plan will not remain completely unchanged over those 10 years. For example, imagine new legislation results in the

current favorable capital gains tax rates expiring in three years. Since the owners are already poised to transition out of ownership,they may choose to accelerate their sales to the ESOP to benefit from the lower rates while they still exist. By this time, all parties are comfortable that the ESOP structure is working well, and the owners consequently decide to leave management at the same time. Since the owners are still healthy and perfectly capable of working, the successor managers negotiate noncompete agreements with Joe, Tracy and Sam as part of the transaction. The noncompete agreements provide additional comfort that the owners will not become competitors when they leave. In addition, the payments scheduled under the agreements are a liability to the company that may serve to reduce the purchase price the ESOP has to pay for the stock.

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Any number of facts could change after a succession plan has been decided. Perhaps the strategic buyer that the owners turned down when they set up the ESOP makes another offer in five years to buy the stock at an even higher premium. Now that the ESOP exists, the trustee has a fiduciary duty to act solely in the interest of employees' investment in the corporate stock. The trustee may decide that selling the stock at the premium is the best option, and the stock could be sold and the ESOP terminated. Although this seems detrimental to the original owners' desires regarding employees, the employees now participate in the sale premium and thus receive some benefit that may offset any negatives of the stock sale to outsiders.

Conclusion and possible next steps

The optimal succession plan for each business is unique. Not only do owners' goals differ, but the changing legal and tax landscapes may also affect decisions over time. This article series introduced compensatory devices with respect to the succession planning process and explained how multiple tools can be combined to address various succession goals. A number of options and considerations exist that were not explored in this series. For example, once owners exit from business ownership, they have changed the nature of their investment and need to consider tax and estate planning needs from that perspective.

In addition, it is likely that some noncompensatory tools will be combined with the compensatory tools in the overall plan. For example, an ESOP may not be a good fit for all companies, or the corporation may not be able to fund it to a level that would allow for the transfer of the desired ownership percentage. When the ESOP is removed as an option, owners may still set up equity incentive plans for successor managers and use compensatory tools to pull some value out of the company, but the remaining equity may be sold directly to managers or to another outside party through a traditional stock or asset sale.

The earlier a business owner considers ownership transition, the more options that usually remain available, and the more likely all succession goals can be met. If you have not begun planning for the succession of your closely held business, contact your advisors to begin the discussion. Early planning should consider your goals and the current status of the business, including financial and nonfinancial aspects. Once these factors are known, all options can be considered that will address both you and the continuing business operations, and your succession plan can begin to be shaped.

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