Before Starting Your Business Prepare An Exit Strategy

By Burke Barclay

One of the biggest mistakes entrepreneurs make when going into business is they never stop to think about how they are going to get out when the time is right. Everyone dreams of that IPO, but the real truth is almost no one ever sees that day. So, why not take a couple of hours to sit down with yourself or your attorney or your business partners and design the correct exit strategy when it's time to call it quits.

There can be a number of different reasons for doing so. Many different "triggering events" can set the stage for the exit of an owner. If there are multiple business partners, there will be a time when someone looks to pull the plug on the relationship. Besides death or retirement, such triggering events could also be termination of a key employee with stock paid as an incentive, or a divorce or a bankruptcy of an owner. The last thing a business wants is a bankruptcy trustee telling them he is now a partner and will be looking to liquidate his position, or a divorce attorney telling the other members that they will soon be partners with an ex-spouse. In other words, something will happen along the long road of owning a business, and that something is usually not good.

This article isn't about giving tax advice on cross-purchasing for a stepped up tax basis, nor is it about IRS compliance with an alternative minimum tax imposed on the corporation because it was paid out of the life insurance proceeds after the death of one of the owners. It would be too long and difficult for the average reader. More importantly, those conversations are better left to CPA's and business attorneys to discuss with their clients.

If you can take anything away from this article, please think about your exit strategy before you head off into business. The simple rule is that if you don't, you will find that: One, the company doesn't have the retained earnings to pay off one of the owners of the business and he or she wants out almost immediately; or two, you didn't set up the buy-out correctly and now there are major tax implications. Therefore, here are just a few things to think about:

One, do all of the owners of the business all own the same percentage? If that's the case then it's easy. Talk with your accountant or attorney and determine how life insurance should pay out to get the best tax benefits for the company as well as taking care of deceased owner's heirs. If all do not own the same percentage, then you are going to have to find a way to take care of the whales and at the same time not completely burden the minnows. A buy-out of a whale could completely destroy a business while the same transaction could be as easy as cutting a check for a minnow. Therefore, you may need to know how to buy out the bigger investors.

Second, if you're selling your business to an employee or an outside buyer, perhaps there's an easier way to do the deal than just looking for immediate cash. If the business if profitable, few people are going to have the ability to buy into a business at such a high price. Then, there is the capital gains issue to think about. Here's an idea: If you're going to sell out, why not have a payout over time? The owner could retain a smaller amount of their salary and keep his or her voting rights, which would also still provide them with insurance and other perks he or she has become dependent upon through the years. Most owners don't trust this because they fear the company will fail before they are completely paid off. However, if he or she is still going to have a say-so in the business then this greatly decreases the chance of this happening. There also could be majority control until a certain amount of the buy-out is complete and then commence a stepping down of control within the company. The point is, if there is a plan made out like this in advance, someone could start down this road earlier and still be in the same position he or she desired instead of attempting to find one buyer with enough cash to purchase the business outright.

Third, determine if your shares of stock, especially in a closely held corporation, are really even marketable to an outside buyer. The real answer is they probably aren't. It is very hard to find a buyer for a business and even harder to sell shares of stock in a closely held corporation in the open market. If a potential buyer has the cash to do so, he or she will more than likely go out and start a business on their own. It is very difficult on a personal level to buy into an already established company that has other owners. It takes all the right personalities to make it work. For most, it's like eating off someone else's plate. It's not appealing to most entrepreneurs. There are just too many potential problems. An entrepreneur with cash on hand is going to want to set up a business and have it run his or her own way. So, be honest with yourself in determining if there really is a market for your shares.

Fourth, decide how you are going to value your business or your shares in the company. Is it going to be straight book value, or some other kind of method to determine the company's value? There's many different ways to determine the value of a company, depending upon whether or not it is asset heavy or provides intellectual property or services, etc. Owners of a company need to decide on which one they want to use and then make an effort every two years to revisit the formula and vote to decide if it is still a relevant or practicable way to evaluate the value of the business.

Fifth, the owners of the business need to determine if they are going to have a right of first refusal. Will the departing owner be able to sell his or her shares out in the open market? Will the company purchase the stock and hold it as treasury shares? If the owners are going to have a right of first refusal, again it's important to know the value of the shares. Also, this right by the other owners must be exercised reasonably. They can't unduly prolong the event. Since personalities are so important in a business, the owners that are left behind will usually want a say in the matter. On the other hand, there also needs to be notification guidelines for a leaving owner. Many companies impose strict penalties on any owner that gives less than six months notice so there will be time to find a replacement.

Finally, it is imperative that there not be a showdown with one of the owners. What happens here is that a departing owner draws a line in the proverbial sand and tells the others to have him or she completely bought out by a certain time. If this doesn't happen, then there will be a selling off of assets or an attempt to sell the company outright. You may think there's no way for this to happen without the other owners agreeing, but if they are a super-majority owner, then the other guys need to start looking for a new job.

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