What to consider when selling or passing along the family business – it's much more than just the cash

Succession strategies

LEGAL AFFAIRS

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There is much more to family wealth management than simply keeping track of cash and investments. As critical as it is to build the business, it is equally and perhaps even more important to plan a timely and appropriate exit strategy. Whether the exit involves relinquishing leadership and management while retaining ownership, an outright sale, management buy-out, transfer to children, or – for larger enterprises – an IPO or income trust, all relevant factors must be considered. The objectives and goals of key family stakeholders, tax minimization and availability of a successor are all relevant considerations.

Why some fail

Approximately 85 per cent of Canadian businesses are family-owned and managed and they account for nearly one-half of Canada's gross national product. Yet only 30 per cent of family businesses survive to the second generation, just 10 per cent survive to the third generation and only one per cent to the fourth generation. This underscores the importance of addressing not only the day-to-day operations of the business and maximization of profit but the long-range planning, which should include an exit strategy.

Research indicates that the reasons for failure of most businesses is failure to have an adequate estate and succession plan in place to prepare for transfer of the business and to ensure there is funding for estate taxes (capital gains tax and probate fees). Most entrepreneurs are so busy working they don't spend adequate time or resources on the business.

First, you should clarify the goals and objectives of family members, both those who are active and non-active in the business. Then you should hold family meetings with the assistance of a facilitator to reach agreement on the option that is ultimately chosen. Once the alternative is selected, the planning begins:

• Relinquish management but retain ownership: This requires competent and experienced management whether it is an existing employee, family member or new recruit;

• Sale of the business or a management buy-out (MBO): Under this option, the owner may need to finance a portion of the purchase price. In this case, appropriate security would be granted in favour of the owner, although this may rank behind the buyer's senior lender's security/charge. In any sale, the vendor must provide representations and warranties and the purchaser undertakes a due diligence process. Both aspects are usually less onerous in an MBO then a sale to an outsider.

• Sale to a third party – the purchaser may be a consolidator, independent financial buyer or strategic buyer. Accessing the $500,000 capital gains exemption on a sale of shares of a "small business corporation" may reduce the tax burden significantly.

• Inter-generational transfer – transfer to children or grandchildren – tax considerations are key. Undertaking an estate freeze and use of a family trust structure may make it possible to transfer ownership and participation in future growth to the next generation on a tax-deferred basis.

Remember, in transition planning you can control certain factors, not others. The process and selection of options and type of exit strategy are within your control. Factors you don't control include: death, disability, illness, marriage breakdown and, in some cases, franchise termination, brand disappearance, market shifts and legislatives changes. You never know when the need or the opportunity for a sale may arise. Contingencies that are unpredictable may cause you to consider a sale earlier than you had planned.

Getting your business ready for sale can improve market exposure, buyer identification, interest of qualified buyers, price and, ultimately, expedite the transaction. Even if a sale is not imminent, any of the steps taken to groom your business will in fact be good business practices. In any event, grooming your business for sale requires time and preparation.

Are you ready?

Ask yourself a few key questions: Are you able to respond if you receive an unsolicited offer to buy your business? Do you know what your family's vision and desires are? Do you have a business and strategic plan? Do you have a competent management succession plan in place? Have you groomed successor(s)? The following steps will help prepare the business for sale or transition:

• prepare a business plan with projections

• prepare a SWOT Analaysis (strengths, weaknesses, opportunities and threats)

• prepare a brief description and summary of your business and industry

• ensure your financial statements are audited or at least reviewed

• financial statement presentation may involve normalization of earnings and such things as eliminating inter-company loans and extraordinary management bonuses

• structure of sale – assets vs. shares – a buyer may prefer a purchase of assets rather than shares due to the fact that liabilities of a corporate vendor do not affect the business (eg. latent income tax liabilities), and it is likely to produce greater tax shield for the buyer due to greater base or value against which to claim capital cost allowance (depreciation)

• prepare a management development and succession plan

• prepare employment contracts to formalize relationships with key management and executives

• ensure third party contracts (customers and suppliers) are in place and assignable

• ensure intellectual property is protected through patents, trademarks or copyrights

• business documents, records and contracts should be organized and accessible

• ensure that disclosure of proprietary information and processes is monitored closely and that all prospective buyers sign non-disclosure and confidentiality agreements

• ensure that approvals and consents are identified and, where appropriate, relevant parties have been approached e.g., minority shareholders/partners, trustees, creditors and regulatory authorities

• eliminate or transfer redundant or extraneous assets

• co-ordinate legal, accounting, tax and financial advisors.

What is it worth?

Be aware of the realistic value of your business by reviewing industry comparables and applicable valuation approaches, for example, multiples of earnings. In the current climate there is a strong appetite and keen interest in quality enterprises.

When preparing for a sale or transition do so with your strategy and your prospective buyer or successor in mind. ◆

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