2018 Forum on Construction Law Annual Meeting

Taking Care of Business: A Mini-MBA Program for the Construction Lawyer

Business Succession Planning

Biff Bayard and Sherri Lazear
What would happen to your client’s business in the event of a divorce, disability or death?

30% of family businesses survive to the second generation.

10% survive to the third generation.

3% survive to the fourth generation.
I. BUSINESS SUCCESSION PLANNING

What is it?
- Planning for the transfer of both ownership and management to the next level of owners and managers.

What is the process?
- Gathering information
  - owner goals and objectives,
  - owner forecast
- Interviews
- Establishing first round of priorities
- Review current and personal business planning documents
- Design a plan
- Implement the plan
- Continually review the plan
II. NON-FAMILY CO-OWNERS

How should the business deal with voluntary withdrawal or retirement of an owner?

- Divorce
- Disability
- Buyout provisions
- Death
- Insurance
Divorce

Encourage purchase by divorcing owner from the spouse.

Option to the Company.

Option to the other members at a formula price, payable in installments.
Disability

Look at some period of short term disability prior to any consequences.

Strongly encourage the purchase of appropriate disability insurance.

If applicable, provide for a buy out with installment payments at a formula price.
Buyout Provisions

Consider buyout provisions with a formula price and installment payments.
Consider the class of permitted transferees, such as descendants, spouses or unlimited transfers.

For transfers that violate the restrictions, transferees are required to sell back to the Company or the other owners.
Insurance owned by each owner on each of the other co-owners can be a useful and tax advantaged funding source for the purchase of the deceased owner’s interest.
III. FAMILY MEMBERS AS SUCCESSOR OWNERS

Considerations

- Willingness
- Income needs
- Employees
- Community
- Charitable concerns
- Ability
- Issues with Siblings
- Key employees
IV. NON-FAMILY MEMBERS AS SUCCESSORS

In some situations, the best successors are found within the Company in the form of managers or key employees who may not be related to the current owners.
Non-Family Members as Successors

Key employees

- Key employees should be evaluated for their leadership abilities, capabilities and perhaps moved into management positions while the owner can evaluate their ability to succeed as a manager.
Non-Family Members as Successors

Ownership

- Retaining key employees by transferring actual ownership to key employees during the life of the owner may not be advisable, but a combination of benefits can be given to employees short of ownership, including performance based bonuses, stock appreciation rights or phantom stock plans. In the event such programs are considered and used, they should be connected to the employees continued loyalty through employment agreements that contain covenants not to compete.
V. FAMILY OWNERS AND NON-FAMILY MANAGERS

A fun combination! In many cases, it makes sense to continue the ownership of the business within the family while retaining non-family members as managers and key employees.

Family owners remaining in the business should be fairly and objectively compensated and evaluated, another example of when outside directors may be advisable.

Options to non-family managers might be considered.
VI. NO SUCCESSORS AVAILABLE IN THE FAMILY OR IN THE BUSINESS

In the right circumstances planning for the sale of a business to an outsider, either at death or preferably during the life of the owners may be the best solution.

A sale during life can have advantages including the ability of the current owner to know and relate to the new buyer, his business, his customers and assure a smooth transition.

Even after the owners death, passing on cash resources or an investment portfolio to the family may meet the owner’s and family’s goals better than passing on a business to successors unwilling or incapable of continuing its success.
## VII. Seller Alternatives

<table>
<thead>
<tr>
<th>Objective</th>
<th>Do Nothing</th>
<th>Sale to Third Party (LLC)</th>
<th>Sale to ESOP (LLC to C to S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation of Gain 1 (Federal, State, Local)</td>
<td>Risk of the Unknown</td>
<td>~ 27%</td>
<td>~ 0%</td>
</tr>
<tr>
<td>Maximize Value</td>
<td>Risk of the Unknown</td>
<td>FMV determined by market</td>
<td>FMV determined by valuation firm</td>
</tr>
<tr>
<td>Liquidity &amp; Payout</td>
<td>Shareholder Distributions</td>
<td>Upfront plus <strong>contingent</strong></td>
<td>Upfront plus <strong>fixed</strong></td>
</tr>
<tr>
<td>Likelihood of Close</td>
<td>N/A</td>
<td>Unknown</td>
<td>~ 100%</td>
</tr>
<tr>
<td>Disruption to Operations</td>
<td>None</td>
<td>Material (Buyers access to employees &amp; customers)</td>
<td>Minimum (Specialized Deal Team)</td>
</tr>
<tr>
<td>Due Diligence Process</td>
<td>Not Required</td>
<td>Multiple buyers, Detailed</td>
<td>One Buyer, Streamlined</td>
</tr>
<tr>
<td>Escrows, Reps &amp; Warrants</td>
<td>Not Required</td>
<td>Onerous</td>
<td>Less Contentious Straightforward Negotiation</td>
</tr>
<tr>
<td>Employee Impact</td>
<td>Neutral</td>
<td>Unknown</td>
<td>Positive</td>
</tr>
<tr>
<td>Post-Close Involvement</td>
<td>No change</td>
<td>Buyer’s discretion</td>
<td>Flexible</td>
</tr>
<tr>
<td>Does Plan Meet Objectives?</td>
<td>TBD</td>
<td>TBD</td>
<td>TBD</td>
</tr>
</tbody>
</table>

1. For discussion purposes, this presentation assumes that the Company converts from an LLC to a C Corp prior to an ESOP transaction and then to an S Corp at close. Tax rates represent an estimate. Please consult with your tax advisor.
ESOPs are defined contribution plans that invest primarily in employer stock and are governed by The Employer Retirement Income Security Act (ERISA) of 1974.

- Intent was to create ownership and retirement assets for working-class Americans
- Subject to DOL and IRS regulation and compliance

An ESOP is an Ownership Transition Tool

- ESOP Trust is a single shareholder
- Creates ownership-minded culture

An ESOP is an Employee Retirement Plan

- Qualified retirement plan, non-discriminatory, tax-deferred growth
- ESOP Trustee acts as a plan fiduciary
- Company buys out employees when they retire or leave

An ESOP is a Tax-Efficient Leveraged Buy-Out

- Tax deferral on the gain is available to Sellers following the conversion of an LLC to a C-Corp prior to the ESOP transaction
- Tax free status is available to the Company upon conversion of a C Corp to an S-Corp at close
- Tax-deferred / tax-free sale
IX. The Valuation

- The ESOP sale is a negotiated M&A transaction with the ESOP Trustee, who hires an independent valuation firm to determine the Fair Market Value

Valuation takes into consideration:
- Projected growth compared to historical trends and industry forecast
- Soundness of EBITDA Adjustments
- Concentration Risk (customers, suppliers, product lines, geography, employee)
- Predictability of revenues and margins
- Size (risk premium for smaller companies)
- Capital Expenditures going forward

- The purchase price cannot exceed “Fair Market Value” as determined on an arm’s length basis by a neutral valuation firm
- Transactions are subject to IRS and DOL regulation and compliance

Typical contractor ESOP sales range from 4.5x to 6.5x EBITDA
X. Tax Savings
(Typical $3 million EBITDA Contractor sold at 6.25x)

The value of the ESOP “tax shield” to the Company over the next 20 years is approximately $22.1 million.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>3,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(100)</td>
</tr>
<tr>
<td>Interest</td>
<td>(40)</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td><strong>2,860</strong></td>
</tr>
<tr>
<td>Tax Rate</td>
<td>34.6%</td>
</tr>
<tr>
<td>Taxes Net of Depreciation</td>
<td>990</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>5.0%</td>
</tr>
<tr>
<td><strong>20 Year Present Value</strong></td>
<td><strong>22,092</strong></td>
</tr>
</tbody>
</table>

Tax savings to shareholders from IRC 1042 is approximately **$4.5 million**.
Over a five-year period, the Sellers would receive approximately $18 million in Transaction Value plus approximately **$6.2 million in interest.**

<table>
<thead>
<tr>
<th>($ in thousands)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction Value</td>
<td>18,000</td>
</tr>
<tr>
<td>Seller Note Interest</td>
<td>6,239</td>
</tr>
<tr>
<td><strong>Total Pre-Tax Cash</strong></td>
<td><strong>24,239</strong></td>
</tr>
</tbody>
</table>
XI. Seller Objectives

The members ("Seller") of ACME Contractor, LLC ("ACME" or "the Company") are looking for an optimal way to monetize their investment in the business with the following key objectives:

Shareholder Liquidity
- Maximize cash at close
- Maximize after-tax cash
- Defer capital gains tax per IRC 1042

Tax Savings For the Company
- Make company Federal and State tax-free
- Use increased cash flow to pay off Seller more quickly and fund growth

Corporate Governance
- Maintain operational control of the Company
- Maintain the legacy of the Company

Incentivize Management and Employees
- Create a valuable incentive for key employees
- Create large retirement savings for the employees
- Program to attract and retain key employees
- Job security of valued employees
9 REASONS WHY AN ESOP MAY BE THE RIGHT SOLUTION

1. Total proceeds typically exceed other exit options
2. Company can become federal and state tax free
3. Seller can potentially sell tax-deferred / tax-free
4. Operations continue in the same manner
5. As owners, employees benefit from the success of the company

6. Key employees have the ability to receive additional incentives
7. If you own real estate, you can maintain a tenant or sell the real estate to the ESOP
8. Due diligence is less intrusive, and confidential information is not provided to competitors
9. Third-party studies show that ESOP companies out-perform non-ESOP companies and have better employee-retention
Customized Approach

- Structure transaction to optimize results
- Present an assortment of options
- Make the Argument for Value
- Negotiate the deal terms with the Valuation Firm and ESOP Trustee
- Keep transaction within budget
- Arrange financing and negotiate terms
- Manage deal process and professionals
- Close transaction on time
On December 22, President Donald Trump signed legislation referred to herein as the "2017 Tax Act." This legislation provided multiple changes and opportunities for business succession planning both on the income tax side and estate tax side.

## Estate Tax Changes

The Federal estate tax and gift tax remains in effect and greatly affects business succession planning. The 2017 Tax Act doubled the exemptions against the Federal estate tax and gift tax which, at the time of this writing, is estimated to be $11.18 million dollars per person, generally allowing a couple to transfer $22.36 million dollars at their death, or during life, without incurring a federal gift tax or federal estate tax. This expands the opportunity to transfer businesses to family members. From a planning standpoint, however, the step-up in basis that occurs upon a transfer at death, potentially allowing the income tax adjusted basis of the assets passing at death to increase, must also be considered prior to making lifetime transfers.
Changes in The Income Taxation of Business Entities

The 2017 Tax Act also greatly changed the income taxation of business entities, including sole proprietorships, partnerships, LLCs and corporations. In general, the highest income tax rate for C Corporations was reduced from 35% to 21%. The top income tax rate for individuals, trusts and estates, including owners of pass-through businesses, has been reduced from 39.6% to 37%.

A new deduction is available to taxpayers other than a C Corporation, of 20% of the qualifying business income of pass-through businesses (sole proprietorships, partnerships, S corporations and LLCs which are disregarded, or taxed as partnerships or S corporations), which provides new opportunities for the structure of a business or, even consideration of modifying the current structure of a business. Generally the deduction is equal to 20% of certain income of those businesses. While the deduction phases out for taxpayers with income above certain levels, (generally $315,000 in the case of a joint return and $157,500 in the case of other returns), with taxpayers having income in excess of those amounts, the deduction may be larger based on W-2 wages paid to employees of the business and the unadjusted basis of qualified property, either of which may allow taxpayers with income far in excess of those limits to qualify.
XIII. EXAMPLES

The following illustrate some combinations of planning techniques that might be used alone or in combination in the appropriate circumstances.
Example 1:

A C corporation was advised to elect S Corporation tax treatment to avoid potential double tax on a sale and save income taxes. A corporation might convert to a limited liability company to save Louisiana franchise tax IN SOME while still maintaining its S Corporation tax treatment for federal purposes. A Company could be recapitalized to provide both voting and non-voting shares. All of the Company’s governing documents can be revised to reflect appropriate safe guards and protections against business interests being owned outside of the family. The second generation should be advised concerning prenuptial agreements or, if already married, declarations of separateness. Parents can begin an annual gifting program using discounted values for the small interests funding the annual exclusion amount (currently $15,000.00 per donor to each donee). A very small gift of voting shares can be made to any of the children involved in the business while the remaining gifts are of non-voting shares. Beyond the annual gifts, the parents can make more substantial gifts up to all of their remaining lifetime exemption. As the Company continues to grow in size and profits, the parents could later sell their remaining interests to their children on an installment basis with the remaining voting shares being sold to the child in the business and the remaining non-voting shares sold to all other children. The Company’s profits can fund the installment payments due to the parents with the parents achieving good tax results on the sale and freezing the value of their estate at an amount equal to the ever diminishing promissory note while allowing the continuing growth of the Company to pass on to the children free of estate tax. The Company could eventually form an ESOP, sell shares to the ESOP, generate a cash event for the children and grandchildren. Outside directors to determine compensation is very important with children inside and outside the Company.
Example 2:

Parents could follow a similar course but not wish to transfer any voting shares during life. This is a more common situation which may result in less of a discount for ownership interests transferred. Until the entire ownership of the Company is transferred to the children, the succession plan can be to leave all remaining ownership interest in a trust for the children with a carefully designed group of trustees. The trustees can be a combination of family members involved in the business and non-family managers of the business. The group can change over the years so that there is a strong contingent of family and non-family managers that stay in place for a substantial period of time with an eventual phase out to family trustees.
Example 3:

A long established company with a well-known name was considering an additional line of business in their same general industry but a different segment of the market. A new company was formed, still using the well-known name, but that company was owned solely by the children. This allowed the children to run and operate the new startup while taking advantage of the reputation the business name already had in the industry. As the parents never owned any interest in the new business, its growth and subsequent value will never be included in their estates. This can be an important planning option under the right factual circumstances.
Example 4:

Another company was transitioned to siblings who got along well but did not wish to remain in business together forever. The company was divided along two separate business lines, generally paralleling the responsibilities each sibling had for the years before the division, into separate and distinct companies, in a tax efficient way, with each sibling ending up with their own company and allowing them to do their own planning within their families.

Finally, a number of companies have effectuated sales while the first generation owners were around to make introductions to customers and served in a management transition role, yielding a comfortable retirement income for the original owners and financial assets for the family that was not interested in continuing the business.
Each successful company will go through a succession of ownership eventually, whether voluntarily or through outside events such as divorce, disability or death. That succession could take the form of gratuitous transfers to family members who continue the legacy of the successful business; sales to family members or non-family managers of the business; sales to outsiders; a transfer by a merger or split up; a sale to an ESOP; or liquidation of the business possibly through bankruptcy. A successful succession plan is essential to achieving the right result.