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# Exit Planning NAVIGATOR

*Exit Planning Strategies for the Entrepreneur*



Issue 59

## Passing The Smell Test

*Almost reluctantly, Casey Cummings decided to sell his business to a friendly competitor. When we met, Casey wanted to know if he'd made the right decision for his company and for himself. In short, he wanted to know if the contemplated sale passed the "smell test."*

Subjecting the sale or transfer of a business to the "Exit Planning Smell Test" means to hold it up to the scrutiny of the seven step Exit Planning process. Let's look at this test one step at a time.

**Step One.** Does the sale meet Casey's fundamental goals and objectives?

Does it:

- Allow him to leave the business, *on his timetable*?
- Provide Casey and his family with *financial security*?
- Meet Casey's desire to *transfer his company to the best possible successor*? Is the friendly competitor his best choice? Has Casey considered the benefits (and risks) of selling to family members, one or more employees, or a co-owner (if any)?
- Achieve Casey's *other objectives* (such as providing for key employees)?

To answer these questions, Casey first met with his financial advisors (his financial planner and CPA). Initially, they determined how much money Casey wanted and needed after he left the business. Without that vital piece of information, Casey was in no position to judge whether the transaction could meet his financial exit objective.

Casey and his advisors then discussed Casey's timetable. They helped Casey to understand that his decision to sell to a third party sale would allow him to leave on his timetable. On the other hand, his preference to transfer the business to his two key employees, (who were not financially able to immediately acquire the company) would delay his departure. To resolve these conflicting goals, Casey decided that any proposed sale must include a substantial financial benefit to his two key employees. If it did so, it would pass that part of the Smell Test.

**Step Two.** While it is possible to begin the sale process without knowing the worth of a business, it is not advisable. Casey needed to know if the proposed purchase price was at least equal to the fair market value of the company. Rather than using the would-be buyer's offering price as the starting point for negotiations, Casey hired a valuation specialist familiar with recent transactions in Casey's industry to inform him of the value

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and the marketability of his company. If the value and terms of the proposed purchase were in the ballpark as determined by the valuation specialist, the deal would pass that part of the Smell Test.

**Step Three.** Any exit strategy must include in its design, tax minimization, asset protection and constant value building. How does the proposed transaction meet these criteria? For example, Casey's transaction will take time to complete--perhaps a year or more--without a guarantee that it will ultimately close. Is the proposed sale structure designed to minimize taxes, protect assets and grow company value regardless of whether the business sells? Questions like these need to be asked and answered affirmatively if this part of the Smell Test is to be met.

**Step Four.** If we determine that the sale to the friendly competitor achieves Casey's goals and wishes and reflects the real value of the company, how should the sale be structured? Simply stated, deal structure and terms must reflect the decisions made during the first three steps of the Smell Test. Don't jump directly to this Step without completely analyzing whether a transaction meets an owner's objectives or reflects the true value of the business. Only if it does both, does it pass the Smell Test.

**Step Six and Seven.** (Step Five is only for those owners selling to insiders.) In the last two Steps of the Smell Test we look at what would happen to both to Casey's family and to his business if Casey dies before the contemplated sale. Would the business likely continue under the new ownership without Casey's involvement? Would Casey's family enjoy the same financial security should he die before the sale as it would had he lived to see the sale close?

The Exit Planning Smell Test is simply a means of analyzing a transaction by running it through the Exit Planning seven step gauntlet. If the transaction passes through successfully (with only a few modifications), then it has passed its first important test and deserves your time and effort. And if it does not, you must determine whether it warrants the time and money necessary to correct its deficiencies.

*Subsequent issues of The Exit Planning Navigator® discuss all aspects of Exit Planning.*

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