Baby Boomers in Franchising: Exit and Succession Planning

Proper planning benefits the franchisee and avoids business interruption, distress sales and possible brand damage.

BY BRUCE S. SCHAEFFER

MORE THAN 10,000 PEOPLE turn age 65 per day in the United States where there are about 40 million baby boomers. Between 2010 and 2020 that population segment is projected to grow to 55 million, a 36 percent increase. Many of these boomers own franchise companies and need to address their exits and succession plans because only two things are said to be certain: death and taxes.

In the case of franchisees approaching retirement age, the most valuable asset they own – indeed often far more than 50 percent of their net worth – is tied up in their franchise companies. In the case of franchisors facing this demographic-driven turnover in franchisee ownership, the best they can hope for is a seamless transfer and an uninterrupted royalty stream. Thus, proper planning not only benefits the franchisee, but it avoids business interruption, distress sales and possible damage to the brand.

What should be done?

Franchisors Must Enlighten Their Franchisees

If a system has a substantial number of baby boomer franchisees, it is in the franchisor's own self interest to alert their franchisees about the need for exit and succession planning. One of the best venues for raising awareness is through seminars or workshops at franchisee conventions. Among the topics that should be discussed are:

1. Contractual Limits. What are the restrictions on transfers? For example, does the franchisor have a right of first refusal? Under what circumstances can the franchisor withhold consent?

2. Timing. Is it preferable for the transfer or sale to occur during the owner's lifetime or after death?

3. What is it Worth? When must the fair market value of the franchise be determined, who does this and how?

4. Tax Considerations. Does the franchise owner have gift or estate tax issues?

Elements of Planning in General

At a minimum, franchisors and franchisees must consider and prepare:

1. A Succession Plan. This is a business contingency plan. It addresses questions such as: What happens if the principal unexpectedly dies or becomes disabled? Is there anyone in the family or in the organization who is qualified to run the business? On the other hand, should the business be sold or liquidated?

2. An Estate Plan. This is a dispositive (or gifting) scheme that must consider the pros and cons of a lifetime sale versus a disposition at death. Such a plan is generally implemented with wills and trusts.

3. A Valuation. If a franchise owner is going to sell, or dispose of his or her franchise company by bequest, the value of the business must be determined.

4. An Estate Tax Plan. Under current law an estate is subject to a tax of 40 percent on assets beyond $5 million (or $10 million for married couples). Since many franchise owners, especially multiple-unit owners, have assets worth far more than the threshold, tax planning is essential. These people must consider making maximum use of discounts for lack of marketability and minority interests.

Franchise owners should consult with experts and advisors because they often lack preparation for disposing of a business; they often fail to have an accurate valuation

done; they fail to organize the books and records for review by potential buyers or they fail to de-emphasize the owners' personal role in the business.

Exit Planning – Sale or Other Lifetime Disposition Options

Whether a franchisor or a franchisee, a business owner has only a few options to exit.

1. Sell or give the company to a family member,
2. Sell the business to insiders such as key employees or other shareholders,
3. Sell to an outsider outright or keep a minority interest,
4. Go public,
5. Hire a management company and become a non-working owner, or
6. Liquidate the business.

It is also essential in preparing for a sale to gain an understanding of the current market for the company, how the market is for lending and equity and what buyers are paying for similar companies.

Valuation

A valuation or appraisal is necessary to determine the worth of a business, known as "fair market value." A valuation is particularly important in determining whether an owner makes a lifetime sale or leaves the franchise business by will or trust – and it is essential in determining gift and estate tax liability, if any. The specialized vocabulary of appraisals and valuations is filled with technical terms and some legal and accounting definitions overlap appraisers' usage while others do not.

The three main methods that are acceptable for determining business value are book value, capitalization of earnings and comparable sales.

1. Book value is the net worth of a company determined by either its balance sheet assets or the replacement cost of its balance sheet assets – minus liabilities.

2. The capitalization of earnings method assumes either that the earnings of a business constitute an annual percentage return on the value of the business or, more accurately, that the present discounted value of all of the business's earnings into the future is the current business value.

3. Comparable sales are recent sales of similarly situated businesses. Because those prices are not estimates but actualities, the comparable sales method is generally preferred as the most realistic proof of fair market value; however finding true "comparables" is often difficult.

One major pitfall for business owners is failing to get a realistic and professional opinion about the value of the business. Often they estimate value by relating it to the amount they feel is needed to maintain their lifestyle in retirement. But too often owners are overly optimistic, basing their exit plans on faulty valuations, causing major overhauls of retirement plans and some bruised egos. Therefore business owners should seek an objective appraisal well in advance of any projected departure, to see if their business will fetch what they think it will, and if not, the owner needs to adjust his retirement plans.

Estate Planning

An estate plan is a blueprint for the disposition of assets, whether by gift or upon the death of a franchise owner. The most-often used documents, particularly for those who will be subject to estate taxes, are:

1. Pour-Over Will
2. Revocable Trust
3. Durable Power of Attorney (Financial)
4. Durable Power of Attorney (Health Care) – also known as a "living will" or "health care proxy"
5. The Health Insurance Portability and Accountability Act Form
6. Irrevocable Life Insurance Trust
7. Grandchildren's Trust
8. Grantor Retained Income Trust, Grantor Retained Annuity Trust and Grantor Retained Unitrust
9. Charitable Lead Trust or Charitable Remainder Trust

Estate Tax Planning: Valuation Discounts

Using family limited partnerships or other pass-through entities such as LLCs or LLPs can facilitate the use of discounts for lack of marketability and for minority interests in determining fair market value of closely held businesses. The outcome of family limited partnership tax cases continues to be fact-specific but if properly done – and documented – substantial tax savings can be achieved through the use of FLPs with case law allowing discounts of more than 50 percent in certain instances.

Working with the franchisor and with professional advisors to create an exit and succession plan, in advance of a crisis, is a must to preserve the value of the owner's estate for future generations. ■

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