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1st Wednesday of every month at 12:15 p.m.
Upcoming meetings: Feb. 5, March 5, April 2

Corporate Practice YLS Committee
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Upcoming meetings: Feb. 13, Mar. 13, April 10

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CREATING VALUE FOR YOUR CLIENTS
THE NEWSLETTER FROM CORPORATE CREATIONS CHICAGO LLC

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EXAMINING EXIT STRATEGIES WITH YOUR CLIENTS: IT'S NEVER TOO EARLY

by Jay Sebben

Are you an advisor to small and mid-sized businesses? Does your client rely on you to inform them of potential pitfalls? Have you talked to your client about exit strategies for their business? No matter what stage of growth the business is in or what age the owner, it is never too early to discuss exit strategies with your client.

What Is An Exit Strategy?

You might be wondering what is meant by an "exit strategy." Most people think of an exit strategy as the sale of a business and that would certainly be correct. But exit strategies for business owners can include many other options and components. Exit strategies include retirement plans (too much of their net worth tied up in the business), transition plans (family members or manager seeking to buyout owner), back-up plans (in case the owner fails to grow or loses a client), capital plans (to merge with or acquire another company for growth), and investor return plans (to maximize return on investment). Although the sale of a company is the most traditional exit strategy for business owners, more than anything, an exit strategy is a plan. And as someone once said: unsuccessful business owners do not plan to fail, they fail to plan.

"I'm not ready to sell yet!"

Most business owners will tell you they are not ready to sell their company. Many business owners excel at planning for growth but few have planned for unexpected circumstances. So many things can happen in life and business: sudden illness or death, divorce, partner dispute, change in business climate, change in business interests. Too many business owners wait until things are less than ideal to examine exit strategies. When that happens, options diminish and value decreases.

Timelines, Stakeholders and Advisors

Possibly the most important reason to plan ahead is that exit strategies and major business transitions are often

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tremendously complex and can take much longer than expected. There are a lot of moving parts.

Once you have convinced your client that they need examine their options it is helpful to consider a timeline. Unlike publicly traded stocks and bonds, closely held businesses are some of the least liquid assets there are. Consider the time, effort and anxiety that is involved with selling a home (considered to be one of the most stressful life experiences) and multiply it by at least a factor of two. It will take several months, and in some cases years, to find the right buyer and complete any transition.

There are many stakeholders in any closely held business. Consideration of all parties involved is often difficult and can require considerable planning. As a result, business owners would often rather ignore the possibility of a business transition than begin to prepare for an exit. Owners, investors, family members, advisors, employees, suppliers, customers, and even competitors all have different and often disparate agendas when business strategy and transitions are being considered. Passive investors are often some of the first to push for an exit strategy and are primarily concerned with ROI. Family members may be alternately seeking to assume leadership roles and exit from the business. Advisors, employees, suppliers and customers may be concerned with the changes that will come from a transition. Competitors might smell blood.

Advisors are on the front lines when it comes to investigating options for their clients. If the exit strategy being considered for the business is a full sale of the company, all will ultimately be involved and all will need to cooperate and work together. Typically an intermediary will be retained to work closely with an attorney. Bankers and accountants will also be required to advise on financing or tax related matters. Additionally, Boards of Directors and other close advisors may need to weigh in on any major corporate decision. As a result, various parties will initially seek to pull the business and its owner in multiple directions but in the end, success will be predicated on everyone working together. Accomplishing this can take considerable time and effort.

Preparing Your Business

After everyone is on board, after a timeline has been developed, and after the decision has been made to proceed with an exit strategy, all that is left to do is execute. And that is when the real work starts. All of the components that can go into the transition of a closely held business such as valuation, negotiation, legal documentation, financing, retaining of third parties, and much more have their own set of complications and hurdles. All can be a separate discussion in and unto themselves.

But first the current business should be looked at and scrutinized carefully. The business owner may need to clean up their financial statements by removing obsolete inventory or related party business that will not continue. There may be family members who take a salary but are not part of the business and other expenses that are passed through but not part of regular operations. Presenting the business absent of these items will increase the value to a prospective buyer or investor. Perhaps the business is driven by long-term contracts that could be renewed under current management with relatively little effort but add significant value in the event of a transition. Many items will need to be looked at and reviewed and the more time (often several months or years) there is to execute the plan, the more likely the business owner will be satisfied with the transition.

Developing an exit strategy can be complex and is often perceived as unnecessary to a small or mid-sized business owner. But waiting to focus on the transition or sale of a business until one is forced to can result in significant decreases in value and success. Advisors need to recognize this and approach their clients regularly with ideas and considerations in this area. Ensuring that your client has an early start to planning an exit strategy may help ensure that you remain as an advisor to the business when a transition takes place.

Jay Sebben is a principal of DEGARDgroup Ltd., a Chicago based boutique corporate advisory and business brokerage firm. DEGARDgroup provides assistance to small and mid-sized firms in the areas of mergers and acquisitions, corporate finance and corporate strategy. For more information about DEGARDgroup please call (312) 942-0941 or visit their website at www.degardgroup.com

Managing Business Risk

by Cary R. Rosenthal

Perhaps the hottest area in business law today is the proper role of the various business players in risk management. The Enron/Global Crossing/Worldcom crises has focused new attention on officer and director liability.

Business management largely boils down to business risk management. Business risk might be defined as threats to an organization's ability to achieve objectives and execute strategies. Business risks that come to fruition might either prevent good results, or create bad results. The consequences of a risk that comes to fruition range from minute to catastrophic, bringing down the organization, its officers, directors, and even its auditors. Even worse under recent federal legislation attorneys are now coming into the federal government's crosshairs too.

Managing these risks entails the art of identifying the various risks that the company faces and creating strategies to deal with potential consequences. Those who manage business risk are charged with doing their homework and being reasonably prudent. In legal jargon this is sometimes known as "the business judgment rule". Under Illinois law directors must exercise their best care, skill, and judgment in the management of the corporation; they must do their due diligence to identify the risks and create strategies to deal with potential consequences. Section 8.85 of the Illinois Business Corporation Act urges directors to act in the best long and short term interests of employees, suppliers, customers, or communities in which the corporation or its subsidiaries are located.

In the wake of Enron, the buzz centers on how these standards have changed. Congress and the President fired the first shot on July 30, 2002 enacting the Sarbanes-Oxley Act of 2002, one of the most sweeping revisions to federal securities laws in 60 years including:

CEO and CFO Certification Requirements. Under Section 906 CEOs/CFOs must certify that all periodic financial statements fully comply with SEC requirements and that the reports fairly represent the financial condition and results of operations of the issuer. Under Section 302, CEOs and CFOs must certify that they have reviewed quarterly reports, the reports do not contain untrue statements or omissions of material facts, the reports fairly present the condition and operations of the issuer, the signing officer maintained sufficient internal controls to ensure discovery of information and disclosed all significant deficiencies and all fraud to the auditors and auditing committee, and that the disclosing officers have indicated any significant changes in internal controls or other factors that could affect the controls since the date of evaluation.

Loans to Directors and Executive Officers. Publicly traded companies are now precluded from extending, maintaining, renewing, or arranging for credit, directly or indirectly, for its directors and executive officers.

Acceleration of Section 16 reports. Directors and officers must file Form 4 reports by the second business day after execution of the transaction, instead of the tenth day of the month following the month in which the transaction occurs.

Statutory "clawback" of bonus and stock options. If a company is required to prepare an accounting restatement due to "material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement," then the CEO and CFO forfeit incentive or equity based compensation and profit on sales of issuer securities during the 12 month period following the release of the financial statements.

Whistleblower Protection. Companies, officers, employees, contractors, subcontractors, and agents may not retaliate against an employee for commencing or participating in legal proceedings with respect to any investigation of conduct the employee reasonably believes to be in violation of U.S. securities or antifraud laws.

Non-audit services. Audit committees must approve all audit and non-audit services provided by the company's outside auditors, and approvals of non-audit services must be disclosed in periodic SEC reports.

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Officer and director bars. The SEC may bar an individual who violates antifraud provisions from acting as an officer or director of a reporting company.

Auditors and audit committees. An independent auditor oversight board with broad investigative and sanctioning powers is established.

Insider trades during retirement plan blackouts. Directors and officers generally cannot trade in equity securities of the issuer during blackout periods for an issuer of 401(k) or other retirement plans.

These rules mostly apply to publicly traded companies, but are generally expected to trickle down to directors of smaller, non-public entities. Sections 1107 and 1102, the whistleblower protection and tampering provisions, respectively, do not specify whether they apply to publicly traded companies or even to SEC matters. These sections, imposing criminal fines and stiff prison terms (up to 10 years and 20 years, respectively), presumably

apply to all matters and investigations conducted by any federal agency. In addition the broader issues raised by this legislation and its ancillary effects center on the proper role of directors and officers. What must directors and officers do to ensure that they fulfill their duties? Simply stated directors and officers must design and implement strategies and systems to identify and manage risk, devoting sufficient time and energy to these tasks.

Several strategies may be employed to manage risks: i) avoid the risk; ii) mitigate effects of the risk; iii) transfer the risk; and/or iv) price the product or service to compensate for the risk. The strategy or strategies we employ are business decisions, plain and simple. Good risk management decisions comply with the business judgment rule, and presumably with Sarbanes-Oxley.

Enron is the standard of what is no longer acceptable. Enron's Audit Committee had an agenda of evaluating risks, an agenda that should have conservatively taken 2 days to go through adequately. The committee met for an hour and a half. This was standard procedure in corporations where the officers set board agendas, distributed the materials for board members to review, and otherwise controlled their board's information and the timing of distribution of that information. Today those procedures appear to be insufficient.

It is prudent that directors, in light of Sarbanes-Oxley, take more care in overseeing risk management. Boards must develop a methodical process to prioritize risks and determine coverage:

1. Identify the primary risks faced by the company;

2. Assess the probability of each risk occurring, and joint probability of risks occurring together;

3. Prioritize risks to determine coverage.

Towards this end it is prudent to hire appropriate consultants who have already identified and benchmarked various risks, and have expertise in designing and documenting such processes. In addition boards should invest in outside, independent legal counsel to monitor, document, and assist in the process. Different risks may require additional independent counsel. Not only does the mere act of retaining expert advice and counsel demonstrate a board's due diligence, but it may also distribute the risk of liability to those professionals.

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Spread the Risks

by Dan Feldstein

If you've been investing the majority of your funds in one stock or other investment vehicle, you need only to read current news headlines to see the impact of not doing what financial consultants have been saying for years-diversify, diversify, diversify. That means all of your financial holdings, whether they are stocks, 401(k) plans, bonds or other funds. Diversification is one of the best ways to help you reduce possible devastating effects of holding all your investments in one or a few asset classes.

The process of determining which kinds of investments you will hold, and in what proportions, is known as "asset allocation." Its purpose is to help you achieve an optimal mix of investments to produce the desired returns with the least amount of fluctuation in your overall portfolio holdings. Asset allocation seeks to accomplish this by reducing your exposure to losses that could result from a decline in one or more of your portfolio investments. By spreading your funds among several investment types, you may increase the probability that if the performance of one investment type is disappointing, others are holding steady or outperforming.

What are Your Choices?

Most types of assets fall under three broad categories: stocks, bonds and cash equivalents. On a long-term historical basis, stocks have provided the highest returns but have also experienced the most fluctuations in price. Cash equivalents (CDs, savings accounts, for example) have historically offered the lowest returns with the fewest fluctuations in price. Bonds have generally fallen somewhere between these two categories in both risk and returns.

Under these three broad categories lie numerous asset classes. For instance, most stocks can be identified as either "value" or "growth." In addition, they can be further segregated into large, small and mid-sized according to the total market value, or capitalization, of all the shares outstanding. Bonds can be classified by maturity-short, intermediate or long-term, and further segregated by type of issuer-corporate, U.S. Treasuries, mortgage-backed or municipal, taxable and tax exempt. Stocks and bonds can also be categorized depending on whether they have been issued by U.S. or foreign entities.

Diversification and Performance

Studies of the past performance of these asset classes have revealed distinct patterns regarding their historical returns and risk (as measured by price fluctuations). For instance, a study by Salomon Smith Barney's Consulting Group revealed that "value" stocks (those perceived as priced below their true worth) and "growth" stocks (those expected to grow faster than average) tend to outperform each other over intermediate time periods ranging from three to eight years. However, over long time periods of a decade or more, the difference in performance of these two asset classes diminishes. Studies have also revealed return and risk differences between large- and small-company stocks and between U.S. and foreign stocks over long periods.

Because of these differing patterns, the returns on various asset categories may not move in the same direction or by the same amounts. As a result, their returns may partially offset each other. By combining asset classes in a portfolio, you may be able to achieve returns that fluctuate less than any single asset class held separately. This can increase the compounding effect of incremental returns over time, possibly leading to substantially higher total returns.

Determining an asset allocation strategy that best suits your particular circumstance depends on many variables. These include the returns you would like to achieve and the amount of risk you are willing to take. You should also consider your current income requirements and the number of years required reaching your particular investment goals. Once those variables are known, a Financial Consultant can help you make an informed decision.

Past performance is not a guarantee of future results.

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