The Business Owner®

Disaster Strikes: Will Your Business Survive?

Dear Business Owner,

Business owners invest, strategize and labor year after year to grow revenue, market share, profit and capabilities. Much or all could be instantly lost if a disaster strikes. With proper disaster recovery planning (DRP), losses can be limited to acceptable levels. But few businesses have a disaster recovery plan. Most small and mid-size businesses remain at risk.

The risks of not having an effective recovery plan can go beyond the loss of assets physically destroyed in the disaster. Legal action can be taken against a business, its owners and executives if they are negligent in their duty to take reasonable precautions to protect others from harm. Damaged parties and potential claimants can include customers, shareholders, creditors and lenders.

Faced with the risk, why do business owners fail to plan? First, disasters are random and rare, so the tendency is to assume that it won't happen to you. Second, the payoff is uncertain for efforts taken to avoid such a loss. Owners naturally want to dedicate their limited capital (time, money and labor) towards more predictable returns. Neither reason is acceptable given what is at stake.

The risks of not having an effective recovery plan can go beyond the loss of assets physically destroyed in the disaster.

If you are a business owner, ask yourself this question, "How would my business be impacted if my physical facilities disappeared tonight?" In effect, this could happen with a fire, flood, earthquake or explosion. If the answer is unacceptable, then you need a disaster prevention and recovery plan. The cost in time and dollars to develop and implement one do not need to be significant. Use the following as a guideline.

Step One: Identify What You Cannot Live Without

The first step is to identify your most critical assets. Do so by listing the assets that you and your business use in the creation and delivery of your goods or services and in the operation of your business. The primary asset categories are facilities, personnel, data, network/connectivity, voice, hardware and software. Add to the list items that are necessary to prove ownership of valuable assets, rights or interests such as titles and insurance policies. Then rank each asset or asset class from most valuable and/or critical to least valuable and/or critical. Estimate the impact that each asset would have if lost. Quantify the impact in dollars, customer relationships, public perception and contingent liability.

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The Reference Source

for owners of small and mid-size businesses and the professionals who advise them... since 1975

How to Build and Retain Wealth Through Private Business Ownership

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From The Editor

David L. Perkins, Jr.

Dear Reader:

Hello! With this issue I excitedly invite you to begin a direct dialogue with me, and with the editorial staff of *The Business Owner*. In each future issue I will write to you through this "From the Editor's Desk" column. The purpose is to communicate more personally with you and to respond to your comments and suggestions.

The Business Owner is now in its 27th year and we are working harder than ever to provide you with a product that is valuable, interesting and applicable. To insure that we stay on target, we need to hear from you regarding your interests, preferences, concerns and ideas.

The challenges that you face, as a private business owner, may have never been so steep. The opportunities are great, but the potential pitfalls are numerous and ever varied. And just as was the case when this publication was founded in 1975, the information needs of the small and midsize business owner remain largely unsatisfied, replaced instead by opinions, special interest stories and overwhelming focus on the large public corporations that can have little in common with the small private firm.

Will you accept my invitation? Please email me at David@TheBusinessOwner.com, fax a note to me at 918-493-4924, or log on to www.TheBusinessOwner.com and click 'Ask the Editor.' I look forward to hearing from you!

David L. Perkins, Jr.
Publisher and Editor

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Step Two: Reduce the Likelihood That Disaster Strikes

The second step is to reduce or eliminate the likelihood that a disaster occurs. Begin by listing any perils that could cause damage or loss to one or more of the assets that you listed for step one above. Disasters, referred to as perils in the insurance industry, include: fire, flood, tornado, earthquake, bombing, riot, etc. Initiatives could include updating electrical wiring, installing and maintaining fire extinguishers, moving computer data and systems from a basement where flooding could occur, or locating in an area protected from tornados. Implement strategies that offer the highest reward as it relates to the associated cost.

Step Three: Develop a Survival Plan

Step three is to develop a plan for minimizing loss if a disaster strikes. To do so, consider each asset listed in step one and develop ways to mitigate or recover from loss. This might include backing up critical computer data, storing data off-site, buying and maintaining an electrical generator, and developing a detailed action and recovery plan. Consider the maximum length of time that you can tolerate being without the use of each asset or capability. The recovery plan should adhere to these thresholds.

Next, identify disaster recovery teams, team leaders and their alternates. Consider having leaders carry disaster recovery cards in their wallets or purses at all times. Include important phone numbers, addresses, meeting places and action steps. Assess the merits of having pre-written scripts that can be issued to the media upon the occurrence of a disaster. Include in your plan the location of your temporary or alternative office or how the location will be determined.

Step Four: Test the Plan Periodically

The final step is to test, implement and periodically audit the plan. Test to make sure the plan, and each component of the plan, works. Check every step before you adopt it. Don't bet your company on a plan you can't test. When the bugs are worked out, implement the plan and make all employees aware of it and their responsibilities. Periodically check to be sure that the plan is being maintained. For example, make sure backups are being made of data, and that the backups are of acceptable frequency and quality.

A terrific resource for additional information, products and services is the 'Disaster Recovery Yellow Pages,' that can be found at www.disaster-help.com or by searching the Internet by name. There is also software that can help. Business Impact Analysis Software helps a company assess the impact that a disaster could have. Recovery Plan Development Software assists in the development of a recover plan.

In summary, don't gamble your life work or your career on whether or not a disaster will hit your business. Assess the risk, develop a plan, make sure it works and then test it regularly. Do so and you will sleep better and your business will be more likely to survive for the long run. ❑

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Utilizing Insurance to Protect Your Company in the Event of a Loss

Business owners are all too aware that accidents happen. Failure to protect your company against such unfortunate events could have devastating effects on its future. This article provides a brief overview of the basic types of property and liability insurance coverage available, touches on several specialty products and explains how to protect your company in the event of loss. Health and life insurance policies are not addressed.

I. Traditional Types of Coverage

A. Commercial Property Insurance

Commercial property insurance is known as "first-party" insurance because it reimburses the policyholder for losses it has sustained to its property or as the result of temporary cessation of its business. Property insurance policies can cover such losses as fire, theft, flooding and business interruption.

Business income (formerly known as "use and occupancy insurance") and extra expense coverage are generally part of a commercial property insurance policy, either within the body of the policy or attached as an endorsement. They are intended to help the insured resume its normal business operations as quickly as possible. Available coverage includes reimbursement for loss of profit and payment of fixed and continuing expenses.

While policy forms differ, most business income provisions pay only for actual profits lost due to an interruption in business operations arising from physical loss to property that is specifically covered by the policy. Extra expense coverage compensates the policyholder for incremental expenses that would not have been incurred but for the need to continue operations elsewhere. Such extra expenses are distinct from the fixed and continuing costs covered by the business interruption provision of the policy.

B. General Liability

Commercial general liability (CGL) policies, formerly known as comprehensive general liability policies, cover a variety of claims brought against the policyholder by third parties. For this reason, CGL coverage is "third-party coverage." Generally, CGL policies follow the standard form prepared by the Insurance Services Office, an entity that prepares uniform policy forms used by many insurers. In most cases, policyholders have little to no input into the language of their insurance policies.

CGL policies cover a wide range of claims, beginning with slip-and-falls on the policyholder's premises. Coverage is also available for claims arising out of injuries alleged to have been caused by use of the insured's products. In addition to covering any judgment obtained by or settlement with the third party, the insurer will pay the costs of defending the policyholder in the underlying suit.

C. Workers' Compensation

State law requires companies to maintain workers' compensation insurance, which covers bodily injuries sustained by employees during the course of employment. The purpose of the workers' compensation system is to streamline the insurance recovery process while limiting a company's liability in the event of an on-the-job injury by its employee. Under certain circumstances, some workers' compensation policies may provide limited coverage for employment discrimination and other employment-related claims.

D. Automobile Insurance

Certainly, any company that uses its own vehicles during the course of its business, whether they are company cars for executives or trucks for hauling the company's materials, must have a comprehensive automobile insurance program. Such a program should include coverage for claims made by third parties against drivers of a company's vehicles, as well as coverage in the event a vehicle is struck by an uninsured or underinsured motorist. Policies in many states also must cover, on a "no-fault basis," medical care for drivers and occupants of company cars. Such coverage may not extend to commercial trucks.

E. Umbrella Liability Coverage

An umbrella policy provides extra limits of liability for your auto, general liability or workers compensation policy. In effect, it "sits on top of" these policies as an additional amount of insurance coverage. Umbrella policies can provide a few miscellaneous coverages as well.

II. Specialized Insurance Products

A. Environmental Coverage

Companies that handle or manufacture products that involve hazardous materials are at risk of environmental contamination claims by third parties or the government. Current standard CGL policies do not cover damage due to pollution or other environmental contamination for which the insured may be liable. Older CGL policies may provide coverage where state law permits an insured to recover under such policies for environmental contamination when the policies were in effect.

Specialized environmental liability policies can provide a source of recovery in the event that the insured is ordered to pay for the cost of environmental clean up. Policies known

as "cost cap" policies can help limit the cost of environmental clean-up by paying costs that exceed a sum established in the policy.

B. Employment Practice Liability Insurance

The explosion of employment discrimination lawsuits in recent years has necessitated the creation of a specialized insurance product that covers claims such as sexual harassment, age discrimination and disability discrimination in the workplace. Employment liability policies can provide a valuable source of recovery for these claims, which are excluded under workers' compensation and CGL policies.

C. Computer and Internet Policies

The advent of the Internet has led inevitably to another vast expansion of litigation. Parties across the world may now transact business on the Internet, which provides not only an added source of business but also fertile ground for litigation. The Internet has strained traditional notions of personal jurisdiction, as well as the provisions of CGL policy forms written years ago. Some insurers refuse to provide coverage under CGL policies for third-party claims such as copyright or trademark infringement arising from the content of a policyholder's website. Other insurers will not cover claims under first-party commercial property policies for interruption of computer systems and loss of data because, the insurers contend, the policyholder did not suffer physical damage to its property.

Many Internet or computer-specific policies are now available to protect companies in these situations. For example, at least one insurer offers a policy that covers claims against the insured for Internet-related activities. The definition of "Internet Activities" includes dissemination of material and the transaction of business on the insured's website. The policy excludes coverage for claims of patent infringement and copyright and trademark infringement in conjunction with the design or logo of the insured's product. Other policies may specifically cover copyright or trademark infringement.

Some insurers refuse to provide coverage under CGL policies for third-party claims such as copyright or trademark infringement arising from the content of a policyholder's website.

D. Intellectual Property Policies

The explosion of the Internet and the accessibility that is now available to intellectual properties has left parties even more vulnerable to infringements on ideas, trade names and slogans. Disputes in this arena arise from the allegedly wrongful use of or infringement on another party's ideas.

Many insurance companies offer policies that pay the cost of defending an intellectual property claim. For example, several insurers now offer patent insurance policies. Policies are available to cover defense costs and indemnity, including damage awards, settlement payments and prejudgment interest. These policies are termed "defensive" because they offer protection from claims by others against the policyholder.

Given the often cost-prohibitive expense of prosecuting intellectual property actions, "offensive" policies are also now available. These policies, which may fund a claimant's infringement litigation, include intellectual property infringement abatement and patent abatement policies. At least one insurer offers patent abatement infringement coverage, which covers the cost of an attack on patent infringement by a third party.

III. What to Do in the Event of a Loss

A. Notice to the Insurer

First and foremost, it is critical that you provide your insurance agent, broker or insurer, whichever applicable, with prompt written notice in the event that your company suffers a loss or receives notice of a claim against the company or one of its employees. If you provide notice through your agent or broker, you should follow up on a regular basis until you have confirmed that the insurer is on notice of the claim. The insurer must have prompt notice of your claim so it has an opportunity to minimize your loss or arrange for the defense of a lawsuit, depending on the nature of the claim. Failure to provide timely notice may result in a denial of coverage. Insurers often claim prejudice as the result of late notice, which could potentially bar recovery under an applicable policy. State law varies as to whether a policyholder may recover under its policy where the insurer contends that notice of the claim was untimely. In some states, such as New York, prejudice to the insurer is assumed in the event of late notice. In other states, including New Jersey and Texas, the insurer must demonstrate that it has been prejudiced by the policyholder's late notice.

The form of the notice varies according to the type of claim or loss. For example, both a telephone call to the insurer or agent and written confirmation of the loss are advisable in the event of property damage caused by fire or flood. If your company is sued by a third party, written notice of the claim with a copy of the summons and complaint should suffice. Regardless, what constitutes proper notice depends on the specific language of your policy, and you are obligated to follow the notice procedures set forth in the policy.

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Business Valuation — A Confusing and Misunderstood Concept

Want to know the value of your business? Pose the question to your closest friends and advisors. Write your own answer down and that of your spouse. You will be amazed at the range of responses. For further amusement, ask each how their answer was determined.

Despite that value and valuation is foundational to our entire economic lives and free-market system, the concepts remain misunderstood and are constantly misapplied. It can be said that only a precious few possess a true working knowledge of valuation. From these few come the capitalists that earn 99 percent of the wealth of our day. They do so by combining their knowledge with risk capital and putting both to work. The personalities are on the front pages or our newspapers and financial journals.

There should be little wonder why valuation is shrouded in confusion. Our high schools and colleges don't teach it … outside of basic microeconomic theory. Contrary to common belief, the basic curriculum for accountants and attorneys do not include business valuation. Most graduate business schools only cover the valuation of publicly traded securities. And many would be surprised to find that bankers aren't trained in business valuation, and they almost never look at business value when assessing a loan.

Despite that value and valuation is foundational to our entire economic lives and free-market system, the concepts remain misunderstood and are constantly misapplied.

However, regardless of the above, business valuation has some inherent characteristics that foster confusion and misinformation. The reasons include the following:

Value Is Subjective: Valuation is not exact, but rather very subjective. It is like beauty, as they say, "in the eyes of the beholder." What is the value of the watch on your hand? Or the diamond ring that your spouse gave you? What is the value of the old 1971 Lincoln Continental that has been sitting in your backyard, unprotected, for the past eight years? It was your father's last car and his prized possession.

Few People, Even Business People, Are Exposed To Factual Business Sale Data: The fact that so few of us own businesses means that few experience the purchase or sale of a business first hand. Businesses are not bought and sold as frequently as real estate or cars. And when they are, the data is much more complex and usually protected as confidential. Conversely, real estate sale data is of public record and is automatically recorded, typically at the county government level.

High Interest and Little Factual Data Breeds Misinformation: For whatever reason, people in our culture are immensely interested in both people and money. Business sale transactions involve people and, often, a lot of money. Therefore, there is much interest in the terms of sale. Combined with the fact that business sale data is not typically made available, and is usually held tightly, misinformation quickly fills the void. This phenomenon is well documented in research studies. Add to this the fact that the buyer or seller may allow or even seed false data that may put him or her in a favorable light.

Complexity of Business Sale Transactions and Prevalence of "Terms": Unlike cars and houses, businesses usually don't sell for 100 percent cash at closing. And it is very common for the price to ultimately be contingent on certain events occurring after the date of sale. The portion of a purchase price that is not paid at closing is referred to as "terms." As such, the actual sale price is often very difficult to determine. In these cases, the actual sale price can only be determined after all contingent events occur and the "terms" payments are calculated and paid.

Each Business is One-of-a-Kind: Most things we buy have identical or close substitutes. Even a used car or most houses can be considered to have very close substitutes. This makes the task of valuing any one much easier because we can compare it to others with similar characteristics. In contrast, businesses are almost all unique. They rarely have close substitutes. Therefore, applying the "comparable sales" method is much more challenging.

Finally, the coup de gras of confusion is the fact that the question, "What is the value?" has no definite answer unless the business is actually sold … and sold in a certain manner. Since the valuation task is often separate from an actual sale, value can only be estimated. In fact, this is precisely what is the valuation task. But to do so we must first answer three important questions: 1) Value to whom? 2) What definition of value? 3) Value as of what date? These concepts will be covered in future issues of *The Business Owner*. ❑

What Do Small and Mid-Size Businesses *Really* Sell For?

Ninety-five percent of businesses in the United States post annual gross revenues of less than $2 million per year. Despite this fact, hard data about the price for which these businesses sell is not well documented or disseminated. The primary reason has been that such data was not extensively gathered and analyzed. However, in recent years the available resources have improved somewhat as three groups are now tracking small business sale data. The three are The Institute of Business Appraisers, Pratt's Stats and Bizcomps.

In a publication titled *Transaction Patterns*, Toby Tatum reports the results of his extensive analysis of the roughly 4,000 business sale transactions documented in the Bizcomps database. The results may be chilling to many business owners, yet could explain the frustration many endure when trying to sell out. Below is a reproduction of some of the key results.

It is important to note that the average selling price in the Bizcomps database was $271,000 and the mean selling price was $127,000. Small companies indeed. Also, selling price is calculated by totaling the consideration paid for the inventory; furniture, fixtures and equipment; and intangible assets of the business. Excluded from the purchase price is consideration paid for accounts receivable, if any. Consideration includes cash paid and liabilities assumed (whether trade debt, seller financing or other).

The earnings value used in this study is Sellers Discretionary Cash Flow (SDCF), defined as annual pre-tax profit plus the total annual compensation and benefits paid to a single owner. To this total is added non-cash expenses such as depreciation and amortization and any interest paid on long-term debt. Added as well are any non-recurring expenses and/or expenses not necessary for the ongoing operation of the business. Likewise, if there are additional expenses that a new owner would have to incur in running the business, this amount has been subtracted.

Here are some of Mr. Tatum's findings:

- Businesses sell for 49 percent of annual revenue, on average.
- Businesses sell for 2.4 times seller's discretionary cash flow (SDCF), on average.
- Seventy percent of all small businesses sold include seller financing.
- Of the transactions that include seller financing, the most frequent percent of the total price financed by the seller is 50 percent.
- Of the transactions that include seller financing, seventy percent of the notes are amortized over five years or less.
- The payback period for the buyer's down payment has a mean of 1.1 years and an average of 1.5 years.

Although this data can help the business owner estimate the market value for his or her business, business valuation is a complex discipline. Before any results are relied upon, the business seller should consult an experienced appraiser or business broker. ❑

IDEAS TO INCREASE AND PROTECT YOUR WEALTH

Accounts Payable: Evaluating Early-Payment Discounts

Look for early-pay discount options on bills before you pay them. The offer might be a pretty good deal. To assess the attractiveness, simply calculate the effective annual interest rate that you will be paying if you don't take the option. Use the following formula:

$$\text{EAIR*} = \left(\frac{\text{Discount \%}}{\text{\# days payment could be delayed past early pay date}}\right) \times 365$$

**Effective Annual Interest Rate*

Example: If a $10,000 trade payable has a discount of 2 percent if paid within 10 days and payment is not made for 30 days (i.e., delayed 20 days), the effective annual interest cost for not taking the discount is 36.5 percent (2% / 20 x 365). ❑

Getting the Deal Done: Eight Tips to Get You to Closing

During my years as a commercial real estate broker, banker and business consultant, I've seen deals and financings fall apart when they shouldn't have. The reasons can usually be attributed to the basics, things that legendary football coach Lou Holtz calls "blocking and tackling." To maximize the odds of getting your deal done, do the following:

Don't Try to Teach A Pig to Sing

"You'll only frustrate yourself and irritate the pig," as a former boss of mine used to say. If you are looking for financing, find a lender that specializes in loans of the type that you are seeking. If you are looking for a buyer, look for persons or entities that are most likely to make investments of the type you are offering. Resist the temptation to try and fit a square peg into a round hole. Hard selling can rarely overcome a poor fit. And if the deal does close, the odds of it being a mutually successful relationship are diminished.

Be Prepared

If you want to get off to a bad start, show up at the first meeting unprepared. Carelessness may communicate that you run your business sloppily. In the case of debt financing, you should have in hand, and be ready to discuss, the following items:

- Description of your business including history, what you do and how you do it.
- Summary of your request and why the money is needed.
- Income statements and balance sheets for the past three years plus year-to-date.
- Projections for the next year or two, including cash flow.
- How the loan will be repaid – both primary and secondary sources.
- Personal financial statement.

For owners of closely held businesses, personal guarantees are normally required by lenders. Bring a personal financial statement to the meeting and you'll make a very strong first impression.

Follow-Up

If in your initial meeting the lender or investor requests additional information, send it promptly. If it will take you some time to gather the requested data, tell him how long. Confirm in writing what you will do and when you will do it. Then be sure and do as you say. You will establish credibility and communicate that you will be a good customer. Moreover, the parties will be more likely to mirror your professionalism and promptness.

Get Good Advice

We have all heard that lawyers kill deals. They can make them as well. Get good advice and you will maximize the chances that a good deal gets done for you. Good advice primarily comes from experience. Find counsel that is experienced in the type of deal on which you are working.

Be Realistic

Before you start spending time and money, be realistic as to whether the deal you are buying or selling has merit. Will the cash flow work with realistic projections of income and expense? Do the equity amount, collateral and cash flow coverage fall within acceptable norms? Don't be overly optimistic as you may be unwittingly putting a pin in your own balloon. This can be particularly true near the closing date when you are asked by the lender for an actual vs. budget comparison with the figures you provided when talks began.

Move Swiftly

Time kills deals. If you really want to get your deal done, move swiftly. Don't expect that you can take vacation during negotiations and have everyone still excited when you return. Have you ever heard of the pendulum theory? The pendulum never stands still. It is either moving forwards or backwards. Your deal is doing the same. Only your time, energy and diligence will keep it moving forward.

Give Them What They Want

No, don't give away the farm. Listen to the comments, concerns and requirements of the other party. Ask questions to understand not just what they are saying, but what they really mean. Then, address their needs. Whether you are seeking financing, a buyer or investor, resist the temptation to respond to objections by selling harder. Instead, address the party's concerns and figure out how your deal can be presented or altered in a way that addresses their needs and concerns.

Negotiate and Compromise

Negotiating any deal is give and take. Don't expect everything to go your way. Know the market, give yourself room, and accept the fact that you're going to have to compromise. An unreasonable request without a valid basis kills deals and destroys your credibility. Also, keep in mind that your opportunity will not be their only opportunity. Make sure yours is a win-win.

Adhere to the above and you'll maximize the chance that your next deal will get done. ❑

Cautions on Negotiating Business and Personal Contracts

Negotiations of legally binding contracts take place constantly in a business' operations. Protect yourself in all contract discussions, whether business or personal. You don't want to lock yourself into a deal before your advisers have reviewed it.

If your talks take place in a series of letters, as is often the case, be careful. You may unknowingly be entering into a binding contract when you sign a letter outlining the terms of a proposed deal. To avoid this occurrence, and to maintain your credibility if you have to change the deal, consider ending all negotiating letters and conversations with a sentence like this:

I will, of course, consult with my attorney before any agreement is finalized, and the matter is subject to my attorney's and board of directors' approval.

If you can't agree to a request, explain why and try to offer something in exchange. Good deals are built on a series of concessions and compromises. Finally, be sure to get sound advice when negotiating any major contract. That way, all the business, tax and legal considerations can be thought out well in advance. ❑

A Negotiating Checklist

Here is a list of items you should make sure are covered in any contract. Being familiar with them will also help you during your negotiations.

- Identify the parties and the purpose for entering into the contract. This is critical to establish the overall reason for the purchase and sale.
- Delineate precisely the price, terms, delivery requirements, payment schedule, cancellation provisions and penalties for noncompliance.
- List all warranties and representations (e.g., accuracy of the financial statements), and specify the conditions to be met prior to closing.
- Be sure the contract is self-contained, meaning that it excludes all items not written into the contract, such as prior memoranda. If prior memoranda prepared by the other side are very important, your lawyer should include them as addendum to the contract. This also applies to any information on which you are relying and the accuracy to which you want the other side to attest.
- Provide for instances of default and a specific time period to correct the default.
- Secure the right to assign the contract because it may be very important when negotiating and closing a future transaction. An example might be a real estate lease. You will want the right to assign the lease to another party in the event that you need to re-locate prior to expiration of the lease term.
- If you're a buyer, check all liens, tax claims, employment contracts, legal disputes, warranty liabilities, unfunded pension costs and any other contingent or off balance sheet liabilities.

IDEAS TO INCREASE AND PROTECT YOUR WEALTH

Depreciation Allowances Increased

The Job Creation and Workers Assistance Act of 2002 has increased the depreciation expense that can be taken on Section 179 Property such as automobiles, trucks, machinery and equipment use in a business. For tax years beginning in 2001, up to $24,000 can be depreciated in the first year ($44,000 for businesses in enterprise zones). Additionally, you may be able to claim an extra 30% first-year depreciation allowance on depreciable property acquired after September 10, 2001. More generous depreciation rules apply to certain property acquired after September 10, 2001 and used in the area of New York City damaged in the September 11, 2001 terrorist attacks.

Amended return: If you have already filed your 2001 income tax return, you may use Form 1040X, Amended U.S. Individual Income Tax Return, to claim the additional 30% first-year depreciation allowance. ❑

When Can an Employee Obligate Your Company?

When you hire or promote an employee into a position of some responsibility, you are holding out that individual as someone you trust who has the authority to represent your company to third parties. But you cannot personally oversee every action that the employee takes.

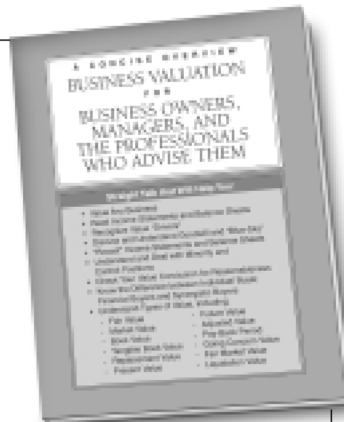
Major question: When does an executive or employee enter into an arrangement that your company will be legally obligated to honor?

Guideline: An employee, whether or not he or she is an officer, may commit the company to an obligation if you hold him or her out as authorized to make that type of obligation. For example, a supplier can regard a company purchasing agent as having the authority to place orders. This is referred to as "apparent authority." If you give an individual a particular title, such as executive vice president or treasurer, it connotes specific authority. And irrespective of your internal understanding with that employee, his title makes you liable for acts that he takes without your direct or personal authorization.

In addition, the CEO or president of a company is presumed to have authority to enter into most contracts in the ordinary course of business on behalf of the business. An officer or employee in a particular area also may have similar "implied authority" to make contracts in his own area of responsibility, e.g., the vice president of marketing or the advertising director.

What to do: Since an employee or officer with actual, apparent, or implied authority can bind you to a contract, you should establish internal controls on contracts above certain dollar amounts. These controls may be in the form of approvals or review by other executives or department heads. Another option is to require two signatures on checks and contracts for large purchases above a certain dollar amount. In addition to educating your staff as to what controls are in place, you may want to advise company suppliers of these requirements by including directly on your Purchase Order the approval(s) and/or requirements for valid orders. ❑

A CONCISE OVERVIEW
BUSINESS VALUATION
FOR
BUSINESS OWNERS, MANAGERS, AND THE PROFESSIONALS WHO ADVISE THEM



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- Value Any Business
- Read Income Statements and Balance Sheets
- Recognize Value "Drivers"
- Discuss and Understand Goodwill and "Blue-Sky"
- "Recast" Income Statements and Balance Sheets
- Understand and Deal with Minority and Control Positions
- Check Your Value Conclusion for Reasonableness
- Know the Difference between Individual Buyer, Financial Buyers and Synergistic Buyers
- Understand Types of Value, including:

- Fair Value
- Market Value
- Book Value
- Tangible Book Value
- Replacement Value
- Present Value
- Future Value
- Adjusted Value
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Avoid Severe Penalties When Rolling Over Retirement Funds

When it comes to retirement account rollovers, there are plenty of traps for the unwary. A mistake can cause the following:

- The total dollar value of the account to be immediately taxed as personal income to you, at rates up to 38.6 percent.
- An early withdrawal penalty of 10 percent of the withdrawn amount.
- Loss of the tax-sheltered status of the account.

Here are four ways you can avoid this from happening:

1) Rollover Extensions: Don't hold out hope. The IRS has held that it has no authority to grant an extension of the 60-day time period for rolling over funds from one retirement account to another, no matter what the circumstances. If violated, the full amount not rolled over is taxable income in the year it was not rolled over. In addition, you may be subject to a 10 percent penalty on the total amount if you are not yet age 59.5 and don't qualify for exceptions such as disability, hardship, high medical expenses, educational use or a first-time home purchase.

2) Saturdays, Sundays and Holidays: Don't get complacent because, in many cases, the IRS will allow you an extra day or two if a key filing or payment date falls on a weekend or holiday. Not so for rolling over an IRA or other retirement money. If the last day of the 60-day period falls on a Sunday, you'd better have mailed or made the deposit in the new account by that date.

3) Death Is No Excuse: What happens if you receive a distribution, plan to roll it over to a financial institution within 60 days, but die before depositing the money in the new account? The IRS has held that no one can make the deposit for you. The amount withdrawn and not deposited is taxable income if you miss the 60-day rollover period. However, one court made an exception: The account owner's personal representative (e.g., executor or executrix), can roll over the amount, but only if he or she does so within the 60-day period. How you plan for that contingency is a tough one.

4) Written Instructions. Don't give verbal instructions to your bank, broker or other financial institution on how to handle a rollover. Put the instructions in writing and send them by certified or registered mail. Make sure you get confirmation of the transaction and that it appears immediately on your monthly statement. That way you can spot a problem immediately and take action to correct it.

Keep in mind also that you are allowed only one rollover per year per IRA account unless you use trustee-to-trustee transfers. Also, the risk of triggering taxable income does not exist for funds that are held in a Roth IRA or are from other voluntary contributions that were not tax deductible when made. However, early withdrawals are still subject to the 10 percent penalty. ❑

Owner Stock Repurchase Tax Traps

There are some very tricky rules that apply when a company buys back stock of shareholders or related entities. Recognize that this is a very complex area and get expert advice before effecting any corporate stock repurchase.

Example #1: If the company redeems or buys back part of a shareholder's stock, the full amount paid (not just the profit) to the stockholder may be taxed as a dividend at ordinary income tax rates up to 38.6 percent, rather than at the capital gain rate of 20 percent.

Example #2: If you sell all of your stock back to the company — for example if you wish to retire — you also must completely sever your relationship with the company for the next 10 years. Otherwise, the full proceeds may be taxed to you at ordinary income rates. That means you can't be an officer, director, consultant or employee. It's okay, though, to be a supplier or rent property to the company on an arm's-length basis. You may also be able to be a creditor, under certain circumstances.

Again, be sure to consult your tax advisor before you make plans to buy back the stock of any shareholder. The rules are complex and the IRS filing requirements are detailed. More information can also be found in the Internal Revenue Code, Sections 302 and 303. ❑

12 Action Alerts to Use Today

1) Move money from demand deposits to certificates of deposit. Interest on demand deposits (i.e. deposits that can be withdrawn at any time such as checking, saving and money market accounts) is at an all-time low. In fact, with inflation estimated to be 1.6% a year and demand deposits earning less than 1%, money held in such accounts is not keeping pace with inflation. Consider moving excess short-term monies from demand deposits to CD's. Comparison shop for yields and maturity dates. Doing so is made easy at www.bankcd.com and www.fisn.com. Only purchase FDIC insured products, and be sure to inquire about early withdrawal penalty provisions as there is always a chance you may need to access the money before maturity.

2) Think Twice About Your Home Office Deduction: If you itemize home-office expenses on your tax return, you will be liable when you sell your home for capital gain tax on the percentage of the total profit allocated to the home office. The tax on that profit is payable in the year of sale. You will not be able to use your home exemption ($250,000 for single filers, $500,000 if you file jointly) to shelter the tax. In addition, tax returns that contain home office deductions receive higher rates of IRS audit. If you plan to sell your home soon, talk to your accountant before claiming a home office deduction on your tax return.

3) You've updated your will but have you drawn up a power of attorney? It's a good idea to legally designate an individual to act on your behalf if you become disabled or incapacitated. Exercise caution though. A power of attorney can authorize an individual to sign checks against your account, sell and buy assets in your name, and even run your business. So name someone you can trust. Another option? Name two people, neither of whom can act alone.

4) Stay away from insurance policies that provide very limited, specific coverage, e.g., death from cancer, accidents while traveling, etc. They often duplicate coverage in your existing policies. If not, it's usually cheaper to add that specific coverage to your general policy, e.g., double indemnity for additional accident coverage.

5) Help long-term employees deal with burn out and boredom. Consider ideas such as offering a lateral transfer to a same-level job in a different department; have two employees exchange jobs; appoint him or her to head a one-time planning or management committee; or authorize him or her to attend a seminar at a local university or training center. Better yet, ask the employee to come up with his or her own ideas for redesigning or expanding the job.

6) When hiring, don't overlook personality suitability. Employee turnover is expensive. Ask yourself, who else has failed in the job and why? Does the job involve difficult work circumstances (deadline pressure, weekend work, etc.)? What kind of work does the employee prefer and is that the kind of work offered by this particular job (detail work, creative work, deadline work, etc.)?

7) Don't solve every problem. Your time is money. First, ask yourself what will happen if you do nothing. If the consequences are minor or there is a good chance the problem will disappear or work itself out with time, forget about it and focus instead on more important problem areas.

8) Reduce unnecessary bank fees: With credit cards, consider the annual fee, the annual percentage rate, grace period before interest fees are assessed, and any penalties for non-use. With checking accounts, consider the minimum balance required, monthly fee, per-check charge, interest rate and method of calculating.

9) Security deposits on rental property: If you own rental property – as many business owners do – never commingle tenant security deposits with your personal funds. The deposit amounts may be deemed taxable income by the IRS. Also, in some states you must pay interest on the security deposit for the entire time you hold the deposit. Place security deposits in a separate savings account to keep track of the interest.

10) Don't arbitrarily cash in an annuity or insurance contract. It can result in taxable income and possibly tax penalties for early termination. Before selling or terminating the contract, investigate the terms and conditions on the policy or contract as it relates to cancellations. Talk to the insurance company and your accountant regarding the tax impact. If you face unwanted penalties or tax liability, look into IRS Code Section 1035 which provides for tax-free exchanges of annuities and life insurance contracts. There are also companies or entities that will pay you money to assign the policy to them.

11) IRS penalty and late payment notices can be wrong: The volumes that the IRS deals with are monumental, and they make mistakes. If you receive a notice from the IRS, check your records to be sure the IRS is correct. Even if it seems to be, send the notice to your accountant for a second check. If the IRS notice or penalty is not correct, send the documentation that supports your contention.

12) Switching mutual funds EVEN WITHIN FUND FAMILIES can be a taxable matter: Mutual fund companies often offer investors a choice of funds and promote the freedom to switch from one fund to another without paying a commission. But as many taxpayers have learned, such switches are of interest to the IRS. They can result in either taxable gains or deductible losses, depending on the comparative value of the fund on the date it was exchanged versus the original cost of the shares. Before you switch, obtain the data from your mutual fund company or broker that will allow you or your accountant to analyze the tax consequences.

Who Can Deduct Interest Payments?

Question Several years ago my daughter took out a mortgage to buy a home. I told her that I would help her pay it off. Now I am wondering whether I can deduct the mortgage interest since I've personally been paying the monthly payments. The loan is in her and her husband's name but they are now separated.

Answer You have to meet two tests to deduct interest on another individual's loan: (a) you have to be directly legally liable for the loan, and (b) you have to make the payments. From a tax point of view, your arrangement for the loan repayment is benefiting neither you nor your daughter. She can't claim the interest deduction because she isn't making the payments, and you can't deduct them because you're not legally obligated for the loan payments. You might be better off giving your daughter the money to repay her own mortgage loan. At least then she could claim the interest deduction.

Editor's note: If you co-signed the original note as guarantor, you may be allowed to take the interest deduction. ❑

RISK MANAGEMENT

Continued from page 5

B. Protecting Your Rights as the Insured

For claims under first-party policies, you must provide the insurer with copies of invoices and proof of payments that your company makes relative to the claim and keep the insurer up to date on the status of the claim. The insurance company must be permitted to examine all damage. Be sure to document all communications with the insurer.

In many cases, an insurance company will advise the policyholder that it will defend the policyholder in a third-party action "under reservation of rights." This means, for example, that the insurer will pay legal fees to defend a claim against your company without giving up its right to disclaim coverage should the facts demonstrate that the claim is not covered under the particular policy. Such a reservation is generally set forth in a letter to the policyholder. Some insurers require the policyholder to sign the reservation of rights letter to confirm that the policyholder consents to the insurer's reservation. Although there is no contractual obligation that the insured do so, as a practical matter, the insurance company will not likely defend on any other basis.

Likewise, the policyholder should reserve all of its rights against the insurer. This reservation may be made by writing a letter to the insurer to this effect. Alternatively, where the insurer requires the policyholder's signature on the reservation of rights letter, the policyholder may make such a notation next to its signature.

Aside from prompt notice, the policyholder's other critical duty for claims covered under third-party policies is to cooperate with the insurer. Such cooperation is generally a condition of the insurer's duty to pay your company's losses or defend it. This duty includes the obligation to cooperate with the insurer's defense of the policyholder in a third-party action.

In the case of claims under first-party policies, the conditions of recovery are specifically provided in the policy. These conditions typically include proof of the losses and submission to an examination under oath, a proceeding in which the insurer's lawyer asks the policyholder questions on the record. The answers may constitute sworn testimony.

If your company has provided prompt notice of a covered claim and cooperated with the insurer's reasonable requests for information, yet the insurer refuses to provide coverage, your company has the right to sue the insurance company to obtain a declaration that your claim is covered under the policy and reimbursement for your costs. Some policies provide specific periods in which to file such an action against the insurer. Be sure to review the terms of your policy and act quickly should you be forced to file suit against your company's insurer.

In summary, a working knowledge of the types of insurance policies available as well as the limitations of each type of coverage is essential to ensuring that your company is adequately protected in the event of a loss. Once your company experiences a loss or claim by a third party, knowledge of your company's rights and duties under the terms of the policy will assist your company in maximizing recovery.

This article was written by Laura C. Conway, an insurance litigation attorney with Porzio, Bromberg & Newman, PC in Morristown, New Jersey. It was edited and adapted for use in The Business Owner. ❑

Case Study: Buying Back Your Minority-Owned Stock

This case study is based on the experience of a business owner who owned 70 percent of his business. The balance was owned by two individuals, one whom owned 20 percent and was causing much difficulty. The controlling shareholder wished to reacquire the shares of the troublesome stockholder whose interest was valued at $200,000. However, after working through the numbers, the business owner decided that the cost to the company was too great. He decided to simply live with the troublesome minority shareholder.

When a corporation buys common stock from its stockholders, the transaction is referred to as a 'corporate stock redemption,' and the stock so acquired is called 'treasury stock.' Corporate stock redemptions are considered by company owners principally for the following reasons:

1. Peace: To silence a troublesome minority stockholder.

2. Obligation: For example, one of your executives is leaving the company and he or she has the legal right to require the company to buy the stock he purchased previously under a stock option plan.

3. Mandated Buy-Out: When a court of law orders the company to buy-out a minority owner's shares.

As principal owner of your business, you have to be concerned with any corporate stock redemption for the following reasons:

♦ Many states restrict or prohibit the purchase of stock by the company from its stockholders, principally depending on the availability of cash and capital surplus within the company to effect the stock repurchase. Basically, you cannot 'impair' the capital account and solvency of the business by repurchasing 'equity' securities.

♦ Other stockholders may complain because of the effect on the corporation, particularly its balance sheet. The operating agreement of the company may also require that such a transaction be approved by some percentage of the shareholders.

♦ You may be accused of unfair dealing if you don't offer all owners the right to sell their stock back to the company at the same time, price and terms.

♦ Your creditors may object since the stockholders' equity account drops after a redemption. For this reason, most loan agreements prohibit or restrict a company's repurchase of equity shares or interest.

♦ You may be sued by the selling stockholder if you know of certain facts that affect the value of the stock and these facts are unknown to the seller (material insider information) at the time of the stock repurchase.

Effect on the Company

Below is a description of the subject business owner's analysis with explanatory remarks. Note that this approach can be applied just the same to companys with other forms of ownership, including s-corporations, partnerships and limited liability corporations (LLCs).

Let's start with the stockholders' equity account, in which there are 100,000 shares of common stock outstanding.

Stockholders' Equity Account

Common Stock -- $1 par;	
100,000 shares outstanding	*$100,000*
Capital Surplus	*$120,000*
Retained Earnings	*$280,000*
Total Stockholders' Equity	***$500,000***
Book Value per Share	*$5.00*
Net Income	*$75,000*
Earnings per Share	*$0.75*

Let's also assume that total company debt is $1 million and that of the 100,000 shares outstanding, 20,000 shares are being acquired by the company (20 percent of the outstanding common stock). The agreed-on purchase price is $10 per share (two times the company's $5 book value per share), which represents a $200,000 total purchase price. Based on these facts, here's the result:

• Corporate cash declines by $200,000 (20,000 shares times $10).

• Stockholders' equity decreases from $500,000 to $300,000 — a reduction of 40 percent.

• Leverage increases from 200 percent ($1 million total debt divided by $500,000 equity) to 333 percent ($1 million debt divided by $300,000 equity). This assumes that no additional capital was borrowed to finance the stock repurchase. If that were necessary, the debt-to-equity ratio would have risen even higher.

Effect on Remaining Owners

The remaining stockholders increase their ownership percents. Since 20,000 shares are in treasury, a stockholder owning 10,000 of the remaining 80,000 shares will now

own 12.5 percent of the corporation (10,000 shares divided by 80,000). Before the purchase, this stockholder owned 10 percent (10,000 shares divided by 100,000). The percent ownership position of all stockholders will increase by 25 percent.

Book value per share declines from $5 to $3.75 — $300,000 pro forma (after repurchase) stockholders' equity position divided by 80,000 shares. The pro forma decline in book value occurs because the buy-back price of $10 per share was double the previous book value per share of $5 ($500,000 stockholders' equity divided by 100,000 shares). That's why other minority stockholders may not be in favor of the transaction — unless they also are given the right to sell shares back to the company on the same terms.

Based on last year's net income of $75,000, earnings per share would increase from $0.75 to $0.94 ($75,000 net income divided by 80,000 shares). Note, however, that if debt is used to finance the stock purchase, pretax income (and net income) should be adjusted downward to reflect the resulting interest expense.

Company cash is being used for non-productive purposes. This may significantly impact the company's future growth and its profitability and, as explained below, can negatively impact the company's borrowing ability.

Finally, the tax basis of each share of stock owned by the remaining shareholders remains unchanged despite the fact that the value of each share has risen due to the fewer number of shares outstanding. When the remaining shareholders sell their shares, as if the entire company were sold, the taxable gain will be greater than it would have been had the buyout of the 20 percent owner been effected by a direct purchase from the shareholders. Such a purchase would have required the shareholders to use personal funds to affect the purchase, but a step-up in the basis of the stock would have occurred and the tax owed in a subsequent sale would be less.

Effect on Company's Value

Since $200,000 is purchasing 20 percent of this company, the value placed on the business is $1 million ($200,000 divided by .20). In terms of fundamental valuation methods, this $1 million value represents:

• A price-earning's multiple (p/e) of 13.3 times last year's net income of $75,000.

• 2.0 times stockholders' equity of $500,000 before the stock repurchase.

• 3.3 times stockholders' equity of $300,000 after the stock repurchase.

This value analysis is presented to give you additional information to help you in deciding whether or not to effect the buy-out. You also will have to determine the value of the company going forward. For example, if this company were projecting net income of $150,000 next year, the $1 million value would represent a P/E multiple of only 6.7. This alone could justify the stock repurchase, particularly if the company's growth continues on course.

Access to Capital

The company redemption/purchase of common stock also has dramatic effects on the company's creditors, who now have a lower stockholders' equity account under their debt position, and a debt-to-equity ratio of 3.3 to 1 ($1 million debt divided by $300,000 stockholders' equity). In addition, the company's future borrowing capacity is substantially lower. Thus, if you are going to redeem any stock, be sure your overall cash position (today and projected) is more than adequate to finance growth and contractual debt repayments.

In any stock purchase by your company, get sound legal and tax advice before moving ahead.

What if You, The Owner, Are the Seller?

If you are the owner and your common stock is being purchased by the company, read "Owner Stock Repurchase Tax Traps" on page 11. Proceeds of your sale could be taxed to you at ordinary income rates rather than capital gain rates unless you completely sever your relationship with the company. Also, for liability reasons, make sure that the:

• Stock redemption price is at fair market value as established by an independent appraiser.

• Shares are purchased by the company on an arm's-length basis.

• Acquisition price and terms don't discriminate against other stockholders.

• Tax impact of the sale/purchase on both you and the company has been reviewed by your accountant.

In any stock purchase by your company, get sound legal and tax advice before moving ahead. In addition, remember this important legal fact: you, as a director and officer of the company, have a fiduciary obligation to all of your minority stockholders, irrespective of the number of shares they own. So be very careful. ❑

Actions to Take Before Moving Money Between You and Your Company

Steer clear of the IRS! If you have borrowed or will be borrowing money from your company, or lending to it, be sure to do the following. You don't want loans to the business reclassified by the IRS as equity capital since that would create taxable income to you as the loan is repaid. You also don't want borrowings from the company to be reclassified as compensation or dividends.

- Formally execute a promissory note and provide for loan repayment dates (monthly, quarterly, or annually).
- Pay a fair rate of interest, preferably what your company pays to its lenders but at least the IRS prescribed interest rate … currently about 5 percent.
- Try to give the company some collateral, particularly if this is the standard practice with other company loan agreements.
- Have the company's board of directors approve the loan and its terms in a corporate resolution that specifically defines it as a loan and record that action in the company's minutes. Abstain from voting yourself since the transaction involves a question of self-interest that could be questioned by the IRS.
- If there are minority owners in the business and the loan from the company is substantial, obtain their approval in advance.
- Check state laws. Some states prohibit or restrict lending company funds to owners, officers and directors.
- Record the loan on the company's books as an asset or liability of the company.

In general, the loan should be made on an arm's-length basis, as if an outsider were borrowing from or lending money to the company. In addition, if you or any other stockholders have personally lent money to the company, talk to your accountant about the IRS' rules on thinly capitalized businesses. Under such rules, the IRS could reclassify your loan as an equity investment and any interest paid to you, and possibly loan repayments, could be treated as a dividend. Dividends are not tax deductible by the company.

In addition, you could raise IRS questions on stockholder/officer loans if there is a possibility of unreasonable compensation or excess accumulated earnings retained in the business.

Best advice: Before making any loans to or borrowing from your company, review the items above with your accountant. If you're doing business as an S corporation, whereby stockholder loans to the corporation can increase your cost basis, check out your personal tax write-offs before making the loan. The same applies to owners of limited liability companies and partnerships.

References on borrowings: IRS Section 385 (Bona Fide Debt), 316 (Constructive Distributions) and 7872 (Below-Market Interest Rate Loans).

Don't commingle funds. If the IRS finds that you deposited business receipts in your personal account (and they frequently check this area on closely held and family businesses), you could be looking at comprehensive personal and business tax audits, possible fraud charges and heavy penalties. You also could lose the corporate veil protection that protects you from personally liability. Sole proprietorships make this mistake more than any. Make sure all receipts are deposited in and all business expenses written on a separate business checking account. ❑

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THE BUSINESS OWNER
7010 S. Yale, Suite 120
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