

# Commercial Bankers Must Know the Owner/Manager's Exit Plan

By Michael Oleksak

In the early days of my consulting practice, I met with the owner of a small manufacturing business. The owner had just learned he had inoperable cancer and confided that he would be dead in about six months. He did not have a succession plan but hoped his daughter, who was then 22 years old, would take over the business. My client wasn't sure because he had not discussed this plan with his daughter yet.

Ultimately, the business owner turned to his accountant, who was also a close family friend, to oversee the transfer of the company to his daughter while the accountant stayed on as advisor. Because it was cancer, the owner had time to draw up a will and organize his estate. His succession plan for the company, however, started with hoping his daughter would take over its management. His exit strategy had been determined by his health.

## Prepare for Sudden Changes in Management or Ownership

Imagine you were this business owner's commercial banker. Your small-business borrower drops this situation in your lap. Your first reaction is disbelief: This

middle-aged man looks healthy. Then you become sad because you know and like this person. But when you hear the owner's succession plan is to hope he can leave the company to his young daughter, you wonder: "What experience does this just-out-of-college daughter have? Have I even met her?"

This leads to more questions. How will employees react? How will customers react? How will you as a lender react? What is the future of this company? Will it stay financially healthy enough to repay the loan? No question, the lender's risk just went up. Should the interest rate rise as well? Is there a change of ownership clause in the loan agreement?

The owner's terminal illness is not his fault. It is, however, his responsibility to prepare for eventualities like his own untimely death. His family, employees and company rely on his leadership and foresight to anticipate future issues.

By the same token, **it is the commercial lender's duty to ask tough questions to protect the bank's position.** Even if there is a change of ownership clause, you as the lender are in the same boat as your borrower. You want the



**Michael Oleksak** was a lender for 17 years at Bank of Boston. He is a principal at Trek Consulting LLC, Winchester, Massachusetts and co-founder of the Exit Planning Exchange. He works with small and medium-sized businesses to increase value and prepare for exit. Contact him at [oleksak@trekconsulting.com](mailto:oleksak@trekconsulting.com) [www.trekconsulting.com](http://www.trekconsulting.com)

company to succeed so the loan will be repaid or taken over at some point by another lender. No other lender will want to step in now unless the conditions can be improved with a defined succession plan along with increased collateral or financial support.

## Understand the Owner/Manager's Exit Strategy

Commercial lenders should address this risk by understanding the exit strategy of every owner/manager in their loan portfolios (if these owners even *have* an exit strategy). The exit strategy will have a big influence on the strength of your credit as

well as on the viability of your relationship with the company. The exit strategy can lead to a conversation about whether the owner has a will and a succession plan. If the owner has not made a will, this could mean that ownership of the company's shares is undecided or that the shares could land in the hands of underprepared family members in case of the owner's sudden death.

Case in point: Miami Dolphins owner Joe Robbie, a successful real estate attorney, did no estate planning before his death. His heirs had to sell the Dolphins franchise and Joe Robbie Stadium at fire-sale prices to pay estate taxes. The family fractured over the crisis, and Robbie's legacy is not his successful real estate development career but the poor planning that harmed his family.

As a lender, you need to ask about an owner's succession plan and whether the firm has the management depth and clear operational assignments to survive a surprising end to the owner's life or incapacitation. A lender who asks these questions can prompt a business owner to develop a strategy and address shortcomings, thereby alleviating the lender's concerns about unforeseen occurrences.

What are the possible outcomes for an owner-managed business besides the dire circumstances just addressed? Let's look at two, both with different implications for the commercial lender: internal transfer and external transfer.

## Internal Transfer

An internal ownership transfer could be (1) a sale to the management team, known as a management buyout; (2) a sale to employees via a tax-advantaged employee stock ownership plan

(ESOP); or (3) a gifting of shares, usually to the next generation of the family, also with significant tax benefits. If the internal transfers are for less than 50 percent of the ownership shares of the company, the owner may stay in control of decisions and finances by controlling the voting stock.

**Influence on relationship with lender.** With an internal transfer, the lender should already be familiar with management if there is a change. With a management buyout, the lender should know the individuals taking over and must make a decision about whether the new team can lead the company despite the increased debt to finance the transaction. If not, the bank will ask to be paid out of the loan.

With an ESOP, the transaction will often be for less than the control of the company, a way for the owner to share with loyal employees by giving them an equity stake. A lender's decision making should be the same, however, given greater debt on the books to finance the purchase.

Gifting of company shares may be done in stages, so the current owner or management team may still be in control.

In all of these scenarios, what role will the current commercial lender play? No outside financing source will know the debt-service capability of the company better than the current lender, making it likely that the current lender will be the first invited to stay on to provide loans and services, including financing an internal transaction or ongoing operations. All these scenarios could be subject to a change of ownership clause in the loan agreement, allowing the lender to opt out

if not satisfied with the new ownership structure.

## External Transfer

An external transfer would be a sale, either to a strategic buyer (such as a competitor) or to a financial buyer (such as a private equity investor). Because the external transfer will likely be for at least a majority of the shares, the owner will likely be out of the picture in a few years.

**Influence on relationship with lender.** With external transfers, it is likely that the private equity group or strategic buyer will have its own stable of lenders. By keeping the lines of communication open with the company and the prospective financing team, as well as expressing interest in taking at least a piece of the financing, however, the current lender may well have a role in the new loan or be kept on to provide some services.

## Exit Strategy: Not Always Obvious

Commercial lenders are not often thought of as trusted advisors to a company's business owners. Trusted advisors are generally the company's CPA; attorney; and, sometimes, the owner's investment advisor. The fault is not with the banker. Decades ago, the relationship was closer. However, successful lawsuits for lender liability cases have influenced lenders' behavior. As such, lenders never want their actions to be interpreted by judges as having exerted undue influence over a borrower's business decisions. Lender liability can result in big financial penalties against the lender.

For this reason, commercial lenders are often out of the loop

when it comes to a critical factor influencing the strength and viability of their borrowers: the owner's exit strategy. Much conversation between a bank and the owner-manager of a business focuses on the owner's managerial role. It can be hard to get an owner to talk about ownership issues because these often require a discussion of personal and family issues. However, the owner's exit strategy can have a huge influence on the health of the company and on the bank's relationship with the company.

A good commercial banker provides numerous services to the owner-managed business, generating considerable fees for the lending institution. Apart from the fees and interest from the loan, the relationship probably also provides income for the bank from cash management services, trade services, account fees and balances.

Sometimes, when the lender is successful in engaging the owner in discussions of exit strategy, the loan and services may be lost anyway. Recently, a 12-store retail chain in the Northeast was sold to a large national retailer. Over the previous year, the lender had actively reviewed all the options facing the owner and the second-generation owners of the family business. In the end, the acquirer will pay out the family members for their shares, and the acquirer's bank at the corporate level will take over the financing and services. Even with this outcome, the former lender had a good understanding of risk throughout the life of the loan and was able to anticipate some form of upcoming change.

## Sources of Strategic Information

The lending officer typically meets regularly with the borrower's chief financial officer, treasurer, vice president of finance, or controller to discuss the quarter's results and trends. The lender can use these meetings to ask about ownership issues, including whether the owner has a will, who the beneficiary is regarding the company's ownership, if there is a succession plan and whether or not there is an exit strategy. If the lending officer is aware of upcoming changes in ownership, the lender can protect the bank's position as the preferred commercial lender.

The lender can help focus the owner-manager on the future by asking probing and thought-provoking questions about the owner's will, succession plan and exit strategy. If the owner is reluctant to discuss these issues, the lender should take this as a signal that such plans may not exist.

If there is a board of directors, or board of advisors, the lender should ask these questions:

- Where will the business be in five years?
- Does the owner want to own the business in five years?
- Does the owner want to be managing the business in five years?
- Does the owner have a will?
- Who is currently the beneficiary regarding ownership of the company?
- Is there a succession plan if the owner gets hit by a bus on the way to work?

- Does the owner simply envision the spouse or other relative taking over if something happens?

## Owners Want Their Businesses to Live On

Given the personal nature of these questions and their implied reminder of the owner's mortality, these can be difficult topics to discuss openly. But the commercial lender is a key stakeholder in a business, and asking such questions protects the bank's interest and capital. Ultimately, most owners would like their businesses to carry on and thrive even after they are no longer active participants in it. Creating and sharing details of a will, succession plan and exit strategy with their lender can help build toward a longer, successful existence for the business.