When starting a business, don’t forget about the exit

By **Claudia Chiappa** - 06/09/2023

VALUE JUDGMENT: Karen Rice, a certified valuation analyst at the Providence accounting firm Kahn, Litwin, Renza & Co. Ltd.*, says it is important for business partners to agree early on about how the value of a company will be calculated to determine how an exiting partner will be compensated. PBN PHOTO/MICHAEL SALERNO*

When starting a new business, the last thing on an owner’s mind is the moment they will walk away from it. But drafting an exit strategy is just as important as drafting a business plan, especially when setting up a venture with multiple business partners.

Failing to do so can get messy.

“Sometimes the situations are amicable, but sometimes they can become emotionally charged,” said John E. Barrett Jr., principal of Cranston-based Barrett Valuation Services Inc. “It becomes almost like a divorce case.”

As a business valuator with over 20 years of experience, Barrett has seen a lot of business partners turn to rivals over the years. He compares this to a marriage, where even the best partnership can unravel as the business grows and eventually devolves into a conflict.

Partners might disagree on the value of the business, on how to calculate it, or on the payment plan. And when this happens, disagreements can easily inflate into lengthy and costly legal disputes that drag on for years and drain the bank accounts of everyone involved.

In one case, Barrett describes three siblings who, after inheriting a business from their mother, could not agree on the valuation. Three years into the case, each person involved racked up $125,000 in fees, between lawyers, business appraisers and certified public accountants.

There are many reasons that can drive a shareholder away from their business, from simple retirement to incapacity or death. No matter the reason, certified business valuation analysts and attorneys in the state agree: the best way to prevent a messy exit is to plan ahead.

"It goes back to the very beginning," said Amy Stratton of the Providence law firm Moonan, Stratton & Waldman LLP, "so that in the event that something goes wrong or changes, there's a plan."

Stratton does not work on litigation cases, but she helps business owners draft documents that include their exit strategies. Each plan will have different terms, which should be drafted alongside an attorney and, sometimes, a CPA or a valuator.

One of the most important details to include is how much a company is worth and how that value will be calculated, authorities say. Based on the case, business owners might choose an agreed-upon value, a prorated value, or they might choose to hire a business valuator. One important clarification is whether the business will be valued at market value or fair value – meaning whether it will include certain discounts or not.

Agreeing on how the business will be valuated is particularly important because the difference in payout between market value and fair value can be significant, said Karen Rice, a certified valuation analyst at the Providence accounting firm Kahn, Litwin, Renza & Co. Ltd.

Other common details that should be included in the exit clauses are a payment plan detailing how the person leaving will be paid and over what period of time; and transfer restrictions, detailing who the company can be transferred to. In many cases, Barrett says, business owners choose longer payment plans because they might not have the necessary cash on hand. But longer payment plans also come with a risk, Rice says, as companies could go out of business before the exiting partner has been paid in full.

Other times, shareholders leaving a business might be asked to stay on as consultants. This is particularly common when larger companies acquire or merge with smaller businesses to help them bridge the gap between the clients and new management, Stratton says.

“It’s really complex,” Stratton said. “What people forget is that there’s an emotional component, as well as a financial component. The first thing the business owner must think about is: Are they ready to move on? If they really aren’t, negotiations become so difficult.”

Difficult indeed.

In another dispute Barrett is involved in, two shareholders have been arguing over the purchase price of their company. One of them is retiring and wants to be bought out. But because the documents did not detail the exact price of the company, the partners have been stuck in litigation that has cost them each up to $75,000 in fees.

Barrett says as many as 75% of the businesses he comes across do not have proper exit strategies in place.

“When everything is going good, business owners put that on the back burner because it’s not important to them,” Barrett said.

Some programs in the state are encouraging business owners to start thinking about their exit plans early on. Darryl Lindie, president of the nonprofit New Majority Capital Foundation Inc., launched a program in Rhode Island called Succession Ready, a five-week workshop to help small-business owners develop and navigate a succession plan for their businesses.

"Everyone has to leave their business one day," Lindie said. "The idea was how can we help people transition their business."

The program ran in the fall of 2022 and helped 19 local businesses start planning their exit documents. Lindie says he is already planning to run another round of the program.

"Most people think it'll be easy, but the reality is that it's a very tedious process," he said. "They [business owners] have so much going on, [they're] focused on running their business, so they wait until they want to leave to think about it. But they should be thinking about it earlier."

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