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Guest Article

Succession Planning Part II: Business Succession is a Team Sport

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Review of Part I and Its Connection to Part II

Succession planning is a critical part of creating a long-term business plan. Concrete suggestions on how to motivate clients to act and suggestions on additional features in a succession or buy-sell plan are the logical next steps. In Part II, the alternatives available to meet business, tax, and estate planning objectives are discussed in detail.

A significant percentage of the Gross National Product in the United States derives from businesses with fewer than 30 employees. On average, these businesses constitute 70 to 80 percent of the net worth of their owners. A well-drafted buy-sell agreement provides a ready market for business interests in the event of death or disability, can fix the value of the business for estate tax purposes at a reasonable level, and provides for continuity and stability within the business by eliminating the conflicts that can arise if no agreement is in place. Dynasties can be built and enhanced by these basic building blocks. If more business owners understood this paradigm shift could occur, it might alter the long-term success and transfer rates of closely held businesses.

Succession can be defined in many ways, the essential definition being "the continuation of a business in any form with any subsequent team of owners." This "new team" may include members of the previous team. Objectively, advisors will realize that some business owners do not care about the future and can only focus on the issues they must deal with to make their business succeed in the present. Those clients will be less focused than the clients who recognize long-term planning may be the watershed between a business that will carry on for generations and one that may remain successful only for their lifetime. The best advice for clients is to seek out advisors with the experience and creativity to provide a solution uniquely tailored to their business. For most business owners, business assets are the largest part of their portfolio. Succession planning, whether it is done at inception or as part of the documentation process for a more mature business, provides an ideal opportunity to build in "golden handcuffs" for those members of the management team critical to the success of the business. This also provides a forum for the business owners to work out unrelated issues not crucial to the succession plan but that play a part in building the long-term harmony necessary to overcome conflicts as they build the business together.

Challenges of a Family-Owned Business

Often, a family-owned business begins as the brainchild or "baby" of one individual. At some point, every entrepreneur must either include his or her family to support the enterprise, or develop a hierarchy of key employees. When family is involved, equitable distribution of assets is often a key component of both the succession plan and the estate plan. How do you equitably satisfy heirs with differing levels of involvement in a family-owned business? There are a variety of solutions, all requiring a certain level of cooperation and liquidity.

Cooperation. Rather than equal ownership interests held passively, a realistic approach to dividing a family-owned business might compensate inactive heirs for their share. How can this be accomplished?

1. Establish the ownership of the business in an entity with general and limited interests
2. Compensate non-participating heirs for their share out of corporate profits annually until the full value has been paid off
3. Insure the business value to pay off inactive participants

Liquidity. This is especially important when the balance of assets in the estate is inadequate to offset the value of the family-owned business. Giving inactive heirs active interests in the business can be a recipe for disaster. This is where it is critical for advisors to address the combined estate planning needs of the individual with those of the business. What are the key components?

1. A review of the estate tax balance sheet is required to assess the need for personal insurance, liquidity, a long term buyout plan to equalize with the value of the closely held business interests, or division into participating and non-participating shares
2. Determine a growth factor for both the closely held business as well as the other assets of the estate
3. Reassess the equalization needs on a regular basis

Realistically, any of these solutions will require a legitimate appraisal of the value of the business. The detail required in the valuation will depend on the type of business and whether or not there is a generally accepted standard for valuing that type of entity in the market. This is not a one-time event. In response to market conditions the value of any closely held business changes. Even the multiples can change if the market's perception of the long-term value of that type of business has changed.

Challenges of a Business with Unrelated Owners

Succession planning for a business with several unrelated owners has different obstacles. In order to avoid becoming co-owners with the spouse or family of a former business associate, both documentation and a plan for valuation and funding should be in place before any triggering event occurs.

Cooperation. The type of buy-sell—whether it is cross purchase, entity purchase, or redemption, or the hybrid wait and see variety—is the first issue to address. Agreeing on a means for appraising the value of the business may be even more important than the type of buy-sell arrangement. Assessing a current value with some means to adjust that value in the future makes the most sense. Depending on an appraisal or multiple appraisals at the time of the triggering event will not only be costly, it may also be divisive.

1. Bring in professional advisors to help create a plan
2. Agree to a deadline to have the agreements in place
3. Give the advisors latitude to review other business documentation
4. Agree on the single appraiser process; the selected appraiser can then reappraise the business periodically in order to keep the buy-sell up to date

Liquidity. Closely held businesses, particularly those with a corporate form, frequently act as pass-through entities, since earnings on retained capital will typically be taxed at rates higher than those of each individual owner. This translates into illiquidity for the business entity. Liquidity will be necessary to buy out an owner who dies, becomes disabled, or must be bought out for any other reason. Some of this liquidity need can be funded with life or disability insurance. The balance will have to come from the co-owners individually or out of business revenues.

1. With a current valuation in place, determine if the company has adequate liquidity to fulfill the needs of a triggering event
2. If insurance is part of the funding strategy, that coverage must be underwritten and put in place; this includes life, disability, lump-sum disability, and business overhead coverage if they are included in the agreement
3. The formula or method of valuation must be determined and a schedule established for periodic review

Combining Unrelated Owners and Their Families in Succeeding Generations

Stock ownership may simplify matters. For example, if the business is divided into real property for some heirs (i.e., the real estate) and business ownership for others, then conflicts could arise. Per stirpes distribution of business stock or assets can also create conflict when families have differing numbers of heirs. Also, over the long term, per stirpes distribution can dilute the ownership of the business. Limiting ownership to active participants and equalizing with other heirs can forestall some of these conflicts.

Personnel—Planning for Bench Strength

How will the business and its staff relate to the succession plan?

Hiring practices. At the managerial and executive levels, the prospect of ownership can both attract and retain key employees. These key employees can be part of the talent pool that will help a closely held business defy the odds of passing through successive groups or generations of owners. Once again, the risk of diluting the ownership of the company has to be weighed against the desirable outcomes of motivating and retaining key employees.

Creating a team. A well-aligned group of owners or a family that works as a team can present a more united front when employees create problems.

Aligning workforce with business goals. One of the biggest challenges is to hire within the limits of growth and not create salary or overhead liabilities that will put profits under pressure. Planning in advance can allow for controlled growth and adequate staffing at the same time.

Using succession-planning activities to motivate management. Often stock is offered with a rolling vesting schedule. The other positive effect of offering stock to key employees is that it motivates them to put the performance of the company as their highest priority.

Building a Succession Plan

The advisors

1. **Attorney.** An experienced business attorney is needed, with an estate and business planning background
2. **Accountant.** A licensed CPA is necessary to advise and monitor the activities of the business
3. **Insurance advisors**. A specialist in life, health, and disability with a second specialist in property and casualty coverage
4. **Valuation expert.** An experienced valuation team is necessary to provide a baseline for the valuation in the buy-sell agreement
5. **Business psychologist.** This need will depend on the ease with which the owners are able to agree on corporate agreements, buy-sell documentation and means of funding
6. **Family business consultant.** May come from a variety of backgrounds; e.g., if the business has achieved a certain level of capitalization (typically more than $50,000,000), this individual might manage the family office or be part of a multi-family office team; this role might be filled by a talented CPA, attorney, or financial planner
7. **Family systems expert.** Providing information technology (IT) as well as organizational expertise; this type of consultant could also be of value for a closely held business owned by unrelated owners
8. Additional consultants, as appropriate, to each specific industry

Some types of succession plans available. The owners must work with their advisors to design and fund the buy-sell arrangement. The three typical agreements are as follows:

1. **Cross Purchase.** In this plan, the owners individually agree to buy back the ownership interests of any departed co-owner
   - **a.** Advantage: stepped-up basis
   - **b.** Disadvantage: each co-owner is responsible for his/her share of the buyout price
2. **Redemption.** The company buys back the ownership interest
   - **a.** Advantage: A solvent company should have the funds available to make the purchase
   - **b.** Disadvantage: Tax issues—no step-up in basis as well as potential exposure to the alternative minimum tax
3. **Wait and See.** The most flexible alternative—to the extent that co-owners do not buy back the ownership interest of a departed owner, the company must redeem the balance; this alternative is a little more complex, but allows for the owners to choose how they want to treat the reacquisition

Funding the plan. In each circumstance the “plan” is funded, even if a written plan does not exist and funding was never agreed upon. Funding will have to come from insurance, the assets of the owners, the assets of the company, out of annual cash-flow, or new debt from loans negotiated on behalf of either the company or the individual owners.

1. **Death.** Funding can be formally established through the purchase of life insurance or by creating a sinking fund
   - **a.** Term insurance: Guaranteed for a certain number of years (e.g., 10, 15, 20, or 30)—the longer the guarantee, the more expensive the coverage; term is more economical in the short run than cash value insurance and may be convertible to cash value coverage
   - **b.** Cash value coverage. Either universal life or whole life. This is initially more expensive than term, but can be kept in force for the life of the insured, typically these policies accumulate cash that could be used to pay the initial deposit on a buyout at retirement or exit of an owner. Universal life is generally less expensive and more flexible than whole life but might not build cash values as rapidly. Cash values can act as a tax-advantaged sinking fund.

c. Sinking fund. A separate-cash account or fund that is invested and managed to provide funding for succession planning; should a triggering event occur in the near term, accumulated cash may be insufficient to meet the needs of the business.

2 Disability. Funding can be provided through insurance covering income, overhead expense, or lump-sum buy-out.

a. Disability Income Coverage: Pays the individual a maximum, typically 60 percent, of his or her annual income. Often the coverage is limited to $10,000 per month. More coverage may be available from specialty insurance carriers. This coverage could be used to make installment payments on a buy-sell.

b. Lump-Sum Disability Coverage: This is the type of policy appropriate for the partial buy-out of the ownership interest of one owner of a closely held business. The lump sum is usually paid out 12, 18, or 24 months following the trigger event. The longer the waiting period, the less expensive the coverage will be.

c. Overhead Expense Coverage: Provides supplemental income to cover overhead expenses when a key individual becomes disabled. It can shore up the financial situation of the company to make the necessary planning easier following a disabling trigger event.

3 Retirement. Requires funding through a sinking fund or out of profits. If cash value life insurance policies are being utilized to fund the buy-sell, funds can be withdrawn on a tax-favored basis to partially fund this buyout.

4 Departure. Friendly or Antagonistic—If an agreement exists, it should dictate the terms. Compensation terms will apply to any remaining income as well as to the purchase or transfer of ownership interest in the company.

5 Sale. Unilaterally agreed on or not—Similar circumstance to "Departure," above. In this case, a co-owner may or may not be leaving but has decided to dispose of his or her ownership interest in the company. If an agreement exists, it should dictate the terms of a sale and by what means the selling owner will be compensated. If the sale has not been unilaterally agreed upon by all owners, the compensation terms will not be as favorable. If agreement cannot be reached, it may be impossible to complete the sale. Most agreements include a mandatory right of first refusal for purchase by the company as well as the co-owners. Sticky situations arise when no agreement is in place or the price for the company is no longer appropriate and there exists no means to update it.

There are at least two other significant means to transfer closely held business assets not discussed here: Key-person buy-out and ESOP. These stray a little from the multiple owner premise developed here and cannot be properly addressed within this article.

The real message is that a solid agreement is crucial in holding together any succession plan. It must provide for mandatory buy-out provisions with the funding for those requirements established well in advance. This is vital for both family-held businesses as well as businesses that are owned by unrelated owners. Whether or not documents are drafted, funding will be necessary for succession. Proper planning, funding and documentation will save time and money and ensure that the business will continue to grow and prosper into the future.

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