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Guest Article

Succession Planning:

What Prevents a Business from Hitting One Out of the Park?

Leigh S. Harter, CFP®, ChFC, TEP
NFP Insurance Solutions
leigh.harter@nfp.com

In Part I of a two-part article condensed from the original, published by CCH as an Editor's Choice, Leigh Harter discusses the importance of business succession planning and why it can be difficult to convince small business owners of the necessity of this planning.

We are once again in the final heat of baseball season with the leading teams playing hard at the top of their game. A well-run baseball team can provide a miniature laboratory and a valuable parable for all the business owners with blinders on. They either do not take the time or do not have the patience or foresight to put a comprehensive succession plan in place. Every successful team must have a succession plan. By the essential nature of athletics, the younger players require proper training to be ready to play as older players exit the game. Unless they are real all-stars, elder players will see their playing time reduced to allow the rising stars to shine.

Of course, no business can have players perfectly trained in "the minors" waiting to take over should the opportunity arise. Running a business is a different proposition and requires a different type of planning than a team sport. However, the analogy does apply to the extent that business owners must acknowledge the need for long-term planning. They cannot and should not expect to be able to run their business beyond a certain time in their lives. Whether or not they are willing to accept a reduced level of capacity and responsibility, at some point it will become a fact that they cannot manage their business forever. Depending on the structure of the business, either co-owners or family members will gradually accept the responsibilities required to manage the day-to-day operations.

So when is the right time to put a succession plan in place? Most advisors recognize the majority of their clients know they should have an adequately drafted and funded buy/sell agreement or succession plan in place. However, this is not reality. Despite the universal agreement endorsing succession plans as one of the building blocks of a well-run business, most business owners do not have a plan in place and resist the advice they are given that such a plan is crucial to the long-term viability of their business. With a new business, it is often a problem of economic tradeoff. The owners have X amount of time in their day and believe they cannot allocate any of it to the black hole of negotiating the details of a succession plan. Many established entrepreneurs also have yet to agree on and document their succession plan.

Succession planning is the art of putting together a plan for the future of a closely held business. The plan will work much better if it is accepted by all owners, and, if well drafted, should provide guidelines to help ensure the continuation of the business beyond the tenure of those current owners. Majority owners can force a plan into place; however, this should be a last resort. The statistics for business continuation beyond the first generation of owners are depressing. Andrea Fredrickson, President of The American Institute of Management, a Council Bluffs, Iowa-based consulting firm, puts the number of family-owned businesses that make it to the second generation at 30 percent, and the number that make it to the third generation at 12 to 15 percent. The statistics for businesses controlled by unrelated parties may not be quite as drastic, but are similar. Obviously, these statistics confirming failure or financial hardship of second generation, successor management of closely held businesses are staggering.

Initial discussions can be enough to stop the planning process even before preliminary planning begins on the logistics of a reasonable succession or buy/sell plan. No one is looking for another pundit to reiterate the difficulties of getting clients to move forward with a critical part of their business planning. Concrete suggestions on how to motivate clients to act and suggestions on additional features in a succession or buy/sell plan to make it more appealing and "more" airtight are in order. No agreement is going to be perfect over the long term. We need to set our clients' expectations so that they understand that market dynamics and changes in the businesses they own will require their agreements to be reviewed and updated regularly.

Z. Christopher Mercer recommends business owners allocate one percent of their net capital to the services they should utilize from advisors. In essence, they can build a business supported by objective and competent advisors who will do all of the leg work that no entrepreneur has the time, patience, capacity, or inclination to pursue. A good way to rationalize this expense is to compare it to the management fees most people would be willing to pay a financial planner to oversee a portfolio. A typical entrepreneur has one major asset: their closely held business. One percent per year buys a lot of advice from attorneys, CPAs, insurance advisors, and financial planners. It also provides freedom from being bogged down in all of the minutiae that can be very competently taken care of by these trusted professionals. The statistics, once again, are astonishing: "About 75 percent of private equity is held by households for whom it constitutes at least half of their net worth."

As with most planning tools, the permutations are close to infinite when combined with other planning objectives and the various forms each business entity takes. Happily, there are only three basic alternatives for the format of a buy/sell:

Cross purchase agreements. These agreements require the other shareholders to buy out the departing shareholder or his estate under a number of specified circumstances and often require each shareholder to own insurance on the other shareholders that will pay a predetermined amount in the event of death or disability. For example, you might have three shareholders that each own two policies on the other two owners of the business. This can be a decent solution if it is reviewed and updated regularly for changes in the value of the business or for changes in ownership. However, if not properly drafted, the heirs of a deceased owner can end up owning the insurance policies he or she held to buy out the other owners of the business. This is one of many significant details often overlooked when a group of advisors comes together to craft a buy/sell. Also, if the company has numerous shareholders, the number of policies required to cover the "exponential" matrix of shareholders can become excessive.

Entity purchase agreements. These may be most common since they allow for multiple owners and do not typically require insurance to cover all of the ownership interests. They allow the company to buy back shares when a shareholder leaves as a result of any of the stated trigger events. Of course, the company must have adequate liquidity or the capacity to borrow in order to fund the repurchase of the ownership interest unless they planned for this event with either life or disability insurance, or a sinking fund that could meet a reasonable level of required repurchases.

Hybrid agreements. These agreements allow the shareholders to repurchase shares under specific circumstances. The problem here is that added complexity makes reviews more difficult and funding more complex. The specific circumstances that would typically trigger a buy/sell might be if an owner quits, must be fired, retires, becomes disabled, or dies. In order to try to address these disasters before they knock at the door, well-drafted agreements that have been either equitably funded or can realistically be paid out of cash flow should be in place. Removing a co-owner for insolvency, misbehavior, or malfeasance is especially challenging and should be specifically addressed in the succession planning documents in the same fashion spendthrift clauses are an important part of a well-drafted estate plan.

Why should business owners be concerned with the disposition of their business interests? Giving a related or unrelated individual control over your life's work without proper planning seems foolish. For example, if you do not have any contractual agreements in place with your co-owners, they can control the future of your business. If three individuals are co-owners and two decide to band together for any purpose, whether it is beneficial to the future of the business or not, the third owner is the odd man out by default. A reasonably complete buy/sell will prevent this in almost all circumstances. By its very existence, it supports an environment of equitable cooperation since all of the owners had to participate in a collaborative process to create the final signed document.

What Can Go Wrong?

Example 1. You can be tied to a partner who has become disabled and cannot bear their share of the managerial load. They need income and have a family that must be supported. The business has not planned for these contingencies and the disabled owner still owns a large percentage of the stock or is a full partner.

Lump-sum disability insurance, that could cover a significant percentage of this loss, is priced at an astonishingly reasonable rate—and most business owners do not even know it exists.

Example 2. A co-owner dies and his family inherits his interest in the business. There may be family members that have talent and interest in participating, or, there may not.

A written plan provides a map for how this transfer will be handled and can guide the owners and the family members at a time when emotional decisions might not result in the best outcome for either the business or the bereaved family.

Example 3. One of the owners decides he is no longer interested in participating and decides to sell out to … ?

A well-drafted buy/sell will include right of first refusal for the owners at a stipulated price or formula to prevent a sale to an outsider.

Example 4. In a family-owned business passing on to the third generation, each family may have a different number of children. Conflicts can arise between siblings and cousins, and ownership interests may be weighted towards one family depending on how the original interests were divided.

Business valuation. Anyone can add up the value of the property, the equipment, and the accounts receivable; however, that sum does not create a full picture of the value of the business. The intangible elements of a closely held business are difficult to analyze. Goodwill, customer lists, intellectual capital, and reputation are hard to capitalize. A professional valuation of the business definitely makes sense. That professional valuation will also be very helpful to the life insurance underwriters when the time comes to fund the buy/sell. Life insurance can generally be purchased to fully fund a buy/sell. Lump-sum disability, however, will rarely provide 100 percent of the buyout price. But, the lump-sum payment for disability will give the remaining owner or owner's significant liquidity at a time when it is needed both to fund the disability buyout provisions, as well as cover some of the ongoing expenses caused by the loss of a key individual in the business. Disability overhead coverage is another insurance alternative that is frequently discussed in the process of planning for business continuation.

Often, business owners resist the common sense advice that dictates the necessity of succession planning purely because they do not want to assign a value to their ownership interests. This could be called the "ostrich syndrome." The thinking may be that if no value is assigned to the business, the heirs may not have as heavy a tax burden to deal with at the time of my demise. Often this misconceived idea is companion to large personal life insurance policies that might equate to the value of the business for the benefit of each owner's family individually. This is really counterproductive and, even though it might replace the value of the business when one owner is gone, it does nothing to address the issues of buying out the shares of a deceased owner. If you follow this transaction to its logical conclusion, it will result in a bargain sale to the remaining owners, or shareholders, with an inadequate step up in basis for the interests they acquire. Succession plans are funded whether by intent or by default.

A well-documented and funded succession plan will ensure a market to purchase each owner's interest in the business in the event of death, disability, retirement, or bankruptcy, provide some or all of the funds necessary for the purchase of those ownership interests, and keep unwanted "partners" from taking over as owners. These could include competitors or heirs who might not be willing to take an active role in working for the long-term success of the business.

Detailed and thoughtful succession planning will provide a solution to this devolution of interests according to the considered desires of the original owners. Provisions may also be included to allow for revision of the plan in a well-ordered and agreed upon manner.

Leigh S. Harter, CFP®, ChFC, TEP is Sr. Vice President at NFP Insurance Solutions. She has over 20 years of experience and a distinctive track record of wealth transfer and insurance expertise that includes all aspects of high net-worth life insurance ranging from advanced underwriting and life settlement negotiation to portfolio analysis and case design. Ms. Harter can be reached at +1.312.630.0859 or leigh.harter@nfp.com.

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