Business Succession Planning

What Business Owners Need to Know to Pass the Mantle

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Building a successful business can take a lifetime and, for many business owners, their ultimate fulfillment is in creating a legacy that will keep their vision alive in perpetuity. However, as many business owners painfully learn, building a business is vastly different than building the foundation needed to successfully transition the business to new owners while avoiding many of the financial, legal and personal mistakes that can lead to an undesirable or costly outcome. In building a business, mistakes are often opportunities for advancing; however, in business succession, there are rarely any second chances to get it right. Successful business succession requires extensive planning and coordinated execution involving a cadre of financial, legal and business advisors; and, to ensure a successful outcome, it must begin the moment a business owner crystallizes his or her vision for their legacy.

This paper provides business owners with an overview of the essential elements of a business succession plan, providing them with a blueprint for envisioning and initiating the process; and preparing them to work effectively with the advisors who will be instrumental in guiding them and executing the strategies at each stage of the process.

Depending on your particular business and financial circumstances, your business succession plan can be somewhat straightforward; or it can be very complex, requiring the intricate coordination of several facets of your business and personal financial circumstances which may be beyond the scope of this paper. Regardless of your circumstances, it is always recommended that you seek the guidance of a professional advisor with specific expertise in business succession planning.

The Essential Elements of Business Succession Planning

Business owners can't be responsible for having all of the answers they need to successfully navigate the succession of their business. However, they do need to take responsibility for knowing what they don't know and asking enough of the right questions to obtain the answers. Tapping into the hindsight of business owners who have had this experience, as well as the expertise of advisors who specialize in business succession, we have compiled a list of the most essential questions a business owner must answer before initiating the process:

- **What is my true objective for the succession of my business?**
- **What is my exit strategy?**
- **Who are the stakeholders?**
- **Should I keep it in the family?**
- **Who will be my successor?**
- **What happens if I should die during the transition?**
- **What are the steps to ensuring a successful outcome?**
- **Who should be on my business succession team?**

What is my true objective for the succession of my business?

In transitioning a business, whether it's to existing employees or to family members, your motivations should form your objectives, which should then drive the process for developing your succession plan. If your objective is to keep your business a family affair, it will involve many factors that wouldn't have to be considered if you were to pass it on to an existing employee or partner – and vice versa. If, as part of your objective, you want to maximize the your equity prior to your exit, it will require a companion plan to coincide with the benchmarks of your succession plan. Your objective will dictate your timeline and resource requirements along with the type of advisory team you'll need to form. Your objectives, along with a realistic timeline should be established at least three to five years prior to your exit target.

What is my exit strategy?

Your objectives provide the framework of a formal exit strategy. This becomes the blueprint for making all exit planning decisions. Your exit strategy should include a concise statement of your personal, financial and business goals, prioritized by importance. No two exit strategies are alike; however, they all should contain the following components:

- A target date for the exit
- A plan for maximizing your equity in the business
- A determination of whether the business will be transferred to employees, partners or family members
- A determination of your role in the business during and after the transition
- A plan for ensuring the your financially security

After establishing your objectives for the succession of the business and the elements of your exit strategy, the next critical step is to plan for your own financial security. As part of that you will need to determine how you will receive your equity from the business and how that translates into your financial security.

Working with a financial advisor experienced in developing financial plans for business owners, you will have to consider all aspects of your financial future, including assessing your options for receiving equity from the business. In addition, you will have to develop:

- A post-business capital spend-down plan based on available capital
- An investment strategy designed to generate sufficient income while growing your assets
- A plan to protect against risk exposures, such as death, disability, personal liability, life longevity (the possibility of outliving your income and critical illness)

Who are the stakeholders?

In most privately held businesses, the stakeholders are easily identified – a business partner, spouse or family member with an ownership interest, a board of directors, a key employee. And, from a legal or a practical standpoint, their approval may be required in order to proceed with a business succession plan. The timing and approach taken for involving the stakeholders may vary, but business owners need to consider the needs and opinions of all stakeholders before wading into the process too far.

Should I keep it in the family?

Many business owners aspire to building their business as a multi-generational legacy. In an ideal world, the business and the family mature together, a successor is developed, and all of the pieces fall in place for a smooth transition to the next generation. Unfortunately, in many cases, the circumstances are not ideal or the ground work is insufficient to ensure the continuity of the business.

Research has shown that less than 30 percent of all family-owned businesses survive into the second generation and only 12 percent will be survive into the third generation. Surprisingly, only 3 percent of all family businesses successfully transition to the 4th generation. Of the 70 percent that fail in their succession, nearly 85 percent is due to a lack of communication, trust or preparedness. 1

For a family business succession plan to succeed, business owners must engage in a strategic planning process in order to ensure that its mission and values are pursued and its business goals are achieved. The family-owned business needs to engage all family members in a strategic family plan with a separate family mission, goals, responsibilities and roles. Determining what is important as a family and agreeing on values can shape the business mission in way that all family members fully understand the stake they have in building a profitable and enduring business.

Who will be my successor?

The search for a successor may begin inside the business if there are key people or partners that have demonstrated their commitment and competencies for running the business. If there aren't any candidates inside the business, then the search has to go outside. This is a much more difficult path and, unless you have a well-developed business network in your community, it may require a professional recruiter to find suitable candidates. This can take some time, as you will need to be as thorough in your search and selection as necessary to find a person with the skills and commitment you need.

If you are successful at bringing in a possible successor you will need a very detailed business plan that includes the succession strategy, the timeline, the terms of ownership transfer, a method for valuation, and method of financing. Very specific benchmarks should be established against which your candidate's performance is evaluated. If the candidate is brought in as a partner, then a partnership agreement with buyout provisions should be in place. It is very critical to have competent legal and financial advice throughout the whole succession process.

What are the steps to ensuring a successful outcome?

A business succession plan can take many forms but a written plan with specific action steps and time lines will ensure the best possible outcome. Business owners should seek the counsel of a business succession specialist in developing and implementing the plan. At its core, the plan should include three elements critical to its success.

Create a succession operational team

One of the more difficult aspects of business succession is managing the business while preparing it for succession. A business owner must be able to attend to both strategies in order to maintain the confidence of customers and employees. The business owner should appoint one or two point persons within the business to co-manage the succession plan.

These point people could be successor candidates, but, they should at least have operational authority. The succession team could also include lower level employees in key positions that impact the operations during the transition. The succession team should meet at least quarterly to review and assess the plan.

Implement an operational continuity strategy

At the beginning of the transition process, it is critically important to identify those positions and functions that must remain intact and productive in order to meet customer expectations and business goals. A key element of this strategy is to conduct continuous performance assessments and identify at-risk staff positions that may require new staffing. Special attention needs to be given to critical staff in operations and contingency plans should be drawn should the business experience employee turnover. The strategy should be assessed once annually throughout the transition timeline.

Implement a successor development plan

Once a successor is identified, a multi-year strategy should be launched to develop his or her management competencies and leadership capabilities. Successor candidates (there could be more than one) should be given increasing responsibilities and opportunities to demonstrate their capacity to manage and lead an organization. As the business owner, you are the trainer and coach who must provide close-hand instruction, critique and encouragement in all aspect of your successor candidate's performance.

What happens if I should die during the transition?

Business owners concerned with the continuity of their business in the event of their death should have a business continuation plan in place regardless of their exit strategy. Without such a plan, there is a greater chance the business will not be able to continue as the owner envisioned. At the death of a business owner, in addition to the need for a succession plan, there is typically a need for capital in order to pay estate settlement costs and personal liabilities. If the surviving family finds itself lacking in liquidity, it may be forced to sell the business at a fire sale price. Business owners should have sufficient life insurance in place for such contingencies.

It can get more complicated if there are additional owners, partners or stakeholders. The death of a partner or major stockholder can be devastating for a business if there isn't capital available to purchase the deceased partners' interest from the surviving family. The surviving family could initiate a claim on business assets which could result in a forced liquidation. Worse (in many cases), the surviving business owners could wind up having the surviving spouse as a business partner.

As part of an overall succession and continuity plan, businesses with multiple owners should have a written business continuation agreement (buy-sell agreement) that specifies a formula for valuing each partner's equity portion along with specific terms for purchasing their interests. To ensure that funding is available when it is needed, the agreement should mandate life insurance be purchased on the life of each partner. Depending on the number of owners, the life insurance can be purchased by each partner on the life of the others (cross purchase agreement); or, the business itself can purchase and own the life insurance on each owner (entity plan).

Buy-Sell arrangements are a simple, yet effective way for business owners of privately held companies to plan for the orderly transfer of business interests where two or more owners are actively involved in the business. In addition to securing the needs of the surviving family members and ensuring the continuation of the business, a buy-sell arrangement also ensures each owner that there is a buyer for their business interest at a fair price.

Business succession planning involves legal, tax and personal financial issues. Guidance from a qualified attorney or tax professional is strongly recommended.

Who should be on my business succession advisory team?

Business succession planning can encompass many facets of business strategy as well as personal financial strategy, which is typically beyond the capacity of any single advisor. Most successful business owners are already surrounded by a cadre of trusted advisors, each of whom performs a vital service from within their separate silos of expertise. At the earliest possible point in the process, business owners should carefully evaluate whether their current advisors have the capacity to advise them in business succession planning.

Business Succession Planning Specialist

Business succession planning is a specialty requiring expertise in business strategy in the specific context of transitioning a business from one owner to the next. A business success specialist acts as a consultant in helping the owner develop the plan, he or she also provides ongoing guidance in the implementation of the plan. In addition to business consultants, there are attorneys, CPAs and financial advisors who specialize in business succession planning.

Attorney

At points throughout the implementation of the plan, an attorney well-versed in business succession planning will be required to draw up agreements and advise the owner in the legal ramifications of different aspects of the business transfer.

Financial Advisor

The transfer of a business will impact every aspect of a business owner's financial life. In addition to planning for the financial security of the owner after the transition, the financial advisor needs to work with the owner in developing a comprehensive plan involving investment management, risk management, the owner's philanthropy, as well as an estate plan that needs to be coordinated with the transfer of the business. A financial advisor experienced in working with business owners, can be effective at selecting, coordinating and monitoring the team of tax, legal, insurance and philanthropic advisors the owner needs to successfully navigate both his business transition and his life transition.

Conclusion

Business owners who hope see their enterprise live on as a legacy to their families, their communities and their employees must rely on much more than hope as a strategy. The successful succession of a business can be a long process requiring intricate planning and disciplined execution. Planning should begin the moment a business owner envisions the future of the business; because, the longer the timeline, the easier it is to shape and control the variables. To begin the process, business owners don't need to have all the answers; however, they need be able to ask the right questions and surround themselves with a team of trusted and experienced advisors.

[1]Roy Williams and Victor Pressier. Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values. Robert D. Reed Publishers (2003)