Ideas to Encourage a Successful Business Succession

By Bill Schretter, CLU, ChFC, CFP®

One of the most difficult decisions to make in your professional and entrepreneurial life is the development of the succession plan for your business. Many entrepreneurs compare it to other major personal decisions such as marriage or the raising of children. Making the ultimate decision even more difficult is the myriad of related financial and personal decisions that do not just affect you. The decisions affect your family, your employees, your customers, your creditors, and your legacy.

Succession Will Come – But How

It is important to realize that "succession" will come, whether you plan it or not. So that your business has a better outcome and you achieve your goals, it is important to plan for this transition so that it can be a "successful succession." Of course, no single article can cover all the financial decisions and emotional decisions that need to be made with all their implications, but there are some basic choices for Succession:

1) Close the business when you are no longer interested in running
2) Maintain ownership, have other people run it, you receive the dividends, and leave the difficult decisions and the legacy to those who are managing your estate.
3) Sell or give the business to family members, relinquishing control over time to their skills and judgement.
4) Sell or give business to employees and key personnel, relinquishing control over time to their skills and judgement.
5) Sell business to outside buyer (cashing out). Trusting that they will continue the business and care for your personnel and clients, but the new owners make all the decisions.

Close the Business

Closing the business is a possible solution. As an owner manager, there comes a time that you no longer have the health, focus, energy or interest to run the business. If the business is not run well, it quickly becomes a liability to both your enjoyment in your later years, your financial stability, and to your estate. The assets of the business may be worth more than the ongoing operation and risk, especially when real estate, proprietary processes, and equipment are involved. Often the decision is beneficial when there are no employees involved in the operations and the business is really dependent upon your skills. You can close the business and become a consultant in the industry helping other entrepreneurs.

Maintain Ownership – Others Manage

Just because you own a business does not mean that you need to control it on a daily basis. Hire talented people to manage the daily operations. Become the Chairman of the Board. You can grant phantom stock or create other profit sharing arrangements to reward key personnel for effective management and achievement of growth goals. It is important to have them sign non-compete agreements and confirmations that you are the owner of the client relationships and the proprietary assets of the firm. Pay them well and trust them to do the job. Of course, this leaves the matter of succession to your Power of Attorney (if you are incapacitated) or you're Executor/Trustee (upon your death).

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Sell/Gift to Family

Often, family members express an interest in owning and running the business. Of course they should want to own and operate a profitable business. But you need to decide if they have the ability to. Business acumen is not a genetic trait that is inherited. If you want kids to become their heirs of the business, they need to develop their skills, reputation, executive responsibility, and relationship with the other team members and clients. This development plan can take years. This development plan is not dependent upon the pedigree of a college degree.

Meanwhile, you also need to know what you can afford. Sell the business for a reasonable value. Gift the business over time if you can afford it. You can transfer ownership over time and you do have the ability to separate controlling interest from the receipt of dividends. This way, they can earn the shares of ownership over time as you still receive the profits from the business. Any remaining shares can be transferred in accordance with the instructions in your Last Will and Testament or Trust. In case of untimely death within a specific period of time, you can have term or permanent life insurance owned by the business buy your shares from your estate to provide for your surviving spouse or other estate goals. This will leave your kids in the ownership and control of the firm.

Sell/Gift to Employees

I know many business owners who have a trusted employee that has been with them for many years that they want to have run the firm in case of their disability or death. I also have owners who have recently hired talent and are impressed with the direction that the new executive is taking the firm in. Over time, you may want that person or other key personnel to buy the firm from you.

The actual purchase of the firm can be executed using many methods depending upon how quick you want to transfer ownership, the tax treatment you want for the transfer, and the risk you want to retain regarding the ongoing operations of the business. Some examples include:

- You can bonus non-voting shares of the company to employees as an alternative or supplement to cash compensation.
- You can allow them to buy the shares through an ESOP or deferred compensation plan.
- You can let them invest cash directly into the business as an investor.
- You can work with them to buy life insurance and commit to a Buy/Sell arrangement in case of your death or disability.
- If certain “triggers” are activated, you can speed up the transfer of the business to buy you out via bank loans/LOC /life insurance.
- You can include a buyback (put option) of the firm at reduced costs so that you can take control if needed because of mismanagement.
- You can include protective options into the ownership and employment agreements so that the employees cannot sell/transfer their shares to third parties for profit without sharing the gains with you.
- Or some combination of these and other ideas. These arrangements are controlled by contract law and so everything is negotiable, especially if compensated for it.

Through such arrangements, you encourage long-time retention of the talent, develop greater business stability, and encourage the long-term profitability of the firm. These arrangements matter to creditors and customers because they reduce the adverse financial and operational impact of your untimely disability or death.

Sell to Third Party

Often owners think that this is the simplest of processes and easy to complete. Such a belief is wrong. Capital venture firms and other third party buyers will acquire a firm only if it has followed professional management style with a business model that is independent of the activities of the founder. They will want a detailed valuation and liability review and interview key employees. They will want to make sure that the talent, proprietary assets, and customers will be retained through the transition.

Often, professional business consultants, attorneys, and accountants must be hired to create the offering documents and the marketing materials to express the interest to sell the business to the third parties. Finally, such arrangements often require the founder to stay engaged with the business for a period of time and require a combination of retention holdbacks, stock swaps with the buying entity, and limits on the sale/cash out of the proceeds from the sale until a certain time period. The terms of the buy-out depend upon the popularity, growth, and specialization of the firm.

Steps to Succession

The following steps are not chronologically listed. Further, elements of these steps are circular, interactive, dynamic, and mutually dependent. Often such negotiations and steps require a professional advisor to help the process progress because these require difficult conversations:

- Succession Planning begins with imagining your future. What do you want to do in the future? If you want the business to be sold of given to someone else, you must be willing to let go of control. That will only occur if you choose to engage in new professional and personal activities.
- Give employees or involved family members the opportunity to take on more responsibility in the operations, client relations, and strategic planning of the firm. This can be done by taking more vacations and being involved in outside activities. Be willing to spend money to help with their professional development, so they become better managers and confidently increase their management activities. This also helps other staff members professional respect them more.
- Complete your own financial plan to imagine your personal and financial life without the company. It is important to understand your financial needs for your retirement plan, so you know the minimum sale price of the business and potential payment methods.
- Begin imaging your life after the sale of the business. In the interim, initiate some of those activities now including joining non-profit boards, volunteering with religious groups, start another business, encourage entrepreneurism through mentorships, living on your planned retirement spending levels, or just play more golf. If your employees or kids manage the business of increasing periods of time, then you can feel more comfortable in releasing the reins.
- Have a professional valuation of the business completed by a competent third party. That way, you know what the business is valued at and how it is trending. You also have a better idea of liabilities. Through the valuation, you also will develop ideas to financially position the firm for increased future profitability and competitive success.

- Begin process of removing personal guarantees as the founder so that the firm can stand on its own financial footing. Especially important to inform vendors, and suppliers and update any needed contracts to avoid disruptions in delivery or trade credit. Trade partners do not like financial surprises.
- Also, inform key clients of any management transition plans to verify that such transitions will not cause the loss of the customer. Sometimes those key clients are invaluable in planning the professional training needs of the successor employee(s) because they are aware of any mistakes that are made.
- Have the serious conversations with family and employees regarding the future of the business and confirm different party's interest or concerns in the negotiations.
- Since, there are many methods to finance the purchase or sale of a business in accordance with the needs and goals of both the buyer and the seller; hire attorneys and accountants to draft the transition agreements and decide upon terms and methods of sale. In accordance with their advice, inform creditors and lenders of the future transition. Loan covenant and credit problems may occur if a transition is made without creditor consent (e.g. loans can be callable and credit lines can be canceled).
- Adopt professional management techniques to make the firm independent from you as the original founder. A popular method to professionally prepare and transition the business is to become the "Chairman of the Board" rather than the daily "Chief Executive Officer". Through the transition from being owner/manager to minority owner, you share your professional insight and advice while transferring greater responsibility and authority to colleagues and future owners. A business will become more valuable as its operations and profitability become independent of the Founder.

Methodology and Timetable for the Actual Sale.

Often the Founder can become preoccupied with the actual sale price and trying to maximize the sale value while reducing personal liability immediately. If Buy/Sell arrangements are made too fast or the payment terms are extended too far out into the future, it can cause financial problems for the business and the new owners. It can also act as a disincentive for current employees to achieve growth plans because they will be buying the business they helped create at a high value in the future. So, a fair equilibrium has to be negotiated with a timetable that can be as long as 5-10years. The transition has to be initiated and completed in accordance with the agreed contract.

It is recommended you engage your Life-Legacy Consultant, an attorney, and a professional advisor with business succession training, or a CERTIFIED FINANCIAL PLANNER™ to help you in the planning, transition process, and the financial transactions. We can bring the entire team together to help you achieve a successful succession.