Passing the Baton: The Importance of Succession Planning in Business

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The baton may go to those who plan best, not to the swiftest.

Succession: The $10 Trillion Question

An article posted on the Small Business Administration’s web site (Family-Owned Business Success: Leveraging Advantages and Mastering Challenge, September 2005) claims succession has become a pressing issue for family-owned businesses. “Post-World War II entrepreneurs created the world’s greatest wealth and by the year 2010, they will be retiring and passing the baton of leadership in unprecedented numbers.” One economist estimates that this will result in the transfer of approximately $10.4 trillion of net worth by the year 2040—with $4.8 trillion of that transfer occurring within the next 20 years. “Though inevitable, succession is often the least planned and, consequently, the most perilous event for a family business. History has shown that only one in three firms will survive the transition to the second generation. Only 10 percent of the original group will survive into the third generation of ownership.”

A Relay Race

Like a well-run relay race, to be successful the handing over of a company should be graceful, carefully strategized, and well executed. A well-thought out succession plan is essential to the continuation of a business, regardless of its size and structure. Owners should begin planning while they are still healthy and active in their enterprises, preferably when they are between the ages of 55 and 65. The handing over of the baton -- the plan itself -- should be a process, rather than a single event. Some succession consultants recommend a three-to-five year plan while others advocate five to ten years. All agree, however, that the more time allotted for planning, the better will be the outcome.

Succession Checklist

The conscientious business owner should prepare for the best possible outcome by developing a business transfer plan. The plan identifies specific key trigger dates, including dates when you want to begin transferring ownership to others. Those dates would include (a) the date you want to begin transferring ownership to others, (b) the date when actual control is shifted, i.e., more than 51 percent of ownership of voting interests, (c) the date when the remaining balance of control is shifted, (d) the date when responsibility for day-to-day operations rests with your successor, and (e) the date you plan to formally retire. This timeline will also help you determine the length of time you have available to train your successor.

Whom to Hand Off To

Besides developing a detailed plan, the head of a business has the responsibility to identify a successor who will be equally or more successful in running the operation. More often than not, the head of a family-owned operation chooses a son or daughter as successor. However, it’s not unusual for an owner to have more than one child competent enough to step into the parent’s shoes, making the selection process more difficult. Some owners decide to divide the functions, giving each child equal responsibility. That, too, has its problems. Co-leadership may be equitable, but it’s a tough act to pull off. If they are unable to find a successor among their offspring or other family members, they need to set their sights elsewhere, perhaps on a competent employee of manager. Whether the choice is family or employee, the owner needs to identify the individual’s technical and managerial skills, their strengths and weaknesses, and what needs to be done to prepare them to take over.

A Financial Strategy

A business owner also needs to develop a financial strategy for handing over their business, one that protects the owner’s family, the company, and the employees. No matter who inherits the business, it’s critical to determine the business’s true worth. A comprehensive valuation should encompasses tangible assets such as real estate, buildings, machinery and equipment, as well as intangibles like employee loyalty, manufacturing
processes, customer base and business reputation, patents on products and new technologies, and using a professional valuation company may also be preferred. Because taxes can also influence how value is determined, include an accountant as part of the valuation team.

**Passing the Baton**

When it comes time to implement the plan for succession, the transfer method most often appropriate is a buy-sell agreement. Buy-sells enable the owner to safeguard their family's financial future and prepare the business to continue. Buy-sell agreements generally fall within two categories: cross-purchase agreements and redemption or repurchase agreements.

In a cross-purchase agreement, the remaining shareholders of a company are obligated to buy the departing (either by retirement, disability or death) shareholder's stock. The corporation itself as an entity is not a party to the agreement. Cross-purchase agreements enjoy certain tax advantages, wherein proceeds from the sale of stock are treated as capital gains rather than as dividends. In addition, if you fund a cross-purchase agreement with life or disability insurance, creditors cannot attach the cash values of the insurance policies.

Redemption or repurchase agreements specify that the corporation, via agreements made between the company and the individual shareholders, is obligated to purchase the stock of the departing shareholder. The major advantage to this type of agreement is simplicity -- each shareholder deals with one entity, the corporation, rather than several other shareholders.

A third type of buy-sell involves the sale of interest to key parties, most often prized employees. A business owner should consider taking out a life insurance policy as part of their succession planning. Life insurance policies can provide money to pay off estate taxes, fund buy-sell agreements or buy out a family member who is not interested in participating in the business. A major advantage of insurance is that it's the only funding medium that can be estate and income tax-free and even, in some circumstances, gift tax-free.

A successful business succession plan with allow for a seamless transition to the new ownership and management of a business and help ensure its continued success. This is critical not only to the survival of the business, but is often an integral part of the departing owner’s retirement income.

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