Commonly Overlooked Steps in Establishing a Family Business Succession Plan

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Many owners of closely held, family businesses are well-intended when they start the process of developing a succession plan. They adhere to the initial planning steps but then either become distracted with other matters or lose interest before putting the final pieces in place together into a functioning plan. Besides the obvious outcome of impairing the future of the company, not putting a business succession plan in place can have negative financial implications.

It Costs Not to Plan

There is a measurable cost if no action is taken toward planning the future of a family company. According to a recent report by the Boston Consulting Group, there was a 14-point differential in revenue growth and a 28-point differential in market capitalization growth over two years when comparing family businesses that had planned successions with those that had not. Further, unplanned successions yielded EBITDA margins that were four percentage points lower than those achieved by companies that successfully planned transitions. What have family businesses done and what do they still need to do to stay on the positive side of these statistics?

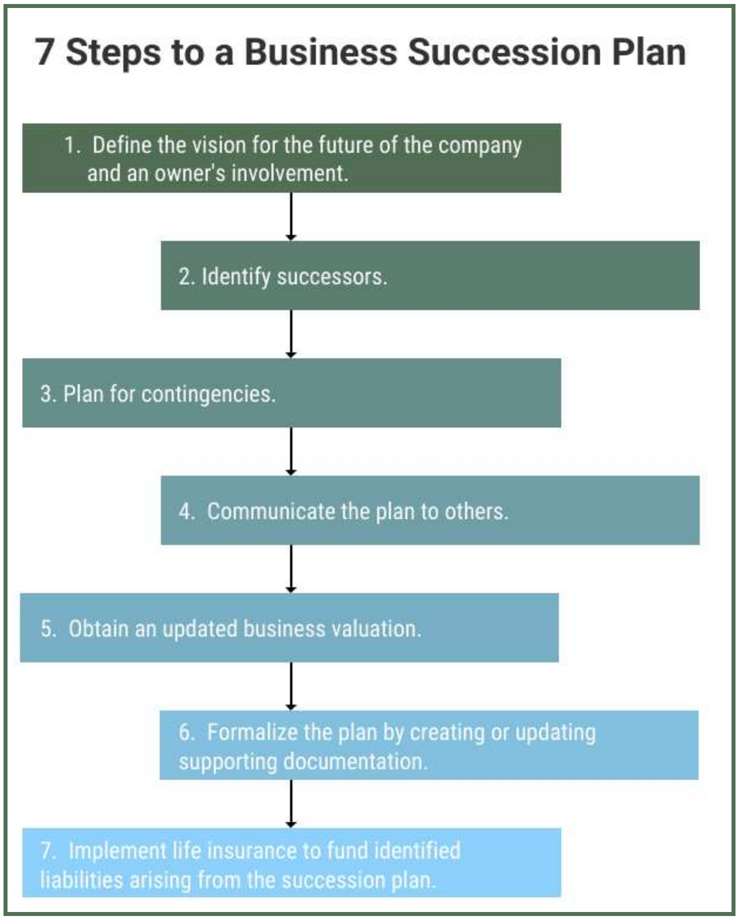
Even the minority of closely-held businesses that have started to plan for succession generally manage to only conquer the first steps of defining a vision for the future of the company and the owner's involvement, identifying successors and considering contingencies. Not surprising, it is the steps which require detailed work and difficult conversations which fall through the cracks, even for those well-intentioned business owners:

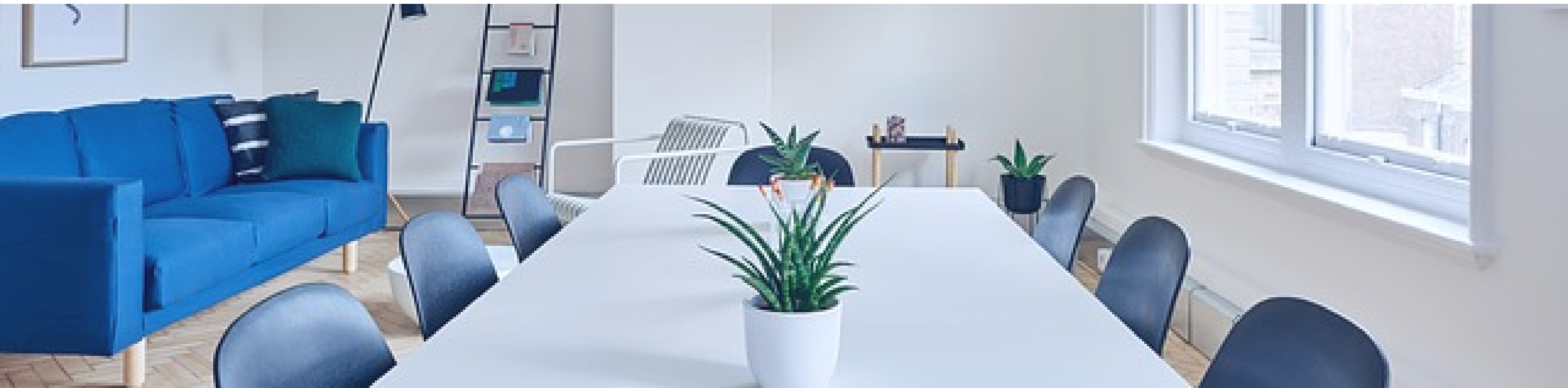
- Communicating the plan to others;
- Obtaining an updated business valuation;
- Formalizing the plan by creating or updating supporting documents; and,
- Implementing life insurance to fund identified liabilities arising from the succession plan.

Communicate the Plan to Others

Bluntly, failing to communicate a succession plan can result in chaos with shareholders, employees, family members and customers. All of these interested parties care about knowing when the owner will be retiring or otherwise transitioning the business; albeit, for different reasons. Customers must be able to know they can continue to count on the business for the goods and services they require. Employees who feel uncertainty about the future of a company are far more likely to jump ship prematurely. Other shareholders and family members want to know, "What's in it for me?" with regards to who will be calling the shots and if the business will continue.

Communicating a succession plan can be tricky because there is a great deal of nuance with it. There is a possibility that a person may not want the position you have them targeted for. Or, there could be some performance issues if a person takes their ascension for granted. Other family members may have strong opinions about the future which differ from what is presented and there may not be a way to avoid emotional and potentially relationship-damaging conversations. But all of that can be somewhat mitigated by open and frank communication.





“Communication from one generation in a family business to another is essential and what I would like to see happen more often,” says Michael Fontanini, Vice President of Advanced Markets for Lion Street, Inc., a national network of elite life insurance producers. Fontanini helps Lion Street firms connect high-net-worth individuals, family offices, business owners and corporate clients with powerful financial solutions. “When considering the longevity of a closely held business, there is tremendous value in senior leaders passing along professional and personal values to future owners. This can only be accomplished through open, honest and frequent communication.”

The best way to start talking about succession planning issues is to formalize business relationships in writing. Employment agreements can be used as a tool to formalize the management succession process and gradually transfer management duties to the successive generation in a clear, well-defined manner. Similarly, shareholder or operating agreements provide a clear ownership succession structure and ensure ownership of the business remains in the family.

Obtain an Updated Valuation

An independent appraisal to determine the fair market value of the company that is kept current is useful for both personal and business purposes. In addition to the usefulness in passing along or selling a business, the value of the business will likely play a role in the estate planning of the owner.

According to Mercer Capital, a national business valuation and financial advisory firm headquartered in Memphis, TN, there are factors which impact what a family business is worth to the family and non-family executives and what it is worth to a strategic buyer. For a family, there are three principal factors to consider in determining what the business is worth:

1. Expected Cash Flows
2. Growth Prospects
3. Risk

Whether using a discounted cash flow method or using methods under the income approach, the value of the family business to the family is a function of these three attributes of the business itself. This measure of value is often equated to the perspective of stock market investors or private equity buyers that look to the operations of the business to drive return apart from a strategic combination with another business.

A family may not wish to, or not be suited to, continuing to operate the business, and finding a strategic buyer will be the path forward. Usually, a strategic buyer is a direct or indirect competitor which can generate a number of efficiencies through the acquisition.

The value to the strategic partner will result from factors such as increasing negotiating strength with vendors and customers, reducing redundancies and measuring the increase in EBITDA. While it is much easier to the strategic buyer to set a value, it may be difficult for the current owner of a family business to know precisely what their company is worth to outsiders.

Once a valuation is in hand, much of the documentation and liability funding can take place.

Formalize the Plan by Creating or Updating Supporting Documents

Chad L. Halsted, JD, is a partner in the Tax Services Group of the Indianapolis-based accounting firm of Katz, Sapper & Miller whose practice includes closely-held business planning. Halsted regularly encounters situations where the valuation of a business does not match what is listed in critical operating documents. “A business might have put a buy-sell agreement into place 15 years ago with a formula based on a valuation which doesn’t make sense today,” says Halsted. “Anytime there is an updated

valuation, you will want to make sure the terms and funding mechanism in an existing buy-sell are consistent."

As the first step, the owner should obtain, review and, if necessary, update any of the legal governing documents which govern the company's existence, and which govern its operations and internal affairs. Many will impact what can or cannot be included in a succession plan.

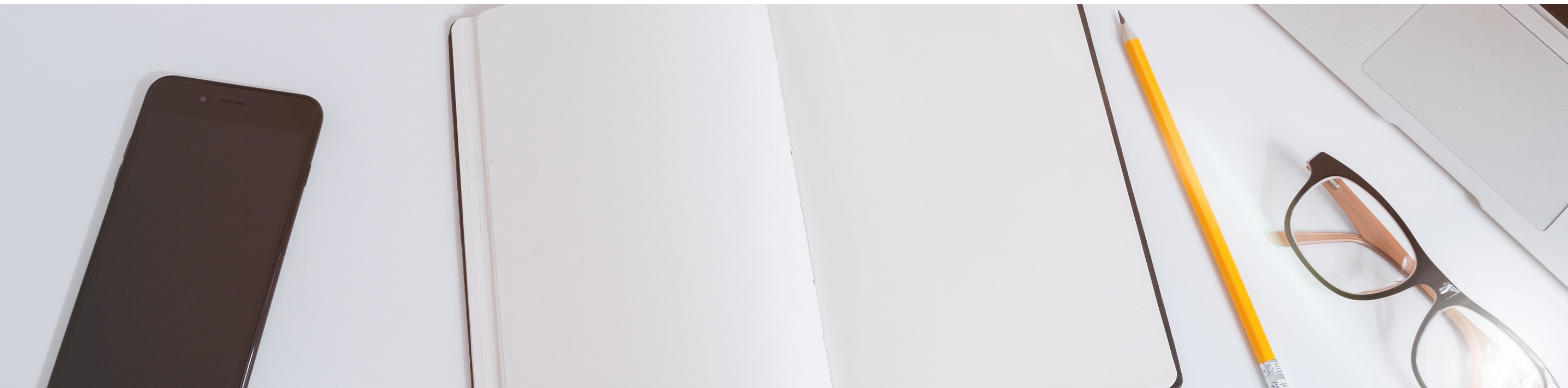
Depending upon the set-up of the business, these documents may include a partnership agreement, an operating agreement and/or articles of incorporation.   The owner should also review any existing estate planning documents to see how the owner's interest is tied to his personal planning.

These documents are where the intent of the business succession plan is recorded. While there are numerous items to consider, these documents should include:

- Details on ownership by heir or outside parties and what to do if an owner dies or becomes disabled.
- A termination clause that can provide the steps necessary for resignation or removal of owners.
- A dispute resolution clause that provides the steps necessary to resolve conflicts among partners.

Additional documents to carry out a succession plan will be needed, and these include:

- Buy-sell agreements, including trust agreements where there are intra-family transfers
- Key-person agreements
- Key-person compensation arrangements
- Power of attorney(s)



An owner of a family business may be the only one with the institutional memory of many of the aspects of the company. Therefore, it is recommended the owner let others know where to find:

- Legal will
- Property deeds/titles, leases, rental agreements, etc.
- Mortgages and notes payable
- Tax returns, financial records and financial statements for the last five years
- Bank account information
- Contact listing of all professional service advisors
- Life insurance and property & casualty insurance policy information
- Password and access information to all of the above

Implement Life Insurance to Fund Identified Liabilities

Life insurance, including disability coverage, is an exceedingly effective tool in a family business succession plan. Structured properly, it can provide immediate liquidity which can be used in a variety of ways.

Funding a Buy-Sell Agreement

If a business does not have the cash on-hand when a payment is due under a buy-sell agreement, they often must turn to less efficient and more time-consuming solutions:

- Selling assets or otherwise removing capital from the business
- Making installment payments
- Tapping into a sinking fund (if one was established ahead of time)

Only life insurance can guarantee complete financing of the purchase from the beginning. "Although there are other methods of buying out the position of a deceased shareholder, a single, one-time payment from a life insurance policy's proceeds can instantly separate the shareholder's interest and wrap-up the transaction," says Halsted. "An alternative is having the shareholder's family reliant upon the company to make a stream of payments in the future and this presents the possibility of an uncertain outcome."

Key Person

Most family businesses have family and or non-family employees that are important to its continued success. To protect against the financial loss due to the death or disability of a key employee, the company should purchase key person life and disability insurance. Key person coverage will compensate the business for the loss and provide the time to rebuild.

Compensation, Incentive and Retention Plans

A family business owner's plan for transitioning the business undoubtedly depends upon the efforts and skills of other key employees. Attracting, retaining and compensating these employees is critical to a smooth succession. Life insurance is a popular vehicle for informally funding these plans because it offers tax-deferred cash value growth, tax-free access to capital via a policy's cash values and tax-free death benefits.

Estate Equalization

In many families, not all of the children will be interested in or suited to take ownership of the business. If the business goes to the children who are active in the business, other heirs will need to be looked after. Life insurance can provide for those children who are not involved in the business.

Estate Liquidity

Commonly, a business owner's largest asset is their interest in the family business. Life insurance can provide the cash needed to pay estate taxes which might otherwise cause the business to be sold or impaired to satisfy. Additional factors which influence estate planning should also be considered such as the use of the federal estate tax exemption, gifting and charitable strategies and life insurance policy ownership.

Michael Fontanini sees life insurance as more than just a means of dealing with the unexpected. "Undoubtedly, life insurance is a valuable tool that helps business owners prepare for unplanned contingencies as well as for the inevitable. Properly designed, life insurance is also a unique asset class which can play a number of roles on a company's balance sheet to make sure the company continues to be well capitalized and intended owners have the proper ownership interest going forward."

Successful Planning

Intrametco is a family business which has gone through succession planning and continues to update its plan as conditions warrant. Established in 1979 and based in Noblesville, IN, Intrametco is a leading merchant of primary and secondary non-ferrous and ferrous metals. The company's president and son of the founder, Jon Town, recognizes the importance of following through on the planning process. "We recently had an updated valuation conducted by a firm our CPA recommended. That valuation then fed right into the documented cross-purchase plan we have to address the death or disability of any of our shareholders."

The company's CFO, Jay Stutz, oversaw the purchase of life insurance to fund the cross-purchase provision of the buy-sell agreement. "Unfortunately, the agreement was triggered with the passing of a family member shareholder," says Stutz. "Having life insurance policies in place made the buyout simple to execute." Town adds, "I'm

glad we put the policies in place and followed through with funding for the liability the agreement created."

For family businesses, a solid succession plan can drive the growth of the business, reduce taxes, and set the stage for retirement. The long-term survival of a business, and the preservation of the wealth that has been built, will likely depend upon getting ahead of those changes through strategic succession planning. Executing a succession plan will involve a team of life insurance professionals, lawyers, financial planners, appraisers and accountants.

About the Author

Mark Leyden, CLU® is the CEO & Founder of Mark Leyden & Associates, an Indianapolis-based firm specializing in assisting businesses and families in the acquisition and management of life insurance assets. The firm is an Owner in the national producer group Lion Street, Inc. Please contact Mark at mark@mlassoc.com.

Mark Leyden & Associates, LLC

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Our team works to ensure that our expertise provides the value to earn your trust. Our work will provide our clients the confidence that their family will realize the full value of their life's work.