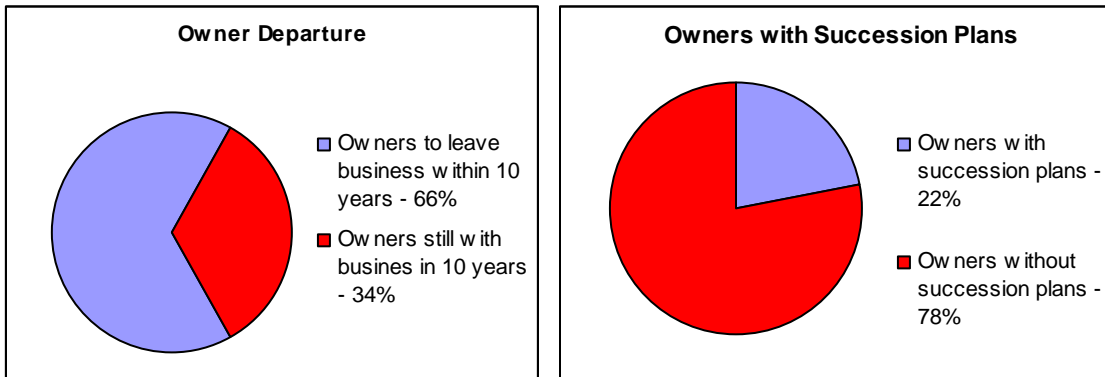


SUCCESSION PLANNING: A Challenge Every Successful Business Must Conquer

Successful entrepreneurs are usually highly optimistic people and somewhat averse to dwelling on the more unpleasant aspects of managing a business. Statistics reveal that most business owners have done very little to prepare for their departure from the company. See charts below. Most business advisors gloss over the subject by asking, “What happens when the business owner dies?” Most communication is focused on the consequences of an owner’s death on the business in theoretical or third party terms. Unfortunately these types of references gloss over the critical issue that you, the owner, must take care of to assure the business would continue to be successful if you would die tomorrow.



Over the years I observed that the owners who have done some succession planning have done so at the behest of an insurance or legal advisor. These professionals know that without a sound plan, families are left totally unprepared and unprotected in the event of a death or permanent disability. As an owner you should and must address these types of family concerns through estate planning. An estate plan is not a business succession plan. Because of the failure to see succession as a series of transfer events, many owners have incorrectly assumed that they have put in place an effective succession plan. In most instances an Estate Business Succession Plan is a plan funded by insurance to financially replace the owner and to pay any estate taxes. However, an effective succession plan must also consider contingencies which would provide financial consideration in the event of a premature death or disability.

Business succession planning must cover the multiple problems which face sole owners and multi-owner companies. Although death or disability magnifies challenges to survivors, the focus needs to identify critical issues which must be resolved in developing an effective exit strategy, whether in life or death.

**TARGET: “BE SURE YOUR BUSINESS CONTINUES
IF YOU DO NOT”**

Although an owner may think about death, often it is a fleeting thought about protecting the family, should the unthinkable happen. Yet, business succession, in its most fundamental sense, has very little to do with protecting the owner's family. Instead it is about preserving and protecting the company in the short term and the long term should its most valuable asset- the owner, die or become incapable of continuing in the business.

The planning model utilized by Summit Advisory focuses on three components in a family-owned business- Family, Business and Ownership. Ownership Succession, the most obvious problem facing a privately held business is enveloped by four vital issues:

- 1) Continuity of Ownership
- 2) Loss of Company's Financial Resources
- 3) Loss of Key Talent- Owner
- 4) Loss of Employee's and Customers

Problem 1: Continuity of Ownership

Sole Owner Company

Continuity of ownership is one of the most critical issues in a sole ownership company. At the death or incapacity of an owner everything revolves around a leadership void. This issue is compounded if death occurs and a successor has not been identified and groomed to fill the void. Often if a non-owner third party takes over the operation of the business issues regarding authority and accountability arise. Putting an untested party into the driver's seat frequently can lead to organizational frustration, envy and employee turnover.

Multi-Owner Company

If there is a funded buy-sell agreement in place, usually continuity of ownership is not an issue. However, problems arise when the owners fail to keep their buy/sell agreement up to date. In some instances the problems created often become greater challenges than if there was no agreement at all. Valuation issues can result in litigation and failed expectations can sever relationships between family members and employees. After years of working together in harmony, everything blows up and the debris generates schisms, anger and possibly legal consequences.

Problem 2: Companies Loss of Financial Resources

Sole Owner

From its inception the privately held business has often sought financial resources from within the family-notably the owner. The Owner's financial statement has usually been the basis of company borrowing and has enabled the company to meet its financial needs. If an owner has not transitioned the company into a self funded position, the business may not survive even if there is a good succession plan in place. More specifically, the death or incapacity of an owner can often cause uneasiness among stakeholders resulting in some choosing to discontinue their relationships with the business. Some of these situations may involve: banking relationships, bonding capacity, lease obligations with personal guarantees and capital shortfalls. Whenever an

owner capitalizes their own company they place the company at risk as any exit can prevent the company from obtaining ongoing capital. The deep pockets go out the door when the owner goes.

Multi-Owner Company

Very simply, if you personally are a principal source of funding (banking relationships, bonding capacity, lease obligations with personal guarantees and capital shortfalls) the company is at risk in the event of a premature death. This situation puts tremendous pressure on the business to perform or face the risk of third parties refusing to lend or make guarantees on behalf of the company.

Problem 3: Loss of Key Talent - You

Sole Owner

Your death has the same bearing as the death of a key employee without any qualified person to fill in the gap. Often your talents, experience, relationships with customers and employees may be difficult if not impossible to replace. This is often the case in the short-term. Without a succession plan which deals with this contingency few companies have the staying power, financial resources and most importantly successor management to weather the storm.

Multi-Owner Company

Although a multi-owner company does not face the exact situation as the sole owner company, if there has not developed secondary talent, the company may still not be able to readily compensate for your loss. To the company, your loss is the same as the loss of a key person. If the remaining owners do not have your expertise, talents and skills, the business will suffer in a similar manner as though it were a single owner company. If you were the key to marketing, or the chief operating officer or the individual with industry and customer contacts, the company will be mortally wounded. At the minimum there will be a slow-down or regression of the company's strength. Beware of the company dying a slow death.

Problem 4: Loss of Customers and Employees

Sole Owner

If an owner dies without a succession plan there is often a speedy emigration of employees and customers for fear that things will never be the same. The death of a sole owner demands immediate implementation of a business continuation effort. Without such a commitment, key and non-key employees may wonder about their next paycheck. In this emotional state many may leave for greener and more secure pastures. Loss of workforce puts all

contracts and commitments in jeopardy and could have a major impact on whether or not you will ultimately be able to deliver your product or service according to the terms of the contract. You want to avoid a mass exodus which could precipitate a shut down of what was once a vital business.

Multi-Owner Company

Companies with multiple owners often have to deal with the inevitable retirement of an owner or owners. Generally, retirement puts a significant cash drain on a company and may require additional staffing. Successor owners must be able to stabilize the cash flow requirements of the company. Without a succession plan which makes allowances for these events, the confidence of the employees and customers can be impacted with insecurities surrounding the company. A written succession plan which integrates retirement needs and the consequences of a premature death minimizes concerns regarding the strength and longevity of the business.

Solution 1: Continuity of Business Ownership

The most important thing any owner can do is create and implement a plan to allow the business to continue after the owner's departure. The loss of an owner requires plans to prevent employees from leaving the business since they are indispensable to the business' continued existence.

For a sole owner, consider a retainer type of bonus that increases compensation if they continuing working with the company. This bonus is a written and funded plan which provides ongoing bonuses over an extended period of time for employees who stay with the company during transition until a new owner takes over. This concept works whether the business is transferred to a third party or family members. For a sole owner, the retainer bonus can be funded with life insurance in an amount which is sufficient enough to provide bonus payments over an extended period of time. Ownership of the insurance can be inside the company or outside and part of an owner's estate plan. The important thing is that employees, especially key employees, are aware of the plan and that the continuation of the business is assured.

In addition, a sole owner should develop a written plan which carries out the wishes of the owner on death or permanent incapacity. Such a plan identifies key employees or others who will be given the responsibility to continue business operations, make financial decisions and oversee the administration of the company. A sole owner should develop a document which will identify the names of professional advisors who should be consulted in the ownership transfer process. If you believe that the business should be sold, whether or not there are family members working in the business, you should indicate your wishes in writing, including the names of prospective buyers whether third party, key employee or family member. Make sure the business continuation plan is given to your spouse and explain the basis of its contents.

When there are multiple business owners there should be an up to date adequately funded buy-sell agreement. If it is difficult to fully fund the agreement then the owners should agree on buy-out terms and the way in which payment of equitable interest will be made. Often buy-sell agreements are drafted when two or more individuals first go into business together. However, most buy-sell agreements need review so that they properly reflect the current value of the

business or extenuating circumstances in the business or industry which might require modification of the buy-out. Since circumstances change the agreement should address the many different transfer events such as death, disability, transfer to a third party, valuation, termination of employment, retirement, involuntary transfer due to bankruptcy, divorce or disputes between owners. The real danger to a multi-owner business is not the risks associated with death or disability but the false feeling of security that all contingencies were considered once and memorialized in an agreement which will last forever and cover all future situations.

Solution 2: Loss of Financial Resources

Incorrectly some believe that life insurance will assure the continuity of a business when the financial resources of the owner are no longer there. Although life insurance may provide relief, it is not a long-term solution. The business will need successor management which is motivated by ownership and cash, both current and deferred. The simple solution for you is to be sure that the business is more than you!

Any long-term solution such as successor management cannot succeed without adequate funds from the outset. Most advisors and owners overlook this fact. The loss of an owner will deplete the company's source of

- funds from bank financing,
- equipment financing guaranteed by you,
- bonding capability guaranteed by you and
- adequate capitalization.

It is highly unlikely that a successor will substitute his balance sheet for yours. A funded buy-sell agreement should not only fund your estate needs and the survivor needs of your spouse and family, but it needs to consider the serious loss of the key person in the business. When life insurance is not possible, you need to begin to build up the company coffers in order to meet current and future needs. If you are sincere and want to see the company continues either life insurance or a strong bank account will enable you to provide adequate recapitalization. Your personal balance sheet will not be a critical success factor in continuing the business as it may be at the present time.

Solution 3: Loss of Talent- You

Sole and Multi-Owner Companies

In a sole owner company the key employee is normally the owner. It is usually the owner's entrepreneurial drive, commitment to the business and experience which ignites a business. When you are gone, a blow is taken from which many small privately held companies cannot recover. When this situation occurs, no amount of life insurance can replace your presence, especially when the business is a mirror of you. As a result, one of the most critical commitments a sole-owner can make is to hire, train and develop competent successor management.

When we consider the needs of a multi-owner company the loss of a key person, you, is not as drastic. But, if you are the drive and vision behind the company, the survivor owner may face serious shortfalls. A funded buy-sell agreement may be the solution for the decedent's estate, but it may not make that much difference to the survival of the business if the talents which you provided are not duplicated quickly.

Depending on your skills and experience finding and training your replacement may take years. Depending on the business cycle, the payment of significant wages to get experienced replacements may not be possible. It is wise to identify a successor management person from within and have him prepared and committed to take over your position. In a multi-owner business each owner, if they are key to the company, should hire, train and develop a replacement.

Life insurance is a band-aid that can go a long way to meet immediate cash needs. The real issue is not cash but successor management. Your business requires motivated, talented key successor management. There is no quick fix. The very process of establishing a continuation plan helps to identify your skills and benefits to the company draws out the type of successor you should be seeking. Additionally, when succession is the goal, owners tend to look beyond themselves and start developing operating systems, financial control and renewed focus on accountability for job performance.

Focusing on continuation of the business and not single-mindedly focusing on the owner has many benefits. By considering succession you will be faced with determining your own destiny versus having a company which will need to react to a crisis event. Ultimately, the goal is to be successful, enhance profits and leave the company on your terms. When you leave the business the value of developing successor management will provide a greater return and may even provide an owner successor.

Solution 4: Loss of Talent- Employees and Customers

An unprepared company, whether a sole owner or a multi-owner company always faces a cascading series of events when an owner dies. This is especially true if the owner is recognized as the contact person for the company. The biggest challenge facing a company in this situation is the potential loss of employees and customers. Loss of employees can drag down companies to the point of non-performance. The inability to complete promised work has a direct impact on customers.

Employees and customers will leave if there is a feeling that the business will not survive. The competition may use this opportunity to leverage a loss to their advantage. Whenever a leadership role is hastily transferred to anyone but the recognized successor both employees and customers get uneasy. With this sense of insecurity migrations can occur by both employees and customers.

When employees are aware of a finely tuned continuity plan and see it being implemented quickly they will tend to want to remain. Succession planning goes a long way to quell the mystery of the unknown and can provide the assurances that both customers and employees need in order to stay with the company.

Conclusions

- It is equally important for sole owner and multi-owner businesses to have a well defined succession plan. Normally a multi-owner company can weather the storm better but that is not always true is the owner who left held the key relationships.
- There is no simple solution when a company loses its owner. However, with proper planning, a loss can occur with minimal consequences to the company, its employees and customers. Without a clearly defined plan, ownership transfers at any time can fall short of expectations.
- If your insurance agent or attorney suggests that you develop a succession plan be sure it encompasses life-time planning and is not just another funded buy-sell agreement. Remember that Succession Planning unlike Estate Planning focuses on the concepts of **leadership succession, business continuation and ownership transfer.**
- Reassess how you will approach your exit from the business and choose to do it in your way and in your timing. “Be sure you can either sell for top dollar and exit in style or do what you can to survive, but still exit in style.”

Robert G. Cook CBI
Summit Advisory
108 West Main Street
Strasburg, Pa 17579
717-687-8271