

Succession Planning For Business Owners



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A succession plan put in place now will provide certainty and liquidity to the value of your largest asset, your business.



On the balance sheet of a business owner, the asset with the largest value will usually be the owner's business. An estate planner will accept this value, assume illiquidity, and then propose to change the owner of the business in some way to minimize estate taxes and costs of administering the business owner's estate. A succession planner will probe further about the value.

A succession planner will ask two questions, and the business owner's answers will reveal the extent to which the business owner has a succession plan.

How certain is the value? While the current leader is "on the job," the value is as certain as it will be, subject always to business conditions. But at some time the current leader will not be there due to one of the four "D"s, namely, death, disability, distraction, or disinterest. Then, the value is certain only if the next leader is in position to assume the leadership role.

How liquid is the value? The value is liquid if the current owner can convert the business to cash. The source of cash may be insurance for some of the four "D"s (death or disability), but generally the source is the next owner, that is, a person in position to buy the business.

A succession plan will allow a business owner to provide solid answers to these questions. It will have two parts, namely, a leader succession plan and an owner succession plan. In addition, an interim plan is needed to cover the period before the succession plan is in place.

Succession plans vary by many factors, but the most important factor differentiating succession plans is the type of business as determined by location of the business' goodwill. The location can be with the entity (entity goodwill business) or with the leader (personal goodwill business). The location is with the leader if it is likely that customers would follow the leader if the leader were to leave the business. Otherwise, the location is with the entity. Where the location is with the entity, the two parts of the succession plan can be separate. Where the location is with the leader, the two parts must be combined in order to preserve the business.

Leader Succession Plan The current leader and current owner together must locate and train the next leader. The succession planner must provide the tools to keep the next leader in place. These tools include an employment agreement with compensation tied to personal and business performance, a deferred compensation arrangement, and perhaps an ownership arrangement.

Owner Succession Plan The current owner must locate the next owner. The next owner could be an existing co-owner, the next leader, current employees through an ESOP, a strategic buyer, or a financial buyer. The current owner and the succession planner must work together to make the business attractive to the next owner. This means doing in advance the "due diligence" that will occur at the time of sale, such as complying with corporate formalities, eliminating special arrangements (eg., loans to insiders, relatives on payroll), formalizing vital relationships, formalizing rights to vital assets, and settling pending or potential claims against the business. This combined with the next leader puts the business in salable condition. Where the next owner has been located, it may be appropriate to enter into an arrangement designed to keep the next owner in place. The succession planner must provide the tools for this, including a purchase agreement, an option agreement, and a co-owners' agreement.

Combined Leader-Owner Succession Plan For a personal goodwill business, the next leader and next owner will be the same person, and the leader succession plan and owner succession plan must be combined. In addition, there will usually be special "earn in" arrangements that require coordinating the compensation paid to the current and next leaders.

Tax Consequences The succession planner must provide guidance on the income and estate tax consequences of the succession plan. The plan can be designed to defer or minimize seller's income taxes using techniques such as a tax-free reorganization, an ESOP, or personal goodwill. In a family context, the plan can be designed to minimize estate taxes using techniques such as valuation discounts and gifting.

Call to Action For certainty and liquidity of the value of a business, every business owner must have a succession plan, and the time to do it is now. To learn more about how our business succession planning attorneys can structure a plan for you, please contact me at 312.621.4400 or LStaat@SNSFE-law.com. ■

Lawrence Staat heads the firm's transactional practice groups.

You must ask yourself, "If I were to die tomorrow, who will take over my business?"