

## Succession Planning For Business Owners



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**Online Seminar**  
**October 26, 2006**

Shaheen, Novoselsky, Staat,  
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Chicago, IL

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### Welcome to Succession Planning For Business Owners!

- This presentation will be available for replay from our website at [SNSFE-law.com](http://SNSFE-law.com) along with a PDF of the slides and separate audio file.
- A 5-question participant evaluation will be emailed to you.
- CPE candidates must prove interactivity by responding to the 2 identified poll questions via the Q&A tab in the lower right hand corner of the screen. Proof of attendance will be sent via email.

#### About SNSFE

- Established in 1960
- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
- From start-up to succession planning
- "AV" Peer Review Rated

#### About Larry Staat

- SNSFE partner
- 30 years experience
- Head of transactional practice groups with focus on counseling business owners and senior executives in matters affecting their businesses and personal estates
- Recognized as Illinois Leading Lawyer

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## Succession Planning For Business Owners

### ORIENTATION

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**Balance Sheet of a Business Owner**

|                       |                    |
|-----------------------|--------------------|
| Cash                  | \$ 100,000         |
| Marketable Securities | \$ 500,000         |
| Residence             | \$1,000,000        |
| Retirement Accounts   | \$ 800,000         |
| Business Real Estate  | \$1,800,000        |
| Business Interest     | <u>\$5,000,000</u> |
| Total Assets          | \$9,200,000        |
| Real Estate Mortgage  | <u>\$ 200,000</u>  |
| Net Worth             | <u>\$9,000,000</u> |

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**2 Questions**

1. How certain is the value?
2. How liquid is the value?

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**What makes the value certain?**

- a. The current leader
- b. What can happen to the current leader?
  - i. Death
  - ii. Disability
  - iii. Distraction
    - Family or health problems
  - iv. Disinterest
    - Retirement, new career

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**What makes the value certain?**

- c. The next leader
- d. Because he will continue to do what the current leader does

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**What makes the value liquid?**

- a. The next owner
- b. Because he has the cash

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**Succession plan helps answer these questions.**

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**CPE Candidates:**  
Please respond to the following question by  
typing the answer A or B into the Q&A box.

**Do you have a succession plan?**

- A. yes**
- B. no**

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**Succession plan is a 2-part plan**

- 1. Leadership succession**
- 2. Ownership succession**

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**2 succession plans**

- a. The plan**
  - i. Covers all 4 "Ds"**
  - ii. Expected timeline**
    - Later**

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**2 succession plans**

**b. Interim plan**

- i. Unexpected timeline**
  - Sooner than later
- ii. Accelerate the plan**
- iii. Insurance for business**
  - Disability for buy-out
  - Life for buy-out

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**Who cares?**

- a. You**
- b. Family**
- c. Employees**
- d. Creditors**
  - Bank

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**EXPECTED TIMELINE PLAN**

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**Succession plans vary**

- a. By type of business
- b. By number of owners
- c. By number of leaders

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**2 types of businesses**

- 1. Personal goodwill
- 2. Entity goodwill

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**Personal goodwill business**

- a. Personal reputation and relationships
- b. Direct leader/customer interaction
- c. Services
  - Doctor, lawyer, accountant, architect, consultant, broker, investment advisor

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**Personal goodwill business**

**d. Selling knowledge or know-how**

**e. Size**

- Smaller business cell
- Team needed to provide what the customer is seeking

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**Personal goodwill business**

**f. Non-balance sheet business**

- i. Business requires few assets
- ii. Capital is not a material income-producing factor

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**Personal goodwill business**

**g. Owner-operator**

**h. If leader leaves, so do customers**

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**Entity goodwill business**

- a. Entity reputation and relationships
- b. Less direct leader/customer interaction
- c. Products
  - Manufacturer, distributor, retailer, restaurant

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**Entity goodwill business**

- d. Selling an object
- e. Size
  - Larger business cell
- f. Balance sheet business
  - i. Business requires significant assets
  - ii. Capital is a material income-producing factor

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**Entity goodwill business**

- g. Non-owner-operator
- h. If leader leaves, customers do not follow

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**The idea is that the design of the succession plan is determined by the location of the business' goodwill.**

- That's where the customers are
- Succession plan must protect the business' goodwill

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**2 types of succession plans**

**a. Personal goodwill**

- i. Leader and owner are inseparable because leader holds the customers
- ii. Plans for leadership succession and ownership succession are inseparable
- iii. One plan
  - Leader-owner succession plan

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**2 types of succession plans**

**b. Entity goodwill**

- i. Leader and owner are separable
- ii. Plans for leadership succession and ownership succession are separable
- iii. 2 plans
  - Leadership succession plan
  - Ownership succession plan

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## LEADER-OWNER SUCCESSION PLAN

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**Example:**  
**Small manufacturers representative**

- a. Personal goodwill more than entity goodwill
- b. Revenue stream is rather predictable
- c. One owner
- d. Next leader is employee
- e. Buy-in by salary allocation

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## Income Statement

|                |           |                   |
|----------------|-----------|-------------------|
| Revenue        |           | \$1,000,000       |
| A's salary     |           | \$ 175,000        |
| B's salary     | \$125,000 | \$ 175,000        |
| Other expenses |           | <u>\$ 400,000</u> |
| Expenses       |           | \$ 750,000        |
| Profit         |           | <u>\$ 250,000</u> |

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**Compensation**

|              | Salary           | Profit           | Total Comp       |
|--------------|------------------|------------------|------------------|
| A            | \$175,000        | \$250,000        | \$425,000        |
| B            | \$175,000        |                  | \$175,000        |
| <b>Total</b> | <b>\$350,000</b> | <b>\$250,000</b> | <b>\$600,000</b> |

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**Value of Business and Purchase Price**

|                      |              |     |             |                          |
|----------------------|--------------|-----|-------------|--------------------------|
| Profit               | \$ 250,000   |     |             | Annual amount over 5 yrs |
| Capitalization rate  | 25%          |     |             |                          |
| Value of business    | \$1,000,000  | 45% | \$450,000   | \$ 90,000                |
| Balance sheet equity | - \$ 100,000 | 45% | - \$ 45,000 | - \$ 9,000               |
| Goodwill             | \$ 900,000   | 45% | \$405,000   | \$ 81,000                |

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**Compensation After Buy-In**

|              |     | Salary           | Profit           | Total Comp       |
|--------------|-----|------------------|------------------|------------------|
| A            | 55% | \$175,000        | \$137,500        | \$312,500        |
| B            | 45% | \$175,000        | \$112,500        | \$287,500        |
| <b>Total</b> |     | <b>\$350,000</b> | <b>\$250,000</b> | <b>\$600,000</b> |

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**Succession plan documents**

- 1. **Employment agreement**
  - a. **Salary allocation for buy-in**
  - b. **Deferred compensation for buy-out**
- 2. **Stock purchase agreement**
- 3. **Shareholders agreement**

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**LEADER SUCCESSION PLAN**

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**Who's the next leader?**

- a. **The current leader and current owner must choose**
- b. **When?**
  - **Before the next leader is needed**
  - **Now**

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### How to locate the next leader?

- a. Look inside
- b. Look outside
  - i. Someone known
    - Competitor
  - ii. Someone unknown
    - Headhunter

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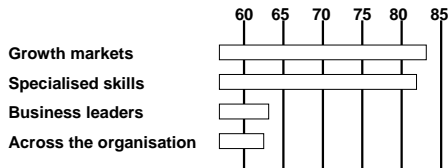
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source: The Economist, October 7<sup>th</sup>-13<sup>th</sup> 2006, The Battle for Brainpower

### Not enough to go round Talent shortages in organisations, %



source: Corporate Executive Board, Corporate Leadership Council

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### How to keep the next leader in place?

- a. Employment arrangement that keeps the next leader interested in the business
  - i. Employment agreement
    - 1) With attractive financial incentives
      - a) Tied to personal performance
      - b) Tied to business performance
    - 2) With restrictive covenants
      - a) Non-solicitation
      - b) Non-interference

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**How to keep the next leader in place?**

**ii. Deferred compensation**

- 1) **Qualified**
  - Profit sharing and 401(k)
- 2) **Non-qualified**
  - a) Bonus deferral plan
  - b) Stock appreciation rights (SAR)
  - c) Phantom stock
  - d) Supplemental executive retirement plan (SERP)

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**How to keep the next leader in place?**

**iii. Ownership**

- 1) Minority interest with buy-back
- 2) Stock option

**b. Continuing education**

**c. Good order to business**

- Is your business attractive to an outsider?

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**CPE Candidates:**

Please respond to the following question by typing the answer A or B into the Q&A box.

**Are you a business owner?**

**A. yes**

**B. no**

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## OWNER SUCCESSION PLAN

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### Who's the next owner?

- a. The current owner should choose
- b. When?
  - Before the next owner is needed
  - Now

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### How to locate the next owner?

- a. Look inside
  - i. Co-owner
  - ii. Next leader
  - iii. Employees - ESOP

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**How to locate the next owner?**

- b. Look outside**
  - i. Strategic buyer**
    - Competitor, rollup buyer
  - ii. Financial buyer**
    - Private equity
  - iii. Business broker**

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**How to attract the next owner?**

- a. Business must appear profitable and clean**
- b. Do the “due diligence” in advance**
  - i. Corporate formalities**
    - Good standing, required records
  - ii. Eliminate special arrangements**
    - Loans to insiders, employment of relatives

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**How to attract the next owner?**

- iii. Formalize vital relationships**
  - Make as permanent and transferable as possible
- 1) Employees**
  - Restrictive covenants
- 2) Vendors**
  - Supplier agreement
- 3) Customers**
- 4) Licensors**
  - Government and private

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**How to attract the next owner?**

- iv. **Formalize rights to vital assets**
  - **Make as permanent and transferable as possible**
  - 1) **Patents**
  - 2) **Name registration**
  - 3) **Copyrights**
  - 4) **Trade secrets**

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**How to attract the next owner?**

- v. **Settle pending or potential claims against business**
  - 1) **Lawsuits**
  - 2) **ERISA compliance problems**
  - 3) **Tax compliance problems**

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**What should be the deal with the next owner?**

**Goal –**  
**Sell for the highest price for cash or marketable securities**

**Exception for family –**  
**Arrangement which satisfies income needs and minimizes estate taxes**

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**Minimize taxes**

**a. Income taxes**

- i. Tax-treatment goals in sequence:  
Defer, capital gain, ordinary income
- ii. Defer
  - Tax-free organizations or reorganizations
  - ESOP
- iii. Capital gain
  - Personal goodwill

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**Minimize taxes**

**b. Estate taxes**

- i. Change ownership to discountable form  
for family succession plan
  - Minority stock
  - LLC
- ii. Gift ownership before value is apparent
  - Outright
  - GRAT – Retain income interest

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**CONCLUSION**

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**Questions?**

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