Estate and Business Succession Planning

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ESTATE AND BUSINESS SUCCESSION PLANNING

Beginning the Process

Background

After World War II ended in 1945, American GIs began returning home to continue their civilian lives. They married and began having children. The birthrate in America increased 24% from 1945 to 1946, and continued to increase until it peaked in 1957. Those born between 1946 and 1966 are the Baby Boomers. There are about 80,000,000 of them.

The Baby Boomers went to college in record numbers. In fact, so many Baby Boomers graduated from college that corporate America could not employ them all. As a result, Baby Boomers were 2 ½ times more likely than any other American generation to own their own businesses.

The Baby Boomers are now between the ages of 52 and 72. They own about three-fourths of all closely-held businesses in the United States.[1] If the typical retirement age is 65, then the oldest Baby Boomers would have started to retire in 2010. In order for a business owner to retire, he ordinarily must exit the business. The most likely buyer for a Baby Boomer's business is a Gen-Xer, but there are almost 30,000,000 fewer Gen-Xers than there are Baby Boomers, and the Gen-Xers are far less inclines to be business owners. When it comes to transferring businesses from the Baby Boomers to the Gen-Xers, we have a demand problem.

In order for a business owner to retire, he or she ordinarily must also exit the business; that is, he or she must stop working in the business and must monetize some or all of the value of

[1] Business Exit Institute survey.

the business. Accordingly, the retirement process for a business owner is much more complex than it is for an employee. Even so, 75% of business owners have done no exit planning at all.[2]

> Those who fail to plan, plan to fail.
> – George Hewell

A business exit plan typically addresses three principal categories: preparing the owner financially, preparing the owner personally, and preparing the business. The potential benefits of exit planning are immense. Exit planning potentially –

a. builds transferable enterprise value
b. increases the likelihood of a successful transfer of the business to a younger generation
c. increases the likelihood of a successful sale of the business
d. provides a basis for business continuity
e. improves cash flow
f. increases the likelihood that the owner will be happy in his or her retirement

In some respects, business owners' failure to plan is understandable. Few of them have ever exited a business before, and few will ever do so again. Most don't even know what their exit options are.[3]

> In preparing for battle I have always found that
> plans are useless, but planning is indispensable.
> – Gen. Dwight Eisenhower

Few professional advisors do a good job of advising business owners on business exit planning. And when they do give exit planning advice, it usually is limited to that professional's own area – law, accounting, mergers and acquisitions, financial management, or life insurance,

[2] Business Exit Institute survey.
[3] According to the Business Exit Institute survey, two-thirds of business owners either do not know all of their exit options or are not sure if they know all of their exit options.

for example. Rarely does a professional advisor truly guide a business owner through the exit process. There are great opportunities for advisors who are able to do so.

Checklist for the owner

Exiting a business takes time – a lot of time. Typically it takes two to five years to develop and fully implement a business exit plan. Business owners are well advised to start early.

During the first phase of the exit planning process the business owner and his or her advisors begin to outline the three principal elements of a business exit plan: preparing the owner personally, preparing the owner financially, and preparing the business.

First, the business owner and his or her advisors should consider the five common[4] ways to exit a business voluntarily[5]:

a. transfer the business to younger generations of the family
b. sell the business to a third party
c. sell the business to key employees
d. sell the business to an ESOP
e. liquidate

> It is time I stepped aside for a less experienced and less able man.
> – Max Asnas

Some business owners already know which option he or she will take. That is especially true when a child already is being groomed to take over the business. In other cases business owners often can immediately eliminate two or more of these options. For example, a business owner

[4] Another business exit option is an initial public offering (IPO), but it's exceedingly uncommon.

[5] One can also exit a business involuntarily, for instance as the result of death, disability, divorce, distress, or disagreement – the five Ds.

might have no family members interested in taking over the business. In that case, "transfer the business to younger generations of the family" can be eliminated as an option. Certain businesses are not well suited for a sale to an ESOP. Most businesses have too much operating value simply to liquidate. Once the business owner eliminates the options that are not practical, he or she can begin assessing the relative benefits and detriments of the remaining options until one option emerges as the clearly superior to the others.

<u>Preparing the Owner Financially</u>

During this first phase, the business owner should be preparing his or her personal financial plan. This should include a "gap analysis," which will require the involvement of a talented investment advisor, a business valuation expert, and CPA. The business owner and his or her spouse should consider how much they will need to spend each year after the owner's exit from the business in order to support the lifestyle they desire. The financial advisor could estimate how much the couple should have in annual income and investment resources to safely cover the couple's future financial needs. After considering the couple's other sources of income and other resources, the financial advisor could determine how much, net of taxes, the business owner will need from the monetization of his or her business in order to achieve financial security at the couple's desired standard of living.

> Retirement is like a long vacation in Las Vegas. The goal is to enjoy it to the fullest, but not so fully that you run out of money.
> – Johnathan Clements

Preparing the owner financially also requires him or her to obtain an estimate of the market value of the business. A full valuation report, like the ones estate planners are accustomed to including with gift and estate tax returns, is not needed at this point. A range of

possible values often will suffice. But the value, or range of values, should be provided by someone who is experienced in estimating the values of privately-held businesses.

The tax advisor – typically a CPA – could estimate the after-tax proceeds on the sale of the business given the range of possible values for the business.

Putting all of this together should give the business owner a good indication of whether she will be able to achieve financial security at her desired standard of living after her exit from the business. Say, for instance, that the business owner and her husband intend to split their time between Florida and Indiana after her exit from the business, and they intend to own a house in each state. They also wish to leave $1,000,000 to each of their two children and an additional $1,000,000 to charity. Given their current ages, their investment preferences, and their individual tax circumstances, the financial advisor calculates that an investment fund of $8,000,000 would be sufficient to provide for the couple's financial security at their desired standard of living. If the couple has just $2,000,000 of investment assets now, then the owner will need to net $6,000,000 from the sale of the business. If the business valuation expert estimates the business's value is between $3,000,000 and $3,600,000, then the couple has two choices: either reduce their intended standard of living or improve the value of the business.

Preparing the Owner Personally

A solid exit plan should include life transition aspects - how the business owner and his or her spouse will spend their time, how they will exercise their minds, and how they will contribute to society after the owner exits the business. Many business owners have a list of things that they want to do after exiting the business. But "play more golf" and "spend time with the grandkids" is not a retirement plan. That's enough to keep a person busy and satisfied for

about nine months. After that, boredom begins to set in, along with a longing to be useful and relevant. Maybe this is why 75% of business owners are unhappy one year after their exit from the business.[6]

> Retired is being twice tired, I've thought;
> first tired of working, then tired of not.
> – Richard Armour

Business owners tend to be driven; they enjoy challenges; they are used to being in charge; and they enjoy a community reputation associated with the business. These personality traits and ingrained habits will follow the business owner into retirement. The life transition plan should include an outlet for these traits and habits. Further, business owners likely have worked long hours, leaving family members to develop independent social networks. The life transition plan should include a means of integrating the business owner into these networks or of developing his or her own social networks.

During this initial phase of business exit planning, the owner should ask himself or herself the following questions:

- How will my role in the family change?
- Once retired, how will my increased presence at home impact my spouse?
- What interests me?

With some forethought, the business owner can make the transition without putting excessive stress on his or her marriage and family relationships by finding other outlets (outlets outside of the home) for achievement and socialization. Too often the retired owner simply replaces the home for the business as the domain to be lorded over. The spouse, who may have successfully run the household for decades, takes umbrage. The emergence of the retired owner can also

[6] Business Exit Institute survey

destabilize the emotional foundation established by the spouse. With clear communication and much thought, the various family roles can be altered and shared with a new emphasis on balance.

> A retired husband is often a wife's full-time job.
> – Ella Harris

In the best case, implementation of the business exit and life transition plan should be seamless – there is no set date for when the keys are left on the successor's desk. Instead, one day everyone realizes that succession has already taken place and the former owner is well into life after the business.

After the owner transitions out of the business, the new owners and managers will be energized to put their own stamp on the business. They will have their own ideas about the business's strategy and operations. This has great potential to drive the retired owner to insanity. The retired owner should let the new owners and managers succeed or fail in their own right.

Few things are as disruptive to a family business as a "retired" owner who won't let go. This does not mean that a retired owner should be prohibited from retaining any role in the business. Many retired owners provide great value as consultants and board members.

> The function of leadership is to produce more leaders, not more followers.
> – Ralph Nader

Former business owners should consider becoming more active in his or her place of worship or in other community organizations. The former owner will find that his or her knowledge, experience, and leadership skills are invaluable. And teaching others can be

immensely rewarding. Many former business owners create private foundations to provide a platform for their community involvement.

> Men and women approaching retirement age should be recycled for public service work, and their companies should foot the bill. We can no longer afford to scrap-pile people.
> – Maggie Kuhn

If the business owner's life transition plan is not considered, there is a great risk that procrastination will set in, exit planning will stall, and the next generation of owners and managers will become disgruntled. By identifying interests outside of the business, whether fishing, traveling, teaching, volunteering, or other, the business owner has a better chance of completing the business transition and being happy with the results. Many business owners fear retirement. But careful planning and execution can make them as successful after retirement as before.

> Slowness to change usually means fear of the new.
> – Phillip Crosby

Preparing the Business

During the first phase of business exit planning, the business owner and his or her advisors also should make a preliminary assessment of whether the business is ready to be transferred. This involves increasing the business's value, first by improving the business's cash flow and, second, by searching for and fixing weaknesses in the business's operations, structure, or documentation. It also requires ensuring that the business's value is transferrable. The exit advisor needs to know what should be done to improve the value of the business; he or she does not necessarily need to know how to do it. For instance, if the business's biggest problem is

stagnate sales, the exit advisor should assist in the selection of a business consultant to assist with development of a sales and marketing plan. If the business has an antiquated bookkeeping system, then exit advisor should coordinate with the business owner's accountant to improve these functions.

To improve a business's cash flow, the owner likely will need to take a step back from the business's operations and focus more on high level tasks like strategy. MBA programs refer to this as "working on the business rather than in the business." It's easy for some business owners to spend their time on the parts of the business they enjoy most – maybe sales or design. And many owners get caught simply handling emergencies – "fighting fires" – all day, every day. But if the owner isn't paying attention to the company's strategy and performance, then probably nobody is.

Checklist for the CEO

In order for a business owner to step back from day-to-day operations, he or she will need a strong management team. Accordingly, developing the management team often is addressed early in the business exit process. In many ways, the "transferrable value" of a business is encapsulated in the management's ability to generate cash flow without the owner's active involvement. A business must grow beyond the owner's abilities and limitations if it is to have significant transferrable value. The business exit planner does not need to be responsible for developing the management team. Rather, the business exit planner is responsible for educating the owner about the importance of having a strong management team; introducing the owner to other advisors (typically business consultants) who have the skills and experience to develop management teams; and coordinating the efforts of the owner and all advisors to ensure that all recommended actions are completed on time. Further, part of every exit plan is to ensure that

appropriate incentives are in place to develop the managers and ensure that they stay with the business after the owner exits.

A number of resources are available to assist business owners in improving the value of a business. These resources typically look at a dozen or more aspects common to most businesses to discover strengths and weaknesses. Some of these aspects are:

- Sales & Marketing
- Revenue growth
- Recurring revenue
- Operations
- Market Share
- Finances
- Market opportunities
- Brand recognition
- Barriers to entry
- Innovation
- Customer satisfaction
- Customer diversification
- Legal
- Management
- Product Differentiation

As each of these areas improves, so too will the company's cash flow and transferable value.

Contingency Plans

Imagine that you are the CFO of a manufacturing company and that the owner, Tim, is 74 years old, still active in the business, and apparently lacking a succession plan. You probably are thinking about whether you will have a job if Tim dies, becomes incapacitated, or sells the business. You might be so concerned about this that you look for other positions where the long-term prospects are more certain.

Or imagine that you are the CFO of a manufacturing company and one day the owner's wife calls and says, "Tim was in a car accident last night. He's in the hospital. His injuries are pretty bad, but we think he's going to make it." Again, you probably are thinking about who's in charge (maybe it's you), whether the company can survive without Tim, and whether you will

have a job if Tim dies, becomes incapacitated, or sells the business. You might be so concerned about this that you look for other positions.

Chances are that if you are thinking about other positions, so too is the VP of sales, the VP of operations, the secretaries, the truck drivers... And as soon as one of the key employees leaves for a more stable position, the others will wonder if they're being reckless by not also leaving. With the owner incapacitated or dead, and the key employees jumping ship, it won't take long before the business must be sold at fire-sale prices.

> One thing that makes it possible to be an optimist is if you have a contingency plan for when all hell breaks loose.
> – Randy Pausch

A contingency plan should address these questions: Who will run the company if the business owner gets sick or dies before the business succession plan is fully implemented? How can we retain our key people under those circumstances?

The contingency plan should be in writing.

The contingency plan should include provisions intended to designate new leadership, retain key employees, and fill key positions. For instance, the CFO might become the CEO and they would outsource the CFO function until a replacement could be found.

The contingency plan should provide for a consistent message to employees, customers, suppliers, lenders, and equity holders.

The business should have a real board of directors.

The business owner's estate planning documents should match the contingency plan. If a person or group will have responsibility for managing the business in the event of the owner's incapacity or death, that person or group should be given the legal authority to manage the business.

Most successful businesses have been approached at one time or another by people interested in buying the business. It might be helpful to know who those people are, in case the family decides that selling the company is the best option. The contingency plan could include their names and telephone numbers and a brief note about each of them.

People naturally think about self-preservation during a crisis. Having a contingency plan in place should go a long way towards calming employees' nerves, but sometimes more will be needed. In extreme cases, like the sudden death of the company's owner and leader, the company may need to offer significant bonuses to entice key employees to stay with the company long enough to effectuate an orderly transition of the company.

> Train people well enough so they can leave, treat them well enough so that they don't want to.
> – Richard Branson

I suggest preparing, in advance, simple "stay bonus" agreements under which the key employees would agree to stay with the company for at least 18 months after the business owner's death or incapacity or after a change in control, for which they would receive a significant bonus. The bonus might be paid in two installments, the first several months after the death, incapacity, or change in control and the second at the end of the 18-month period.

A stay bonus can be incorporated into any employment contract, or can stand on its own.

The employee would not be entitled to the bonus if he or she quits before the expiration of the bonus period or is fired for cause.

The employee would be entitled to the bonus if his or her employment is terminated without cause.

The stay bonus agreement also should include non-compete covenants and non-solicitation covenants and protections for trade secrets.

The company also should have a source of funding for that plan, whether cash on hand or a disability or life insurance policy.

Rumors spread quickly, and it is important to stop them. The contingency plan should include a communication plan. The company's key suppliers, customers, and other stakeholders should be identified in the contingency plan, along with their contact information. A representative of the business should be tasked with contacting each key supplier, customer, and stakeholder with single message, which would be something like this: *"Tim was in a car accident last night. He's in the hospital. His injuries are pretty bad, but we think he's going to make it. Tim had a plan for circumstances like this. The company CFO, Stacy, is serving as interim CEO. You could reach Stacy at 317-555-5555. Business will continue as usual. All customer orders will be fulfilled and all purchase orders remain in effect."*

Having an actual board of directors – something more than just the owner and his family members – can pay big dividends in a crisis. Perhaps most importantly, it offers another group of men and women who already are familiar with the company, its employees and operations, and who can offer time and knowledge to help guide the company through the transition.

Those responsible for running the company should have the authority to do so. There should not be any question about who is running the company. If a board of directors is to have oversight responsibility during this period, then perhaps the board members should have the power to vote the stock. If the owner's daughter is to assume leadership of the company, then she should have the power to vote the company stock. It is not a good idea to designate the daughter as CEO and to give the owner's widow (whom the daughter has always referred to as her "step-monster") as attorney-in-fact, trustee, or personal representative with the power to vote the stock. That arrangement almost certainly will lead to a dispute, and the business will suffer.

CONTINGENCY PLAN

FOR
[BUSINESS]

[[Owners] to insert here a narrative about the history of [Business] and explain why it is important that the company stay in business. An example follows.]

[Business] has been part of the _______________, Indiana, community since [Owners] founded it in ______. Today the company employs about ____ people. These people and their families depend on [Business] for their livelihoods.

[Owner] is the driving force behind [Business]. If [Owner] becomes incapacitated, is absent from the company for an extended time, or passes away, [Business] has the best chance of continuing as a healthy and profitable company if its key employees stay with the company and assume greater responsibility. Accordingly, the company is adopting these procedures in the event of the incapacity, absence from the company, or death of ________________.

<u>Company leadership</u>: __________ will serve as Chief Executive Officer during any period when [Owner] is unable to serve in that role. The company's other key managers are:

Name	Position

<u>Purpose of this Contingency Plan</u>: [Owner] has been at the helm of [Business] since its founding. [Owner] has established a long-term succession plan for the company.

This contingency plan is intended to prepare for the possibility that [Owner] might become incapacitated, be absent from the company, or pass away before the succession plan is fully implemented. In any of those cases, it will be important to show that the company has planned for such contingencies and that its key managers are prepared to run the company.

<u>Communication with Customers</u>: [Business] has many valuable, long-time customers. A list of the company's top customers over the last five years is attached at Exhibit A, along with each customer's address and telephone number, the name of [Business]' contact person at the company, and the identity of the [Business] representative who will visit the customer if something happens to [Owner]. A similar list of the company's top suppliers is attached at Exhibit B. Other people and businesses important to [Business]' success are identified on Exhibit C. If something happens to [Owner], a [Business] representative will contact each person or entity identified on Exhibits A, B, and C and tell them that:

- [Owner] has died, or become incapacitated, or will be absent from the company for a time;

- the company has planned for contingencies such as this;
- the company has taken steps to ensure that its key personnel will stay with the company; and
- that [Business] will continue to deliver its products to its customers on time and with the same quality standards that the customer has come to expect from [Business].

Voting Company stock: If [Owner] passes away or become incapacitated, ___________ or [a committee (consisting of _______________________)] would be responsible for voting [Owner]'s stock in [Business]. ________________ has executed legal documents granting _______________ [that committee] the authority to vote the [Business] stock in the event of [Owner's] death or incapacity.

Possible buyers: [Owner] believes that [Business]' key managers are well prepared to run the business in [Owner's] absence. [Owner] does not expect that [Business] would have to be sold. But if, due to unforeseeable circumstances, the company must be sold, [Owner] suggests that the following organizations be contacted as possible buyers:

[**Owner**] **identify possible buyers here]**

EXHIBIT A
to the
contingency plan for [Business]

Top Customers

Customer	Customer Contact	Address and Telephone No.	Designated [Business] Representative

EXHIBIT B
to the
contingency plan for [Business]

Top Suppliers

Customer	Customer Contact	Address and Telephone No.	Designated [Business] Representative

EXHIBIT C
to the
contingency plan for [Business]

Important People and Entities

Customer	Customer Contact	Address and Telephone No.	Designated [Business] Representative