BUSINESS SUCCESSION PLANNING

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Introduction

The transition of a family owned or closely-held business is a significant undertaking even with the best laid plan. This article will outline the issues that should be considered by the business owner in transitioning a business.

Types of Business Succession Planning

A business succession plan should address two fundamental events – an unexpected death or disability of the business owner and a planned succession of the business. Planning for an unexpected death or disability generally takes the form of a "Buy-Sell" Agreement whereby another party, such as the business itself, another owner of the business, or a key employee, is obligated to purchase the ownership interest of the deceased or disabled owner. A planned succession of a business generally takes the form of a gift or sale to another owner, key employee, or family member.

Implementing a business succession plan is not easy. A considerable amount of time, energy, and thought must be put into a plan for it to be effective. The failure to establish or implement a business succession plan can be fatal to the continuity or survival of the business.

Common Issues

There are common issues that should be addressed by a business succession plan whether there is an unexpected or planned transition of the business:

Basic Estate Plan Documents

Each business owner should have a "basic" estate plan. A basic estate plan consists of a Last Will and Testament, a Durable General Power of Attorney, and a Health Care Power of Attorney. These documents form the core of any estate plan and should be in place for any business owner (and his or her spouse) regardless of the value of the business or the value of the owner's overall estate. Additional planning documents, such as trust agreements and family limited partnerships, may be implemented as needed to avoid federal estate tax and Pennsylvania inheritance tax.

Life Insurance, Business Debt, Income Needs, and Fringe Benefits

The starting point for a successful succession plan is understanding the owner's goals and objectives and addressing contingencies such as an unexpected death or disability. One important issue that must be assessed is the amount and type of life insurance needed. A determination should be made whether the life insurance is adequate to fund the purchase of the owner's business interests. In addition, the owner should assess whether "key person" insurance is needed to provide the business with working capital.

Most businesses carry some debt, and this debt is often personally guaranteed by the business owner. A common misconception is that the owner's guaranty somehow "goes away" if the owner dies. In fact, the death of the guarantor normally is a default under the loan documents of the business. Therefore, the business owner should consider purchasing life insurance, the proceeds of which can be used to pay off all or some of the debt of the business upon the death of the business owner.

With a planned succession or an unexpected death or disability, the owner needs to determine how to replace lost income and fringe benefits. The owner should consider, for example, how the standard of living enjoyed by the owner's family will be maintained. Likewise, the owner needs to consider how health insurance coverage will be provided for the owner and his or her family and the potential loss of other fringe benefits, such as a company car or phone.

Business Related Real Estate

Many business owners will separately own the real estate where the business operates. The transfer of the real estate

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needs to be considered in any business succession plan. Many owners desire to retain the real estate since the rental income is a way to maintain disposable income in retirement or in the event of an unexpected death or disability.

Retaining ownership of the real estate, however, presents some issues. First, the purchaser of the business may desire to purchase the real estate. Second, if there is not a purchase of the real estate, a long-term lease should be in place to frame the rights and obligations of the landlord and tenant. Third, there is some risk involved with retaining the real estate. If there has been a sale of the business with seller-financing (discussed below), then the former owner will have a undiversified investment portfolio consisting of a promissory note from the buyer and real estate whose primary (or only) tenant is the owner's former business. If the business fails, then the note payments and rent payments will cease. Generally, the buyer of the business will be able to obtain third party financing for the real estate since the real estate can be offered as collateral. The business owner can diversify his or her investment portfolio if the real estate is sold without seller financing.

<u>Seller Financing</u>

The purchaser of the business interest may need to rely on compensation and distributions from the business as the source of the purchase price payments. In essence, the seller acts as the "bank" for the purchaser. Although life insurance may be used in the event of an owner's death, the death benefit may not cover the entire purchase price. And, there will not be any life insurance in the event of disability or a planned sale. The business owners should give careful consideration to the terms of any seller financing. Common issues include:

1. How much of a down payment will be required?
2. Will the obligation to pay be secured by any collateral?
3. If there is a redemption, will the remaining owners personally guaranty the payment obligation of the business? If so, will the guarantees be backed by collateral?
4. What events, such as the sale of the business or its assets, will cause payment to be due in full?
5. Will life insurance insuring the lives of the purchasers be collaterally assigned?
6. Will distributions from the business and compensation of the owners be limited?

Unexpected Death or Disability

An unexpected death or disability of a business owner is addressed through a "Buy-Sell" Agreement, which can take the form of a Shareholders Agreement for a corporation, an Operating Agreement for a LLC, or a Limited Partnership Agreement for a limited partnership. Each of these agreements, in addition to addressing transfers in the event of death or disability, should address the divorce or bankruptcy of an owner and otherwise restrict the transfer of an owner's interest to third parties. The most important issues to address in a Buy-Sell Agreement are how the purchase price will be determined, how the purchase price will be paid, and who will purchase the owner's interest. There are various ways to address these issues, and exactly how to address these issues will depend upon the risk tolerance of the parties and the nature of the business.

<u>Determination of Purchase Price</u>

The valuation of a business interest is accomplished in three basic ways. First, the owners may periodically agree to set the purchase price. The benefit of this method is that it requires the owners to meet periodically to discuss the value of the business, which often leads to beneficial discussion about operations, long-term planning, and other important matters. Typically, a Buy-Sell Agreement will require a meeting once every twelve months. The risk, though, is that the meetings do not occur, in which case a "fall back" method must be employed.

A second method to value the business is through a professional appraiser. Although a professional appraisal may be a more scientific way to value the business, it can be costly and may take several months to complete. In addition, the Buy-Sell Agreement should address the qualifications of the appraiser, whether valuation discounts for lack of marketability or control are acceptable, and the possibility that the parties will not agree on the appraised value.
A third method is to calculate the value of the business based on a formula, such as a multiple of earnings or the book value of the business. If a multiple of earnings is used, then the owners should consider averaging several years of earnings to avoid a windfall in a good year and a low valuation in an off year. A multiple of book value is generally undesirable because the book value of a business normally does not reflect the true value of the business.

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Payment of Purchase Price and Identity of the Purchaser

There are two ways to carry out the purchase of an owner's interest. First, the entity can redeem the owner's interest. Second, the other owners of the business can purchase the interests (a "cross-purchase"). In the event of death, the redemption or cross-purchase may be funded by life insurance. If there is not adequate life insurance, or if there is an event other than death triggering a sale, then the purchase price will need to be seller financed, as discussed above, or third-party financing will be required.

A redemption of the owner's interest offers simplicity – there is one purchaser. There are, however, some drawbacks to a redemption. For example, a cross-purchase creates tax basis in the interests acquired whereas a redemption does not. This increased tax basis will reduce the capital gain recognized in a future sale. Also, Pennsylvania law prohibits a redemption if the redemption would render a corporation insolvent or impair its capital.

A cross-purchase works best with a small number of owners. A cross-purchase can be cumbersome if there are a large number of owners, particularly if life insurance policies are to be acquired by the owners to fund the purchase price in the event of death. The Buy-Sell Agreement should address whether each owner has the same rights of purchase. For example, if there are three owners initially do the remaining two owners have an equal right to purchase? Also, if there are different classes of interests, such as voting and non-voting, the Buy-Sell Agreement should address whether voting interest may be transferred to non-voting owners.

Planned Transition of Business

Ideally, none of the contingencies addressed in a Buy-Sell Agreement will materialize and the business owner will be able to engage in a planned succession of his or her business. A business owner should begin the succession planning process as soon as reasonably possible. The owner will need to identify and train new management and scale back the owner's involvement in the business in an orderly manner. The business owner may need to identify one or more children as the next leader or come to the realization that a non-family member is the next chief executive officer (even though ownership may stay within the family).

The common issues discussed above will apply to a planned succession. In addition, the owner will need to determine whether to sell the business, gift the business, or engage in a part gift-part sale transaction. The owner should also consider creating a separate class of non-voting interests which may be sold or gifted to family members before the voting interests are transferred. The retention of the voting interests by the owner keeps control of the business with the owner. However, the transfer of the non-voting interests will shift the future growth in value of the business to other family members. Likewise, the value of the non-voting interests can be discounted for lack of control and lack of marketability. Ultimately, the voting interests of the owner must be transferred. This can be accomplished by gift or by sale (or a combination thereof) when the owner completely exits the business. Alternatively, the owner may give the voting interests to the next generation through his or her Last Will and Testament.

Many business owners have some children who both work in the family business and some children who work outside of the family business. The business owner should consider how the children who are not in the business will be treated. One end of the spectrum is to do nothing. The other end of the spectrum is to provide some benefit to the other children, whether through a lifetime gift or a transfer at death, of the owner's other assets so each of the children is treated "fairly". It is important to realize that treating children fairly is not the same as treating them equally. For some business owners it may be impossible to treat children equally if the majority of the owner's wealth is tied up in the business. Also, some consideration should be given to the fact that some of the value of the business being transferred is the product of the efforts of the donee or purchaser of the business interest.

Conclusion

Establishing and implementing a plan requires dedication and effort on the part of the owner. However, a succession plan is critical to ensure that the value of the business is maximized for the owner's family and that there is an orderly transition of ownership and management.

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