Business succession: Working forever? Or just planning like it?

As businesses continue to recover from the effects of the COVID-19 response, a realization has occurred among business owners across the country: a heightened priority in preparing for probable or inevitable business events or setbacks.

Business succession planning addresses these concerns by creating contingency plans in the event of an owner's death, disability, incapacity, divorce, bankruptcy, retirement, or adverse legal developments. Absent such planning, when adverse events occur, it can be devastating to both the business and the families, employees, customers, and vendors reliant upon it.

On the other hand, a well-planned and funded transition, prompted by a possible or inevitable event, optimizes the business's value for the owners or their families and increases the probability that the firm will continue to operate and benefit its employees, customers, and community well into the future.

Three critical elements to creating a successful succession plan are described below.

Exit strategy

A clear picture of the owner's vision or ultimate destination for the business is necessary for succession planning.

- Does the owner want a legacy family business that his or her children eventually acquire and run?
- Does the owner want to eventually retire and sell the business to a partner, a group of employees, or an outside third party?
- Or does the owner work until the day he or she drops?

Each of these scenarios requires different structure parameters to bring the proposed succession to fruition.

An unhurried, anticipated timeline for an eventual exit permits a coordinated structure to be shaped and formed with an eye directed toward minimizing taxation, acquisition default risks, managerial transitional disruptions, and key employee flight.

Time

The key fundamental element is time. Does sufficient time exist to accomplish the stated goals or objectives of the owner given the business's profitability and prospects? What may be known and anticipated is profitability; what is unknown and uncertain is the amount of time the owner has left to accomplish and direct it.

Profitable businesses may be worth only a few cents on the valuation dollar after the owner's death, disability, or incapacity because the person who knew how to multiply or leverage the business's assets and motivate personnel is gone or unavailable. Often the successor

is unprepared, inexperienced, or lacks the ability, available funds, or knowledge to maintain, maximize, and market the business until a suitable buyer can be found.

Succession plans can be established to blunt or minimize the adverse effects of such events; however, it must be done while the foremost expert on running that particular business can provide the direction and guidance in creating the strategies most likely to succeed in those scenarios.

In other words, the business owner must invest the time and expense to contemplate, create, and fund such plans; however, the eventual return will be many times more than that invested and most often at a time of turmoil for the owner or business.

Operating cash flow

Many operating agreements and corporate governance documents for small to medium sized businesses include generic, boilerplate language indicating that the adversely affected owner's stock or interest will be acquired with a promissory note of varying lengths. Although the succession planning has been done and a document addressing contingent event transfers has been adopted, without a funding mechanism to provide the capital necessary at such a critical time, the likelihood that the operating cash flow from the business will be sufficient to meet both the business's need and the increased debt service for the acquired interest is unlikely. Often the business will default on the obligation out of necessity during an economic downturn, and the owner's surviving spouse or family will lack the funds or the emotional strength (most likely both) to enforce the note; or, if successfully enforced, the obtained judgment may be pointless since the business likely will have defaulted due to poor economic performance in the first place, making any recovery remote.

> Having contingencies in place to address the loss of key personnel is a necessary component for a well-run business.

Another, equally distasteful, remedy may be the reacquisition or foreclosure upon the formerly held business interest, which often is found to be an empty and gutted corporate shell with limited or no remaining assets, value, or prospects.

In contrast, effective succession plans are nurtured and funded based upon realistic knowledge of the business and the forces that act upon it during an entire economic cycle. If some tragedy befalls the owner, funds and binding agreements are established and in place to address the development and respond to it. Conversely, if all goes smoothly during the owner's tenure, the business has available assets that may be paid out as a down payment, used as collateral for loans at a discounted secured rate, or used to structure a secured and protected buyout of the owner at a time of his or her choosing.

Conclusion

Successful companies do not run themselves without at least one or more owners or key personnel who can exercise great business judgment in making day-to-day decisions on actions to take, those to avoid, strategies to implement, and the best way to decompress volatile situations. Having contingencies in place to address the loss of such people — temporarily or permanently — as well as the operation of the business during or after their departure is a necessary component for a well-run, long-term business.

Discussing your future plans and thoughts on succession with a trusted advisor familiar with business succession planning is an essential first step in implementing and eventually funding such a plan, because planning to work forever is rarely a viable option.

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