### Succession Planning – Passing On The Mantle

Source: Small Business Administration (http://www.sba.gov)

Rather than a single, dramatic movement, the smooth succession of a business more resembles a flow of events that occurs over time. Like a well-run relay race, the handing over of a company should be graceful, carefully strategized and well executed if it is to be successful. Unfortunately, the majority of business owners neglect to plan so seamlessly for their own succession.

More often than not, the reasons are psychological. No one likes thinking about their mortality, and entrepreneurs are no exception. Moreover, some owners so closely identify with their ventures that they can't imagine their offspring of long hours and hard work continuing without them. Others believe they're too busy to plan for the day they will leave and consequently put off succession planning until tomorrow.

But tomorrow may be too late. Serious illness, disability or death can catch a firm by surprise. A crisis such as this brings great upheaval, and it's difficult to make rational decisions in the best interests of a company when emotions are running high. That's why a well-thought out succession plan -- a kind of insurance policy -- is essential to the continuation of a business, no matter what its size and structure.

# The Time For Planning Is Now

Ninety percent of the 21 million U.S. businesses are family-owned, and one-third of the Fortune 500 are either family-owned or family-controlled. Yet only 30 percent of family-run companies today succeed into the second generation. An even smaller 15 percent survive into the third. The reason, according to many experts, is obvious: the lack of an orderly succession plan.

"It is a daily miracle that there are any owner-managed firms left in the world with so few making plans for their own continuity," observes Leon Danco, founding director of the Cleveland-based Center for Family Business. "The toughest thing for the entrepreneur to realize is that time is constantly running out. Most owners don't plan because they don't think they are ever going to retire or die."

Owners should begin planning while they are still healthy and active in their enterprises. "If you wait until after you're 65, you can't do many of the jobs associated with succession planning, such as teaching, explaining how the business operates and passing on the spirit and vision with which it was founded," notes Dr. Michael Sales, co-founder of The Family Business Resource Center in Newton, Massachusetts.

The time to plan is between the ages of 55 and 65, experts advise. And the handing over of the baton -- the plan itself -- should be a process, rather than a single event. Some succession consultants recommend a three-to-five year plan while others advocate five to 10. Some even recommend 10 to 15 years. All agree, however, that the more time allotted for planning, the better the outcome will be.

Adequate planning time enables you to test potential successors in different roles and evaluate their maturity, commitment, business acumen and leadership abilities. If you've already anointed your successor, adequate planning time allows that individual to build up expertise so the passage transpires so gracefully that no one in the company even feels it happen.

# Let the Planning Begin

By writing down your thoughts about when you want to step away from the daily operations of the business.

1. Would you like to spend more time with your spouse?
2. What do you want to accomplish over the next 15 years and how much money do you need?
3. What personal goals could you achieve if you weren't running the company
4. What would success in a new endeavor mean to you?

Next, advises Sales, discuss your ideas about the future with your family, senior management team and key employees. Decide how long you want to remain active in the company and in what capacity. If you see retirement as an opportunity to travel, be sure to include that in your discussion as well as where you want to live and what role, if any, you want to play in your community.

At the same time, think about the long-term stability of the business. Most corporations and partnership business agreements spell out what will happen in terms of shares of stock, assets or the buying out of the company by remaining principals or partner(s) if one of the owners or principals retires, dies or becomes disabled. But sole proprietorships often operate without any such legal blueprint, almost as if the owner is immortal.

Once you've established these parameters, begin revising your business plan -- assuming you already have one -- or write one if you don't.

The most effective business plans are prepared by owners in conjunction with their successors. They include any future new products, plans for expansion, growth or new investment, and a candid assessment of a company's current environment and competitive positioning. This joint business plan exercise will give you an opportunity to evaluate your successor's goals and ideas for the firm, while forcing your successor to think through and write down specific plans for running the operation.

And as your successor is putting thoughts down on paper, recommends succession planning expert Mike Cohn in his book, Passing the Torch, you as current owner should be developing a business transfer plan. In it, identify certain "trigger dates," including dates when:

1. You want to begin transferring ownership to others.
2. Control is shifted, i.e., more than 51 percent of ownership of voting interests.
3. The balance is transferred.
4. Responsibility for day-to-day operations rests with your successor.
5. You plan to formally retire.

This timeline will also help you determine the length of time you have available to train your successor, Cohn adds.

Another critical component of succession planning is the appointment of a board of directors. "One of the greatest devices for the continuation of a business is an outside board," believes Leon Danco, "especially if you are passing your business on to your children.

"Some people are reluctant to appoint a board because they feel no one knows their business as well as they do. But when the owner retires or dies, he takes this judgment factor with him. The board can serve as a surrogate parent, guiding the management of the company and acting as mediator, reconciler, cautioner and supporter."

Danco warns against confusing advisers with directors. "An adviser is a paid professional, while a director is a risk-taking peer. You can't buy directors, and you must have faith and trust in them.

**All In The Family**

The head of a company has no greater responsibility than identifying a successor who will be equally or more successful in running the operation, believes John Ward, a professor of Loyola University's graduate business school. Says the specialist in family-business issues, "It's job number one of a good leader."

More often than not, the head of a family-owned operation chooses a son or daughter as successor. However, it's not unusual for an owner to have more than one child competent enough to step into the parent's shoes, making the selection process more difficult. Some owners decide to divide up the functions, giving each child equal responsibility. That, too, has its problems.

Warns Benjamin Benson in Family Business magazine, "Co-leadership may be equitable, but it's a tough act to pull off. If you're thinking of naming two or even three successors, first make sure they meet all the following criteria:

"The successors must have equal ability, motivation and commitment. You should not confer equal authority, compensation and stock ownership to them if their contribution to the running of the business is unequal.

"The successors must divide day-to-day job responsibilities according to their individual talents," Benson continues. "Division may also be accomplished by geographical separation.

"Finally, the successors must share a common philosophy about the future direction they want the company to take and must have a history of resolving conflict constructively."

If you think your potential successors meet these requirements, you need to prepare them for possible pitfalls once you are out of the business. They should be aware, Benson says, that they will lose their referee -- you. Additionally, the company itself will change over time. Moreover, if the venture is passed on to the third generation, the number of potential successors will grow, thus exponentially increasing the chances for conflict.

Whether you choose one or more family members to take over, John Ward suggests a grooming timetable to increase the chances for a smooth and ultimately successful transition.

"Your son or daughter (or both) should spend the first five years after graduation working outside the company," he advises. "The next five years should be spent working in the firm, getting the best job experience you can provide. Teach them about the business but make no commitments in terms of an eventual leadership position.

"After they're 30, concentrate on grooming them. Begin to prepare them to become a leader so that by the time they reach 35, they are ready to take over a lot of the responsibilities. By then, you'll know if they are qualified and whether the process is working. Once they've reached 40, you will have ideally weaned yourself from the business and retired, leaving your successor or successors totally in charge."

**Key Alternatives**

If you are unable to find a successor among your offspring or other family members, you need to set your sights elsewhere. There is probably no more fertile hunting ground than right there in your own company.

Your most likely candidates, believes George Noceti, a human resources specialist with the accounting firm of Hemming Morse, will come from the ranks of middle and upper management. Typically, these employees have already received some grooming and have displayed the necessary capabilities for working their way up your organization.

"When identifying a candidate -- and you really should identify more than one -- you need to ask yourself several questions," he recommends. "`What are this individual's technical and managerial skills?' `What are this person's strengths and weaknesses?' `What needs to be done to prepare this candidate to step in?' `And when do I see this potential successor being ready to take over?'"

Noceti points to candidate development as a critical human resources aspect of succession planning -- and one that is often overlooked.

"Few companies pay much attention to succession management," Noceti claims. He defines succession management as "the procedure of identifying people who can take over for a company's key executives, then deciding what developmental programs are needed to prepare these `heirs' to move up.

"Whatever the size or type of company," he adds, "this process is important. What if a key employee leaves the organization or dies? It can mean loss of continuity of the business and even a loss of profitability while new people are recruited. Smaller firms are particularly vulnerable. You need to ask yourself, "Can I walk away from the company and have it still function and survive?" "Have I delegated authority and trained people sufficiently?'"

Noceti advocates an integrated system of performance reviews and cross-training for a potential successor's own development as well as for the firm's security.

**The Dollars And Sense Of Succession Planning**

The selection and training of a successor will all be for naught if you don't also develop a financial strategy for handing over your business. Perhaps the most significant activity associated with succession planning, a financial strategy protects your company, your family and your employees against a monetary burden that could doom the entire process to failure.

For example, if you plan to turn over your business to your children, you have to think about the heavy gift taxes they will face. If you die, your heirs can suffer an equally prohibitive estate tax.

Setting up an employee stock option program is critical if you plan to sell your business to staff members. And lastly, you may decide to sell your firm to a chain or a local competitor. If so, you need to know what your company is worth so you can get the best price for those long years of hard work.

**For What It's Worth**

 No matter who inherits your business, it's critical that you get an accurate valuation. Such a valuation encompasses tangible assets such as real estate, buildings, machinery and equipment, as well as intangibles like employee loyalty, manufacturing processes, customer base and business reputation, patents on products and new technologies.

Sometimes it is difficult to estimate the value of your firm yourself, however. In those cases, professional valuation companies know what to look for and what questions to ask. You also probably need the help of your accountant and the firm's financial officer (if you have one).

The question of value becomes even more complicated when you attempt to put an exact price tag on your business. Price can vary depending on the circumstances. For example, the selling price to your children may be less than the amount you would ask from a large chain that wanted to buy you out. In any event, a fair value must be used, one that will withstand IRS scrutiny.

Taxes can also influence how value is determined. To reduce potential estate taxes, you may want your accountant to argue to the Internal Revenue Service that your firm has minimal value. Also, current stock purchase price or buy/sell agreements may not reflect the dollar amount you believe the business is worth.

A business valuation is also a way to predict your company's future. Using your firm's historical and financial records and your judgment as owner, work with your valuation firm to calculate whether your business will grow or decline, future inflation rates, and anticipated costs and expenses of running the operation.

The most common methods for determining value are:

1. Book value, which is reflected in your firm's financial statements.
2. Adjusted book value, which reflects the current value of your company's assets (this method is more significant for a company with newly acquired assets or assets that don't depreciate).
3. Standard Valuation Methods, used by national and regional acquisition companies for valuing firms they've targeted for takeover.
4. Capitalization of earnings methods, used by the IRS and the courts in valuing business interests for estate and gift tax purposes. These methods attempt to quantify the goodwill of a company in terms of its earning power, beyond the value of its operational assets alone.

**The Ways And Means Of Transferring**

The primary recipient of all your years of hard work and success -- i.e., whoever you've chosen as your successor -- will help determine the method you use for transferring your business. The structure of your company is another factor that will influence your choice of the transferring method.

Let's say you're a sole proprietor and want to keep your company in the family. If you expect to work until you die and bequeath your business to your children, you need to think about federal estate and gift taxes, which can bite off as much as 60 percent of your estate after your death. Or if you plan to sell your company to a family member so you can retire, you need to make provisions through insurance policies to help your successor finance the purchase as well as pay for the ensuing taxes.

If you're in a partnership, you face a different set of decisions. Does your percentage of the business automatically transfer to your spouse or offspring upon your death or, as part of the partnership agreement, is your partner supposed to buy out your shares? If you have chosen the latter arrangement, you need to take out enough life insurance to provide your partner with adequate funds to pay for the purchase.

Closely held corporations have issues of their own. Stockholders may stipulate that upon their death, their shares will automatically transfer to their surviving spouse or children. However, if the shareholder's heirs subsequently want to sell their stock, sufficient provisions should be made so remaining shareholders have enough cash for the buy-out.

**Gifting**

"Gifting" is one succession option that allows the owner to transfer the business to the next generation over time -- in a way that reduces or even eliminates any estate or gift taxes. Each year an owner can give $10,000 to a child tax-free; husband and wife business owners can each give a part of the operation worth $10,000 to their child, for a total of $20,000. Neither the donors nor the recipient pay taxes on the gift. In addition, the tax-free gift can be doubled each year if the donors give a $10,000 gift to the donee's spouse, and donors can give $10,000 tax-free to each grandchild as well.

You can also, during your lifetime or upon your death, give away an additional $600,000 of the value of the business without paying any taxes. Your spouse has the same opportunity. Jointly, therefore, you can make tax-free transfers of up to $1.2 million in addition to the annual gift of $20,000 per family member.

In addition to minimizing their own taxes, gifting allows entrepreneurs to oversee management succession as well as the change in ownership. You have the opportunity to maintain control of your company while giving your offspring increasingly meaningful roles in running the business.

If you haven't incorporated your business, you might consider doing so, as a corporate entity allows you to transfer the company in pieces, i.e., shares of stock. Each share can have its own value, making the transfer easier over time. Be careful in assigning a value to the shares yourself, however. The government may not agree with your valuation, leaving you vulnerable to taxes. Therefore, it's sometimes wise to consult a qualified valuation company as well as your accountant and tax attorney.

**Trusts**

The most common trusts used by business owners when planning their company's future are testamentary and living. In a testamentary trust, you establish the provisions in your will, and the trust becomes effective upon your death.

A living trust, however, is created during your lifetime and can continue after your death. Unlike testamentary trusts, living trusts are not subject to probate.

In both cases, you as the trustor determine the purpose of the trust, the amount and type of property it will contain, the length of time it will last, and the trustees or beneficiaries. You also establish the amount each beneficiary will receive, and when and under what conditions they will receive it.

Trusts can be irrevocable or revocable. Both have their advantages and disadvantages. On the plus side, irrevocable trusts will save you money on income and estate taxes; revocable trusts will help you avoid probate and, in some states, protect property from creditors. To decide the best form for your business, consult your attorney and your bank's trust department.

**Buy-Sell Agreements**

Inc. magazine calls buy-sell agreements "the next best thing to immortality." A transfer method most appropriate to closely-held businesses, buy-sells enable you to safeguard your family's financial future and prepare your company to go on without you. Contends Inc., "If done well, buy-sells can bolster companies against all kinds of unforeseen events that could threaten their stability and perhaps survival: disability, divorce, death and plenty of events in between."

Buy-sell agreements generally fall within two categories: cross-purchase agreements and redemption or repurchase agreements. In a cross-purchase agreement, the remaining shareholders of a company are obligated to buy the departing (either by retirement, disability or death) shareholder's stock. The corporation itself as an entity is not a party to the agreement. Cross-purchase agreements enjoy certain tax advantages, in that proceeds from the sale of stock are treated as capital gains rather than as dividends. In addition, if you fund a cross-purchase agreement with life or disability insurance, creditors cannot attach the cash values of the insurance policies.

Redemption or repurchase agreements specify that the corporation, via agreements made between the company and the individual shareholders, is obligated to purchase the stock of the departing shareholder. The major advantage to this type of agreement is simplicity -- each shareholder deals with one entity, the corporation, rather than several other shareholders.

"The choice of type of agreement depends on a number of factors. Each business must plan individually to determine what is appropriate," recommends Brian Titus, counsel for Connecticut Mutual Life Insurance Company, and speaker at succession planning seminars co-sponsored by his company and the SBA.

A third type of buy-sell involves the sale of interest to key parties, most often prized employees. For example, the owner of a New England construction company sold two employees four percent stakes. The sales agreement stipulated that in the event of his death, the estate of the deceased would sell his shares of stock back to the company at a fixed price.

Then one day the unexpected happened. The owner died in a car accident, and the two employees were thrust into the position of owners. They met with the family of the deceased to formalize the sale and then called a meeting of all company employees. The buy-sell ensured the continuity of the operation and provided staff, bankers, customers, suppliers and other interested parties with an important sense of security.

**Life Insurance**

Life insurance can be the lifeblood of your company, keeping its heart pumping no matter what fate befalls it. Life insurance policies can provide money to pay off estate taxes, fund buy-sell agreements or buy out a family member who is not interested in participating in the business. Moreover, insurance policies provide cash for emergencies, helping you avoid selling your firm to outsiders if it's hit by hard times.

"A properly designed buy-sell agreement is only half a plan," according to Titus. "Such an agreement should be properly funded as well, and life insurance is often the funding vehicle of choice." A major advantage of insurance is that it's the only funding medium that can be estate and income tax-free and even, in some circumstances, gift tax-free.

Business life insurance can help your company ward off any hazards resulting from your death or that of any other key participant. Each company has its own set of circumstances and requirements, which should be reflected in the way the policy is drawn up. The policies you purchase should take into account any legal, financial, tax and technical complications specific to your operation.

Try to avoid plans that necessitate additional taxes. And because tax laws change frequently, reevaluate your policy on a regular basis with your financial advisers to ensure the greatest advantage for you and your company.

**Write A Happy Ending**

"King Lear, Pygmalion, the Old Testament, Greek tragedies. If you substitute the nouns and verbs, you could write the family business owner's story. His problems are the problems of humanity, and the business funds and fuels them. It's a family passion play, with the business founder center stage, usually all alone," observes Leon Danco.

But the story of your firm doesn't have to end in tragedy. It can have a happy ending if you start writing it now. By planning today for the continuation of your business, you will help it succeed in the present and ensure its health long into the future.

Says Danco, "Few founders think about the future until it's too late. When they start a business in their early 30s, their whole effort is devoted to survival. But the survival instinct, so essential in the first few years, continues long past its usefulness. All of a sudden the owner finds himself turning 65; his kids are all grown; and his business has jumped from two to 200 employees. And he asks himself, `Where did the time go?'"

Succession Planning Profile: Dorothy Locklear-McNeill

Succession of the business has been on Dorothy Locklear-McNeill's mind almost since she and her first husband started their clothing manufacturing company 20 years ago. The mother of three and her husband, Gene Locklear Sr., always expected their children to carry on the family-owned operation. In fact, they groomed two of them for that role for nearly 10 years. Located in Pembroke, North Carolina, Five Gs Manufacturing produces sports clothes for major department stores' private label collections. The company was born during a brainstorming session between Locklear and his then-boss.

"My husband and I were both employed by clothing manufacturers," Locklear-McNeill recalls. "I worked at the sewing end and he worked at the cutting, shipping and receiving end. One day after Gene went on a business trip with his boss, he came home and announced that we were going to open a business. When I asked, `Who's going to run it?,' he replied, `You are.'"

They began as partners with Locklear's boss, but were able to buy him out six months later. Rapid success sparked the company's growth and with the help of an SBA loan, the couple was able to build a 20,000-square-foot plant after just two years. Government contracts for military clothing fueled their growth even further, and the Locklears added a second building to their facilities. The firm the Locklears dreamed of passing on to their children had become a reality. But it was not to last. The government contracts were not renewed, sending Five Gs Manufacturing into Chapter Seven. The Locklears were forced to reorganize in 1983 and, as Locklear-McNeill describes it, "start out small again."

This was not just bad news for the Locklears, but also struck a blow to the community. The company was a major employer in the area, especially for the Lumbee Indians, a tribe to which the Locklears belong. The Locklears had intentionally built Five Gs Manufacturing in Pembroke to provide jobs for their people, but were forced to trim their workforce from 500 to slightly more than 100.

To compound the situation, Gene Locklear developed cancer in 1988 and died a year later at only 53. Dorothy Locklear-McNeill, who had always deferred to her husband, was suddenly in charge.

"I thought about shutting down, but that would have been disastrous for the community and for my sons," she remembers. Her daughter has no interest in joining the family business. "The firm had fed us all these years. I decided to take what I was given and make the best of it."

Although her knowledge of company operations was minimal, Locklear-McNeill was helped by notes her husband had written just prior to his death. She has since prepared a will with each son's role spelled out, and her succession plan is a work in progress as she watches her sons, ages 25 and 21, develop in the business. She hopes to have the plan finalized in the next two to three years. Married again just six months ago, Locklear-McNeill's current husband has no interest in the company.

"One thing I would recommend is the best life insurance coverage a business owner can afford," she says. "We don't all live to a ripe old age. You need to have money to make sure your heirs can take care of the operation.

"Planning your succession takes a lot of time and thinking," concludes Locklear-McNeill. "You have to decide who in your family will do what. We want our children to follow in our footsteps, but they have minds of their own. So you pat them on the back and let them know you think they're capable."

**Succession Planning Profile: Rubio's Restaurants**

Almost nothing causes us to reflect on our own mortality the way birth does. And when business owners start thinking about mortality, the smart ones start thinking about succession.

Such was the case with the Rubio family, owners of Rubio's Restaurants in San Diego. Known as "Home of the Fish Taco," Rubio's was started by Ralph, now 38, and his father Ray almost 11 years ago. Family lore postulates that the uniqueness of the menu (which also features "authentic Baja cuisine"), compared to the fare offered by other Mexican restaurants, made Rubio's almost an overnight hit. Today, Rubio's has expanded to 15 southern California locations; sights are set on northern California later this year and nationwide in five years. This explosive success, coupled with the birth of several grandchildren, finally caused Ralph and his father to seriously contemplate succession planning for the first time.

"We brought in other family members to handle the expanded operations," Ralph Rubio recalls. "My brothers Robert and Richard and our sister Gloria all hold executive positions and have equity in the company. While our business had grown considerably, we weren't professionalized.

"We joined the Family Business Institute about two years ago, and they invited a consultant to speak about succession planning at one of the meetings. We started talking with her and decided it was time to begin planning for the transfer of our own business."

Before developing the actual plan, the Rubios reviewed their shareholders' and buy-sell agreements, their insurance policies and other relevant corporate documents. "We found that they didn't reflect what we actually wanted to happen," Rubio notes. "They had been written when we first started the company, based on information we had at the time. A lot of things that needed to be covered had fallen through the proverbial cracks."

The family's first step was to revise the relevant corporate documents, especially those dealing with death or disability. Currently, they are engaged in estate planning, and drawing up trusts and wills. "In the beginning we were too busy running the business to think about things such as estate planning," he admits. "Now, we've gotten married and had kids, which has made us think about `what's going to happen to my shares?'"

At the same time, the Rubios are writing job descriptions for all executive positions that essentially create succession plans for each key individual. "Something could happen to any one of us," Rubio asserts. "We must have a system in place that specifies duties and responsibilities so someone could take our place. Our jobs have grown along with the company."

While a forceful advocate of succession planning, Rubio also well understands that the process is not easy. "It's tedious, time consuming and can be very emotional," he cautions. "I suggest getting help from a good consultant, someone who can lead you through the entire process."

He pauses, reflecting on the experience his family has undergone. "I started out wearing an apron in my mother's kitchen and today I'm dealing with issues such as real estate. And my role will continue to change. Age is not the issue; growth of the business is. To keep a handle on growth, you have to educate yourself so that you're prepared to deal with things that lie ahead."