Common Mistakes in Succession Planning

For many business owners, business success runs entirely through them. They make the big decisions, develop and lead plans for growth, and serve as the face of the company. They may neglect to plan for a day when, without warning, they die or become permanently unable to run the business. This neglect can cause the successful businesses they'd built over years or decades to fall apart in mere months. How does this happen?

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Planning for how the business functions in the permanent absence of its owners is called *business continuity planning*. Typically, an owner's business continuity planning is comprised of creating a Buy-Sell Agreement (sometimes called a Shareholder Agreement) early in the company's existence and filing it away. On their own, Buy-Sell Agreements are generally too simplistic to handle the complexities of planning for the future of an owner's ownership. Nonetheless, most business owners use Buy-Sell Agreements as their sole business continuity plan. Weak continuity plans are like quicksand: Though they look like they provide reliable footing for a strong future-of-ownership plan, they can end up sinking the owner's company when it is time to implement that plan. As a business owner, how can you avoid falling into the false comfort of an inadequate continuity plan and position your company and family to survive without you?

This white paper will discuss four common mistakes owners make in their business continuity planning strategies. It will also provide you with things to consider to address or avoid those mistakes.

The four most common mistakes are as follows:

1. Overlooking challenges to the business.
2. Neglecting your family's financial security.
3. Not giving your family direction on how to address your sudden death.
4. Oversimplifying the plan.

Addressing these mistakes will help you, your family, and your company adjust and adapt to both planned and unplanned separations from your business, potentially making your business stronger and more resilient. Let's begin by looking at the first mistake: overlooking challenges to the business.

MISTAKE 1: OVERLOOKING CHALLENGES TO THE BUSINESS

Recall that most business owners' continuity plans consist solely of a Buy-Sell Agreement. The most common problem with many of these

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plans is that they don't include provisions to address the challenges that the business will face upon the owner's death or incapacitation; they simply give instructions for how and to whom the business interest should be sold. When owners die or become incapacitated, the new person in charge tends to run into two problems that the continuity plan does not address: the loss of financial capital and the loss of talent. Using a case study, let's look at how the loss of financial capital can be a business continuity hole that must be patched.

Loss of Financial Capital

Sue Ellen Saint-Saens, a long-time trusted advisor, sat down with Joel Canfield. Joel's 51% co-owner, Frank Sobel, had just died. Joel told Sue Ellen that he had purchased 49% of Sobel Construction Inc. (SCI) over several years as Frank's key employee. Joel was president and ran the business, allowing Frank to retire. Sue Ellen learned that SCI undertook one or two large construction projects each year—projects that required a performance bond and a line of credit.

As founder and majority owner, Frank had personally guaranteed the performance bonds, and his personal assets served as collateral for the bonds and line of credit. After Frank's death, Joel was willing to provide his personal guarantee as he transitioned from a 49% owner to the 100% owner, according to the terms of the Buy-Sell Agreement. Joel did not have the money Frank did, so he couldn't satisfy the bank's and bonding company's outside collateral and guarantee requirements. Without bank financing and bonding capacity, SCI could not continue to do business.

In this example, Frank and Joel only covered part of the business continuity problem. SCI's Buy-Sell Agreement stated that the company would be transferred to Joel upon Frank's death. Additionally, Frank's insurance advisor had helped them secure enough insurance for the transfer to occur smoothly, which allowed Joel to pay Frank's estate for the remaining 51% of the company. However, their continuity plan failed to consider the matter of available financial capital.

Frank had personally guaranteed the performance bonds and had enough assets to serve as collateral. Joel, on the other hand, did not have enough assets to satisfy lenders, nor did his personal guarantees hold the weight that Frank's did. As a result, SCI was forced to shut its doors. The bonding company and bank were watching closely at that point, ready to go after Frank's estate for any project requirements or debts the company could not satisfy, since Frank's obligations continued after his death.

Buy-Sell Agreements and the ownership transfers they control cannot achieve common owner continuity objectives, such as the continuation of a strong and healthy business. Even when a deceased owner's family has been paid for the ownership using insurance proceeds, the company may still struggle and fail, leaving employees, customers, and the community in a difficult position.

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Without access to capital, many companies cannot continue to function. As a responsible owner, how can you overcome the false security of an inadequate continuity plan?

1. Determine any personal guarantees and collateral that exist in your business.
2. Do not, under any circumstances, give up control of the business without receiving full payment and full release from any existing and contingent debt or obligations for the business.
3. Get written assurance from your lender that states that with the adequate amount of life insurance (or a specific amount of replacement capital provided by the successor), the lender will forego the need for your personal guarantee or collateral.
4. If adequate life insurance is unavailable (due to age, illness, or otherwise), revise your plan to stipulate that you will not transfer ownership until your successor can provide personal guarantees/collateral acceptable to the lender.

Knowing the importance of preventing contingent business liabilities from following you out the door can protect you from building your future ownership plans on the quicksand of an inadequate continuity plan.

Next, we will look at how to handle a loss of talent. In this case, we'll look at what would happen if it were Joel who died before Frank.

Loss of Talent

A loss of talent, whether by death or departure, can be a massive hurdle for owners with inadequate planning. In many closely held businesses, one owner typically serves as the company's rainmaker or relationship developer. In the case of SCI, Joel was the company's rainmaker. What would happen if Joel were to die?

As we've seen, Frank and Joel—like many business owners—had a Buy-Sell Agreement that addressed how and to whom business ownership would be transferred upon an owner's departure. However, it failed to determine how to position the business to survive following one of the owners' departures. Upon Joel's unexpected death, SCI no longer had the one person who could assure that the business' cash flow and value would continue to grow. Without Joel, where would the next big project come from? Without its primary rainmaker, SCI was unsellable because it had very limited *transferable value*.

Transferable value is what the business is worth to a buyer *without its owner*. It is a key component of planning for the future of your ownership. Thus, having people who can replace an owner who dies or leaves unexpectedly is

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paramount. There are ways to prepare for such a challenge:

1. **Identify risks**. Ask yourself, "If my co-owner or I were to die tomorrow, how will the company replace us?" Your answers will position you to craft solutions to this problem. Most likely, the answer will be that you need to either recruit new management, or train and groom existing management or key employees to take the reins should you or a co-owner depart unexpectedly.
2. **Create a replacement plan**. When a rainmaker departs the business unexpectedly, the company must immediately replace him or her with someone equally or more skilled. In Frank's case, he did not have anyone readily available to step into Joel's role. This meant that he would need to look outside the company. Unfortunately, rainmakers can be hesitant to leave their current jobs, primarily because they are content in their current positions and well compensated.

   When creating a replacement plan, you must be able to entice other rainmakers to come to you. A few methods to do this include selling the rainmakers on your company's strong reputation, providing a challenging position with a path to ownership, or, most effectively, offering compensation that is significantly higher than what he or she is currently paid. Creative incentive compensation plans can get the attention of ambitious people in ways that other approaches can't.

The common thread between identifying risks and creating a replacement plan is time. It can take years to identify all of your risks, build your company's reputation, provide a worthwhile work experience for outside rainmakers, or train current management to pick up the slack should a rainmaker or key employee depart unexpectedly. If you plan to retire within the next 5–10 years, or if you are concerned about maintaining your business' transferable value, you need to begin addressing these challenges to your business today.

MISTAKE 2: NEGLECTING YOUR FAMILY'S FINANCIAL SECURITY

One aspect that is often overlooked in continuity plans is the financial security of the owner's family following the owner's premature death. Since most continuity plans only address to whom the business should be transferred upon an owner's untimely death, they ultimately fail to fulfill the owner's goal of financial security for his or her family. Consider the following example:

Bob and Dan were equal co-owners of BD Designs, a relatively new architectural design and engineering business worth, according to a recent appraisal, $5 million. Bob and Dan each received annual salaries of $375,000. The business' EBITDA had grown to $1 million,

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most of which the owners left in the business to fund its healthy growth.

One day, Bob was killed in a car accident. His estate received $2.5 million (the full value of his ownership interest) from an insurance policy that Dan had on Bob's life. Their Buy-Sell Agreement worked exactly as written but not as the two owners had intended. The result was disastrous for Bob's family.

Before Bob's death, he, his wife, and three children lived on his salary. After Bob's death, his family's principal asset was the $2.5 million from the sale of his ownership in the business. Bob's widow's financial planner suggested that a reasonable withdrawal rate from the sale proceeds would be 4%, or $100,000 per year. Even though Bob's estate received the full value of his interest in the business, his family's annual income plummeted from $375,000 to $100,000.

This example shows the unintended consequences of many continuity plans. While Bob and Dan took the right steps in creating a Buy-Sell Agreement and purchasing life insurance, the amount that Dan paid the estate could not support Bob's family as Bob's salary had. On top of that, Bob's family lost Bob's share of EBITDA, which was another $500,000 loss.

How can you position your family to be financially secure if you die prematurely? The most obvious solution is to buy life insurance on yourself owned outside of the business. However, this method is sometimes prohibitively expensive. Consider, for instance, Bob. For Bob to have insurance coverage that would allow his family to replace his lost salary (without considering his lost share of EBITDA), he might have needed an additional $7 million in insurance coverage. The $7 million in personal insurance, combined with the $2.5 million in sale proceeds for Bob's ownership, would result in $9.5 million in assets that could be withdrawn at the financial planner's recommended rate of 4% per year, or $380,000. This amount of insurance can be difficult or nearly impossible to obtain for owners who are planning for their family's financial well-being while also focusing on a growing business.

When insurance coverage cannot cover losses, you can consider one of the following methods:

- **Eliminate the requirement for a full purchase of the decedent's ownership interest**. Consider a transfer of control to the surviving owner in which the survivor acquires the remaining ownership over time using a purchase price set by an up-to-date valuation required in the Buy-Sell Agreement. This arrangement could have allowed Bob's family to continue to receive a share of annual profits generated by the company to supplement their other resources.
- **Provide income continuation for a set number of years via a wage-continuation plan after an owner's death**. In our example, the company could have been

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obligated to pay Bob's family his ongoing salary or some lesser amount, such as $200,000 per year for 10–15 years. This would have smoothed out the disruption in the family's annual income, and the company would have taken a deduction for the payments.

While each of these ideas can address this mistake in your business continuity plan, none of them are ideal. To truly try to address or avoid neglecting your family's financial security, you should consider the following:

- Include your spouse in initial planning meetings so that he or she understands the effects that your untimely death or incapacitation will have on him or her.
- Review your lifetime goals and ask yourself whether you want those goals to be fulfilled should you die or become incapacitated prematurely.
- Determine whether a gap exists between the financial resources available upon your death (including the money received from the sale of ownership pursuant to the Buy-Sell Agreement) and the financial resources your family will need to maintain its lifestyle should you die.
- Schedule these discussions now, before an unexpected event occurs and before you know whether you will be the surviving owner. This tends to ensure an impartial discussion with your advisors and co-owners.

Taking these steps can help protect your family's financial well-being should you die or leave before you had planned.

MISTAKE 3: NOT GIVING YOUR FAMILY DIRECTION ON HOW TO ADDRESS YOUR SUDDEN DEATH

Many families of business owners rely on the owners' salaries for income. Additionally, many of those families view the business as their nest egg, which they can cash in once the owner is ready to sell his or her share of ownership. All of that can vanish in an instant because of an owner's sudden death, as we saw in our previous example.

If you were to die unexpectedly, would your family know what to do? Specifically, would they know whom to call about what happens to the business? Would they know what to do about personal finances? Many owners fail to give their families direction about what they should do with their personal finances and what happens to the business when they die unexpectedly. Few families know what to do regarding the family's personal finances, the business' continued operations, and any debts (personal or business) the owner may have left behind.

You can address this common and sometimes catastrophic mistake by providing your family with instructions for what to do if you were to die unexpectedly. This includes providing your family with the names and contact information of any advisors, co-owners, and key employees who can help them take the

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first steps in resolving issues your untimely death might cause. You can also list any outstanding business and personal lines of credit you may have and how you suggest they handle those issues. You can even provide information about things like online account passwords that only you have so that your family can access crucial information if necessary.

Without specific instructions about what to do if you die, your family may find themselves in over their heads when trying to handle the personal and business financial decisions you used to make. Buy-Sell Agreements typically do not provide these instructions.

MISTAKE 4: OVERSIMPLIFYING THE PLAN

As we've seen, continuity plans tend to overlook several common problems relevant to an ownership transfer. The problem of oversimplicity goes even deeper: Buy-Sell Agreements are often too simplistic to manage the relationships between the owners who sign them. Specifically, Buy-Sell Agreements tend to overlook the unwieldy problem of mandatory vs. optional ownership-transfer provisions.

Ownership transfers typically include mandatory and/or optional purchase provisions and follow one of four patterns:

1. The seller *must* sell; the buyer *must* buy.
2. The seller *has the option* to sell; the buyer *must* buy.
3. The seller *must* sell; the buyer *has the option* to buy.
4. The seller and buyer each *have the option* to sell and buy, respectively.

These arrangements can be tricky to navigate, but one way to map the course is to consider the difference between a *funded* and *unfunded purchase price*.

A funded purchase price uses means such as life insurance after death or a "sinking fund" built up in the business to purchase the owner's share of ownership. Funded purchase prices are typically paid using money outside of the company's normal annual cash flow. When working with a funded purchase price, you will commonly see *mandatory* provisions (i.e., the seller *must* sell; the buyer *must* buy) written into good Buy-Sell Agreements, simply because the buyer has the cash to pay for the seller's share on hand.

However, transfers while an owner is still alive are far more common than after-death transfers (the latter of which will usually trigger a funded purchase). A lifetime departure and buyout commonly force owners to reckon with an unfunded purchase price.

An unfunded purchase price requires resources such as after-tax cash flow to pay for an ownership interest. When working with an unfunded purchase price, you may see *optional* provisions (i.e., seller *has the option* to sell; buyer *has the option* to buy) written into good Buy-Sell Agreements, simply because the after-tax cash flow is inadequate to fund a full buyout. Buy-Sell Agreements that are too simplistic tend to focus on buyout scenarios that are the easiest

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to fund but are less likely to occur—such as the death of an owner—because insurance funding may be readily available. But good Buy-Sell Agreements take many possibilities into account and consider the availability of funding for each.

Addressing a simplistic Buy-Sell Agreement is twofold. First, begin planning for the future of your ownership in full. In most cases, there is no single Buy-Sell Agreement provision that will adequately cover all lifetime and after-death transfer scenarios. Planning for all possibilities and combining internal company resources with insurance and personal planning outside the business for each owner can adequately cover myriad lifetime or after-death transfer events.

Second, if you are still on the fence about beginning the planning process, you can still try to craft a Buy-Sell Agreement that considers the complexities behind mandatory vs. optional provisions. Evaluate the impact of a totally unfunded buyout on company cash flow, since the business is the likely source of buyout payments. Consider the consequences of a mandatory buyout if funds are limited and the result of an optional buyout in which the option is not taken (i.e., the buyer or seller declines to buy or sell). In short, don't just look at the intended results of the Buy-Sell Agreement: Look also at the possible outcomes.

Oversimplifying Common Lifetime Exits

As you begin to consider your planning, remember that Buy-Sell Agreements often do two, and only two, things:

1. Provide transfer instructions upon the death or incapacitation of an owner.
2. Provide a right of first refusal to the remaining owner(s) when a co-owner wishes to sell his or her ownership interest to an outside party.

Oftentimes, Buy-Sell Agreements and the business continuity conversations between owners do not address some common events that can affect a person's assets, including his or her ownership in a business, such as the following:

- Personal bankruptcy.
- Divorce.
- Forced termination of an owner's employment.
- Irreconcilable differences between owners.

The goal of a good continuity plan and Buy-Sell Agreement should be to assure that all owners are treated fairly. If you review and update your understanding of your written Buy-Sell Agreement every one or two years, you can address the fairness question *before* it becomes a problem. Marriages, divorces, children, and new owners can change how you view the adequacy of your planning. It's much easier to negotiate terms level-headedly than to do so when emotions run hot. Let's look at the implications of each of these common events.

Bankruptcy or Divorce

In bankruptcy and divorce proceedings, ownership in a company is considered an asset, just like a car, vacation home, or artwork. In both events, an owner can be forced by a court

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to transfer ownership to either a creditor or an ex-spouse. Thus, Buy-Sell Agreements should stipulate that when an owner finds him or herself in such a situation, the business (through co-owners or key employees) should have the right to acquire the owner's interest.

In many cases, creditors and spouses often prefer cash to an illiquid ownership interest. It's possible that a creditor's or ex-spouse's lawyers will deem right-of-first-refusal stipulations in your Buy-Sell Agreement unenforceable with respect to their clients' rights. But giving the company the option to purchase the owner's interest can turn an illiquid asset (i.e., the ownership interest) into a highly liquid asset (i.e., cash or a promissory note), making the best of a bad situation.

Forced Termination of an Owner's Employment

For businesses with multiple owners—whether majority/minority or equal split—forced termination is rarely, if ever, considered in a Buy-Sell Agreement. The complexities and inherent hostility in these situations imply that there is no boilerplate solution to this dilemma. For example, controlling owners might want the ability to purchase a terminated owner's interest. The fired owner may want the ability to sell his or her ownership back to the company or the other owners. All owners may simply want the agreement to require a mandatory purchase of ownership in the event of an owner's employment termination for any reason.

It is important for your Buy-Sell Agreement to address these acrimonious conditions. Determining a fair value of ownership interest, along with having specific buyout terms and conditions, can make a forced termination equitable for all owners involved.

Irreconcilable Differences Between Owners

Occasionally, two non-controlling (i.e., equal) owners will have a falling out, for any number of reasons. Whether the owners disagree about the business' future or otherwise, these fallings out are almost never covered under a Buy-Sell Agreement. This means that a particularly vindictive owner can bring business operations to a halt.

Addressing this issue requires a provision in the Buy-Sell Agreement that we call the "Texas Shootout Provision." The Texas Shootout Provision stipulates that either owner may offer to purchase the other owner's interest. The second owner must then either accept the offer and sell his or her ownership interest, or purchase the first owner's interest for the same price, terms, and conditions spelled out in the offer. Thus, the second owner has two choices: accept the offer and sell his or her ownership interest, or turn the tables and buy the offering owner's ownership interest. This provision is used when a disagreement has no alternative solution.

The Texas Shootout Provision will leave the business with one owner in the end and does two things: (1) It encourages the owners to come to an agreement in which one buys out the other

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before the provision is activated. (2) It prevents vindictive owners from stalling the sale process. Additionally, this provision allows for a third solution: If the owners absolutely cannot get along or come to an agreement, they can dissolve the business, sell the assets, and start over.

Oversimplifying Business Valuations

Another common oversimplification within Buy-Sell Agreements is that they typically fall into the trap of using generic valuations when valuing the business for sale. The problem stems from confusion or misinterpretations related to the business' likely value. Additionally, the cost of more-comprehensive valuations, such as an opinion of value from a credentialed appraiser, often causes business owners—even those who own companies worth millions—to balk at a valuation.

The key to addressing this is to determine the goal of a valuation in your Buy-Sell Agreement in the context of your business' maturity. For instance, while it may make sense for a small business that is 100% reliant on its owners for revenue to use a simple, agreed-upon value, owners of a multimillion-dollar company would be remiss using such an inaccurate valuation method. Likewise, a small company probably won't need a full opinion of value (which can cost $50,000 or more) for its initial Buy-Sell valuation. The complexity of your company and your planning objectives will determine which valuation method you use in your Buy-Sell Agreement.

Your Buy-Sell Agreement should reflect your company's current operating status. This is especially true for Buy-Sell Agreements that include a valuation.

Oversimplifying the Plan's Relevance

Many Buy-Sell Agreements are drafted early in the business' life and never reviewed again. As the business grows or changes, owners often neglect to update their Buy-Sell Agreements in light of new business developments. Thus, when the time comes to transfer the business, many owners find provisions that no longer reflect the state of the business or their desires. These Buy-Sell Agreements often fail to manage transfers successfully because they are reflective of a business that only exists on paper.

Your Buy-Sell Agreement should reflect your company's current operating status. This is especially true for Buy-Sell Agreements that include a valuation. As time passes and the business changes, valuations will change, and the farther away from the initial valuation you get, the less accurate the valuation becomes. This can lead to material unfairness between owners, which can lead to bitter, drawn-out litigation.

Addressing this problem is relatively simple: Include your Buy-Sell Agreement in your annual fiscal year–end reviews. Updating your Buy-Sell yearly can keep your company's value and your planning objectives up to date. It can also reduce

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the likelihood of litigation between disagreeing owners.

Oversimplifying the Plan's Implementation

In addition to not reviewing their Buy-Sell Agreements, many owners fail to update them in light of the various changes that occur throughout a business' life. Failing to amend provisions to reflect these changes can have the same prickly outcome as using an outdated Buy-Sell Agreement.

You can address this problem by looking both inside and outside of the Buy-Sell Agreement for changes that can affect its efficacy. During your Buy-Sell Agreement reviews, review the signed Buy-Sell Agreement, not an unsigned draft. Updating and adjusting your Buy-Sell Agreement can prevent acrimony between owners.

CONCLUSION

Many continuity plans are inadequate because they make at least one of these mistakes. When triggered, continuity plans and Buy-Sell Agreements should fulfill the goals of both the departing owner and the new owner. Many continuity plans and Buy-Sell Agreements fail to do so.

Taking time to review your business continuity plan, especially your Buy-Sell Agreement, can position you to rely on your plans with little worry. A continuity plan crafted in the context of your future can prepare you for just about any kind of business departure, whether planned or unexpected.

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