Succession Planning for a Privately Held Business

by Richard A. Hamm

Most commercial and business lenders focus on industry, management, and operations as the most important non-financial parts of a credit analysis. A management assessment usually notes whether the business has a succession plan in place and who may be positioned to take control over time. But this is where many analyses stop. We rarely ask for the details necessary to assess the quality of the plan. This article explores seven important elements of a good succession plan, focusing on privately held or family-owned businesses—the most common types encountered by community bankers.

Demographics and business ownership data have shown that a record number of privately held businesses are expected to change hands during the first two decades of the twenty-first century. And even if a business does not change owners and stays in the same family, here’s an alarming fact: According to the American Society of Chartered Life Underwriters and Chartered Financial Consultants, only 35% of successful family businesses survive into the second generation of ownership, and only 20% make it into the third generation!1

Four of the most common mitigants to the risk of management turnover are 1) depth of in-place supporting managers, 2) various types of “key person” life insurance—both life and disability insurance, 3) business interruption insurance, and 4) buy-sell agreements among the owners. However, these solutions may not be feasible in many situations and can be a costly drain on the resources of small businesses.

Seven Important Elements of a Good Succession Plan

Here are seven key steps that management should take to ensure an orderly, businesslike approach to planning and managing succession.

1. Select and announce the next head of the business as early as possible. Somebody has...
to be the boss, and it’s more reasonable to choose a successor who fits the position than to pick the next leader and try to make the job fit him or her. Current management should use objective criteria and understand in advance that not all family members will be equally thrilled with the choice.

The current leader shouldn’t “waffle,” either. Without being too hasty, decisions on the next generation of leadership should be made and announced as early as possible in the transition process, after carefully considering the personal goals and potential roles of all family members.

Expediency in selecting the successor offers the following benefits:

- The new leader has valuable time to adjust and to prepare for the new duties. This may even include taking a job outside the company or earning additional educational credentials (like an MBA) to gain more experience and credibility.
- Everyone else has time to adjust to the new structure and potential shifts in relationships.
- Continuity is established for outsiders such as vendors, bankers, and customers.

2. Plan financial compensation and incentives for the next generation of management. For family members inside the business, one key practice is to structure compensation for rising young family executives that is consistent with that of other key employees and very dependent on objective performance measures. Good plans lay out a compensation structure for the CEO and other senior executives.

For nonfamily employees, continued opportunities to advance based on performance must be stressed. This should mirror the objective, results-based handling of family members inside the business. Any change in business ownership, not just among family members, can be a time of stress for all employees. Key employees should be identified, and plans should be made for employing nonfinancial incentives, such as job advancement and job enrichment, to promote productivity and loyalty.

3. Plan fair provisions for family members not active in the business. This can be one of the toughest areas to handle. For example, if one family member becomes a passive investor, this uninvolved heir may want only a big dividend payout. On the other hand, an heir running the business will want to reinvest any profits back into the business. To avoid this potential conflict, many families divide business assets among those involved day to day, then divide nonbusiness assets among the other family members. If the amount of assets is limited, there may be no choice but to include the uninvolved family members as owners of the business. In these cases, the ownership can be limited to minority or nonvoting stock or shares for the family members not directly involved in day-to-day operations. Another proven method is to put total ownership into a trust.

4. Plan for governance with a board of directors that includes outsiders. Intra-family conflict is one of the most frequently cited causes of failure for family-owned businesses in succeeding generations. Intra-family conflicts can be avoided by establishing a board of directors that includes objective outsiders who have a true voice in setting policies and strategies. It’s important not to have a group ready to “rubber stamp” the decisions of the family members involved in day-to-day activities. An objective board can help keep the focus on what is best for the business.

5. Schedule formal, periodic meetings of all family members. An idea similar to creating a strong outside board is to schedule periodic, formal discussion forums or “family council” meetings to deal with business and family issues. Advocates of this approach recommend using a trained discussion facilitator to sort through grievances and goals.
This gives all family members—those who are directly involved in day-to-day operations as well as those who are passive investors—a chance to review financial results, strategic targets, and the overall direction of the business. As family members change over time, their goals for income may change, and their qualifications to participate may change. Births, marriages, divorces, and deaths all have an effect on the overall family and its needs. This town-meeting approach gives all the stakeholders a voice and a chance to air their views and to keep other family members informed about changes in their lives and goals.

6. Plan for funding the senior owner’s retirement and for transferring business ownership. Ironically, while caught up in taking care of the continuity of the business and the welfare of upcoming generations, many senior owners fail to take proper care of themselves.

In his book on succession planning, James W. Lea cites three common results that senior owners want when they hand over the family business:
- Confidence that the business will continue to run successfully.
- That his or her experience and input will continue to be valued.
- That he or she will have a financially comfortable retirement.\(^1\)

James R. Devine discusses a similar “harmonic convergence” of business success when five similar, key goals are met:
- Consistent profits.
- Consistent, positive operating cash flow.
- A strong, healthy balance sheet.
- Adequate compensation to the owners and a reasonable return on investment.
- Strong going-concern value that is transferable.\(^3\)

There is an important link between both lists: If the business cannot achieve the five goals outlined by Devine, then it is difficult to achieve the three results cited by Lea. A good succession plan makes sure that the focus on the former does not exclude any consideration of the latter.

An important ingredient in funding for retirement is a good corporate tax or financial planning expert. Tools to achieve the results include qualified and non-qualified retirement plans, including private annuities, or even another type of stock transfer, such as a recapitalization of the company. The point is to get an expert involved and to carefully consider what the business can reasonably generate in the future to provide funding.

7. Create succession rules that set conditions for items such as the successor’s entry into the business, promotion and advancement, handing over authority, and handling family disputes.\(^2\)

Lea notes that behavioral studies show that people function more freely and more focused when they know the system and the rules. Setting fair and constructive rules can go a long way toward preventing disputes and disappointments.

In this area, the business should identify key transition events, perhaps some can be prerequisites for others, that can be triggered by passage of time, level of business sales or profits, or experience level of key players. By setting up and publicizing these milestones or checkpoints, the whole family can be involved in making sure the succession is successful. The senior owner can be assured of progress, and the family can see early-warning signs of trouble if milestones are not being reached.

A Final Word

A good succession plan means a high probability of the business continuing to be successful. As part of our credit analysis as bankers, we should do more than ask the shallow question of whether a succession plan is in place and who the successors will be. We should ask if the seven areas listed in this article have been covered. Better yet, we should ask the borrower to share his or her written succession plans with us.

Notes

1. For more information, see Devine, James R., “Dilemma or Opportunity? What Bankers Need to Know About Business Owner Succession,” The RMA Journal, April 1999.


3. Devine, ibid.

Owners of privately held businesses face difficult questions when it comes to company and business succession planning. Get in touch with our team today. Husch Blackwell counsels owners of privately held businesses as they contemplate reducing their involvement in daily operations and creating liquidity. Understanding the issues and emotions that often arise in these transitions, we provide holistic guidance that helps clients identify their succession goals and how best to accomplish them. Our experienced team of attorneys includes authorities in organizational structure, gift and estate planning, taxes, compensation strategies, employee stock ownership plans (ESOPs), and mergers and acquisitions.