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Business Succession Planning: The time is now

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Family-controlled businesses comprise between 80-90 percent of all business enterprises in North America.[1] And while it is estimated that nearly 40 percent of family businesses are passed successfully to a second generation, only a small fraction of them make it to the third generation or beyond.

In fact, many business owners fail to give any meaningful consideration to what will happen if they die suddenly or otherwise become unable to continue managing their business, or they simply procrastinate in formalizing a succession plan. In situations where there are no family members possessing the expertise and know-how to manage effectively the family business after the owner's death or incapacity, the family may find itself in a position of having to dispose of the business to a third party for a price below what could be achieved in an unforced sale.

Regardless of whether an owner intends to pass the family business to the next generation or maximize its value through an orderly sale at the time of retirement or death, business succession planning is vitally important to ensuring a smooth transition. Fortunately, there are many options to consider when structuring a plan that is right for each business.

The first step in setting a business succession plan is choosing a successor. This can be a difficult task when there is no son, daughter or other family member who has demonstrated the requisite skills and interest necessary to maintain and grow the business. In some cases where there is not a readily available heir-apparent, an owner may consider taking on a new minority partner or hiring a new employee who can be groomed to take the reins. If you are in business with one or more co-owners, you should strongly consider a cross-purchase agreement, which requires each of the owners to purchase the interests of a deceased or incapacitated owner for a specified or determinable price, or an entity-purchase agreement, which requires the company itself to purchase the outgoing member's interest. These arrangements are often funded through life insurance policies taken out on the lives of the participant-owners.

Unless you intend to transfer your business through a bequest under your will, in which case you should consult an estate planner, the final steps to establishing a business succession plan include choosing an appropriate method for calculating the value of your business and selecting a mechanism to fund your successor's purchase. Some of the more popular methods for establishing the value of a business include: (1) engaging a qualified professional to conduct a business appraisal periodically or at the time of transition, (2) setting a fixed price that is agreed upon between the outgoing and incoming owners, which can be updated periodically to reflect changes in the finances and prospects of the business, and (3) preparing a formula based on objectively determinable metrics (e.g., net earnings) that is agreed upon by both parties.

Finally, the successor owner's purchase of the business is typically paid either in a lump sum funded by life insurance proceeds from a policy on the outgoing owner's life (usually only in the case of a minority partner/shareholder as successor) or a loan secured at the time of transition, or in installments that can be paid out of the business's profits.

A franchised business adds an extra layer of complexity to this process. First, a franchisee must understand the process for generational change that the franchise agreement sets in place. All of the planning must coordinate with the franchise agreement process. The process is described in summary form in Item 17 of the Franchise Disclosure Document, and in detail in the transfer sections of the Franchise Agreement. A franchisor will want assurances that the successor managers have the required training and experience, and the financial wherewithal, to carry on the business. This process should start before a life-changing event, because many franchise agreements have a short fuse for making decisions and transitioning to a new generation. Some franchises offer the opportunity for the franchisor or an affiliate, or an authorized franchisee, to step in and manage the business while the ownership status of the business is addressed. The franchisor or an affiliate may have a right to purchase the business, or its consent and payment of a transfer fee must be required. The critical focus for all parties is continuity of customer service and operations, so that the brand's standards of quality and service are met throughout the transition period, and the good will of the business is unaffected, to the extent possible, by the event and change of ownership.

A family-owned franchisor has a similar critical focus on maintaining good will and customer service to franchisees, with the added issues of updating disclosure documents and state registrations when Item 2 disclosures must change. The leadership change will have not only the company's suppliers and its employees as its constituencies, but the entire franchise community as well.

By taking the time to solidify a business succession plan now, business owners can ensure a smooth transition for their businesses while maximizing their value and avoiding unnecessary frustrations and potential discord among family members after they die.

For more information about business succession planning, contact the author of this article or another member of the Firm's Business Department.

[1] (Source: J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," *Family Business Review*, September 2003).