A STRATEGY SPOTLIGHT

The Importance of Family Business Succession Planning

One of the greatest challenges facing a family business is properly planning for business succession. Business owners may be too busy dealing with everyday needs to consider the tough issues of succession planning, such as: Who will be the next operations manager? Do I want my spouse to own the business when I am gone, or do I want my spouse to be bought out? Which of the children will get involved in the business? What if my business partner dies? The list of issues that business owners should consider is lengthy.

Why is it important for business owners to delve into the myriad of issues involved in family business succession planning? If they are not discussed and a plan is not put into place, circumstances could devolve after the death of the business owner which could spell disaster for the business and the family, even possibly resulting in a forced sale of the business.

Let's look at an example that illustrates the importance of dealing with these issues earlier rather than later. John Smith is the sole owner of an asphalt paving business. His wife, Judy, is a teacher in a local school and is not involved in the business and neither are their children who are grown. While they had hoped that one or all would eventually work in the business, it appears that this is unlikely to happen. John is the main salesperson with all of the business contacts. John also has a long-term employee, Sam, who has become the operations manager, and runs the day-to-day paving business. The Smith's primary means of income is John's salary from the business.

John and Judy face several issues with respect to business succession planning. If they fail to plan, the asphalt paving business could be thrown into disarray when John dies. The operations manager, Sam, may be able to maintain the day-to-day business activities, but new sales would dry up if John failed to train him as the new salesperson. If Sam fears the business will fold without John, he may leave to join a competitor. If the business does manage to continue, Judy would be forced to either step in to manage the business as the new owner, or cede management to Sam, without the expertise to know if he is succeeding in his new role. The failure to address these issues in advance could cause the business to be sold or liquidated.

Instead, John and Judy could plan for these issues now and implement a successful business succession plan. If John believes that Sam would be a trustworthy successor as the business manager, he could start bringing him into the fold on the sales side of the business. John, Judy, and Sam could all agree that if John dies, Sam will purchase the business from Judy. Sam could purchase life insurance on John's life which would provide the cash to pay Judy for the business. This cash could provide her with the security she needs to support the family going forward.

Let's change the facts a little. What if John is a co-owner of the business with his sister, Susan. John is the sales manager, and Susan is the operations manager. They are both intimately involved in the business and either could take over the other's role if something happened to one of them. But what happens to ownership if one dies?

Let's assume John dies. Susan could step in and manage the sales and operations until she is able to hire a new sales manager. On the other hand, Judy has now lost John's income, and Susan is doing the work that she and John used to do. There is an inherent tension between Susan, as the business owner and employee, and Judy, as the business owner not involved in the business. The company in the past has not paid any dividends to John and Susan; they have taken all earnings from the company as salary. Going forward, Susan may feel that she should receive a substantial pay increase due to her increased responsibilities. At the same time, Judy may be primarily concerned with receiving a dividend from the business to replace John's income.

If John and Susan engage in business succession planning, they could avoid these potential problems. They could enter into a buy-sell agreement which would provide that if either passes away, the survivor must buy out the deceased owner's estate. They could purchase life insurance on each other to provide the necessary cash to follow through with the buy-sell agreement. If John dies, Susan would buy out his interest from Judy with the life insurance death benefit proceeds. Judy would then have sufficient cash to support her family, and Susan would be free to operate the business going forward.

The Bottom Line:

These examples illustrate many of the issues that are raised in family business succession planning. With proper planning, the problems can be addressed head-on and solved to create smooth transitions for families when management and ownership of the family business changes hands.