

# THE ART OF BUSINESS SUCCESSION

## Part four: legacy

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## LEGACY

Perpetuation of a business legacy is often one of the overriding goals of business owners developing a succession plan. This may be especially important for family-owned businesses where the patriarch or matriarch may express a strong desire to have sons or daughters assume control of the family business and continue the legacy into future generations.

## MANAGEMENT DEVELOPMENT

Management-succession planning requires the contemplation of one's own mortality. As the process seems so difficult and unpleasant, many business owners choose to do very little formal planning when it comes to selecting and grooming successors.

Frequently formal succession planning is deferred. The irony in this complacency is that the family businesses that most need a formal management-succession plan are usually the least likely to implement such a plan. If the business owner waits too long to address management succession, the ability to teach and assert values may also diminish, due to advanced age or failing health. It is better to deal with these issues while the owner still exerts strong leadership over the business and family. Other questions likely to surface include:

- Does the chosen successor want the job?
- Is the successor competent and willing to do everything it takes to develop the necessary skills to succeed?
- Is the parent willing to relinquish the amount of control necessary for the successor to transition into a management role?
- Are there other siblings who feel working in the business is a birthright? Are there other siblings (especially younger ones) who are just as qualified as, or more qualified than, the chosen successor?
- Are there gender barriers to entry into the business?
- What about dealing with non-family key employees who are currently more experienced than family-member successors?



# MANAGEMENT DEVELOPMENT

## Successors must be groomed to succeed, not set up to fail

The responsibility for grooming the next generation belongs to the senior business owners. The younger generation typically does not have the experience or foresight to understand what skills define leadership of the business and are not in a position to implement their own management development plan.

The younger generation may also be reluctant to bring up management-succession planning because they do not want to appear pushy or greedy, or because they genuinely prefer to defer the reality of a beloved parent's mortality. The prospect of life without the presence of mother or father can be very difficult and daunting. It is easier to operate under the illusion of parents who will always be around to help, guide and protect.

For these and many other reasons, the senior-generation owners must be the ones to formulate and implement the management-grooming plan on behalf of the successors. This can be a difficult concept for some older generation business owners to grasp, as a comparable 'management-grooming' process may not have been in place years ago when that individual was building the company, but it is good practice for the successor to be made aware of and understand the business from the ground floor.

Many management-development plans require the family member entering the business to start by 'pushing a broom'. They must earn promotions to line employee, then line supervisor, middle manager, assistant to a corporate officer, and finally into an upper-management position. Rightfully, this process takes years. The successor should be brought along and, gradually, afforded more and more responsibility. The successor will make mistakes, and face the consequences. But undeniably, some of the most valuable lessons learned will come from mistakes and failures.

A pivotal time in the grooming process for the successor will come with the move into an executive position. Even though a successor may have worked for the company for years, s/he may still require additional development to step up to upper management. An entirely new set of skills must be honed or acquired that will forge an understanding of strategic and financial planning, accounting fundamentals, relevant industries, crisis management, leadership, sales/marketing, communication, as well as critical interpersonal skills. In order to develop these talents, a responsible plan may also require that the successor work outside the family business for a period of time to gain insight into how other professionally-managed organisations function. The successor may be required to take university-level courses in finance, accounting, marketing, and management or, perhaps, have a senior executive who will serve as a personal mentor. When mentoring is used, it cannot be over-emphasised that the designated mentor should be someone in the organisation who is not threatened by the successor otherwise the mentor may, unwittingly or deliberately, sabotage the successor's development. Many organisations and local universities offer management-development programs and leadership training, which may be valuable in developing a successor.

# MANAGEMENT DEVELOPEMNT

## When there is more than one successor

Ultimately the senior business owner must name the next CEO of the company and, when there is more than one possible successor, the process promises even greater complications. Not surprisingly fallout can ensue from the nomination of one employee over another, especially in the case of a family-owned business. Family members may not acknowledge the selection of the most qualified candidate and may cloud their view with confused feelings of parental loyalty, acceptance, or comparative love. Other 'personal' issues likely to add further complication may include an oldest child who feels that company leadership is part of a 'birthright', (e.g. when they may not possess the right combination of competency, character and chemistry to succeed with customers and other employees).

To preserve family harmony and promote sound decisions, family-business owners must accomplish the separation of family issues from business issues when deciding on the next business leader. This can be done in a variety of ways. For example, the company may appoint an outside, unrelated advisory board to consider various candidates, monitor their progress and keep the owner apprised of their development. Another option is the use of an impartial outside consultant in developing and monitoring management grooming and incentive compensation plans. Some family businesses form 'family councils', which function as a board of directors for the family to help separate family issues from business issues.

By not being appointed as CEO, despite best efforts to the contrary, a successor candidate may feel deprived of a birthright. When this happens, it is important to evaluate possible alternatives suitable for the disgruntled family member quickly. For example, the company may decide to spin off a division into a separate, new corporation for the 'displaced' family member to run.

Success in the management succession process often hinges upon keeping all communication in the open and available to all stakeholders. Open, honest communication and adequate feedback must also be provided along the way to the successor(s). To this end, you may also wish to consider the use of impartial consultants and other advisors (such as non-family mentors or outside advisory boards) in the development and monitoring of the management-grooming plan. Clearly, the management-development program must also be coordinated with all other elements of the succession plan, (e.g. the share transfer program, the estate plan or the retirement-plan timetable) to be responsive and successful.



# MANAGEMENT DEVELOPMENT

## The continuing role of the business founder

Planning an orderly transition of responsibility from the founding generation to the successor generation can be difficult. Even in situations where the successor generation has developed a high level of competence, some founders may have a desire to remain active in company management, because growing the business has been their life's work. Feelings of identity and self-worth may also be tied to the operation of the company. At work, the founder is comfortable, useful and, perhaps, an important 'drumbeat' in the rhythms of family and community. In keeping with this scenario, without work, perceptions of quality of life are likely to be diminished. In such a situation, it is most likely unreasonable to expect the founder will simply turn company management over to others, even valued family members. In addition, if the founder is relying on the cash flow from the business to fund retirement needs, it may be a further stretch of the imagination to expect an easy resignation of control.

Correspondingly, the younger generation may feel that they have spent an extended amount of time in subordinate roles, and may be over-anxious to make their own mark on the company's history. Motivated by the need to establish independence from the older generation, the successors may contemplate the implementation of relatively undeveloped business plans as soon as the founder relinquishes control. In such cases, the contribution of the experience of the founder and/or the advice of other advisors should serve as an important stopgap for any dramatic strategies or ill-advised plans by the younger generation.

## Satisfying the concerns of the founder

In any company, the key to the successful transition of management is planning and balance. As the successor-generation managers develop and accept increasing amounts of responsibility, they must be afforded room for making management decisions without excessive interference from the founder. However, appropriate 'checks and balances' should be instituted. The founder can continue to play an important role in the company after the period of shared day-to-day management responsibility has passed and in a capacity that may include:

- Maintenance of long-time relationships with important clients, bankers, and others. Some business contacts may be based on personal relationships that will deteriorate if the founder is completely removed from involvement. The founder's continuing contact with clients may be vital to the longevity of those relationships
- Helping with special projects, joint ventures, or expansion plans
- Handling customer problems and complaints
- Providing guidance in the formation of long-term strategic plans
- Providing ongoing mentoring to assist the younger-generation management team to develop.



## MANAGEMENT DEVELOPMENT

There are several options for the founder to continue to serve the business in the capacity described above. The founder may decide to serve as an outside consultant to the business, play a role on the company board of directors, or serve as the head of an advisory board which reports to the company board of directors. It is sometimes helpful if the founder's continuing role is spelled out in a letter of agreement. This helps the senior generation document continuing involvement, and defines boundaries that may be designed to assign certain responsibilities exclusively to the successor-generation managers. Such a document may address terms and conditions such as:

- Required availability of the founder for a defined transition period to work on defined tasks
- Descriptions of the founder's and others' specific roles pertaining to the defined tasks
- Fees and expenses
- Use of company property and resources
- Appropriate contact with company personnel.

A good succession plan requires more than merely anointing a successor. Careful thought and attention must be given to a myriad of issues, especially during the critical 'transition period', when the successor's and founder's roles in the company are evolving into something new. Too many business owners overlook the need to develop mechanics and formalities to help through this often-difficult transition period. When company owners do not act proactively and hope that the pieces will somehow magically fall into place, business difficulties and family discord often result.

## OWNERSHIP TRANSFER TECHNIQUES

Many closely-held business owners desire to pass ownership of the business to their chosen successors, as opposed to simply selling out to the highest bidder. The chosen successors to ownership may be family members, or they may be trusted employees of the company. Closely-held business owners must coordinate the mechanics of the share transfer plan with their individual retirement plans, their estate plans, the timing of the company's management-grooming program, the company's compensation arrangements, the buy-sell agreement, the correct valuation of the company, the proper corporate structure and related elements of corporate finance.

There are many challenges to address when deciding on the technique through which to transfer ownership. If the owner sells the business, will there be adequate cash flow to fund retirement needs? How much tax must be paid upon the transfer of ownership, (i.e. capital gains tax, etc.)? Who should get the company shares: the successors who are active employees of the business, and/or others who are not active? Do both groups of successors want shares? Are successors ready to assume voting control of the company? Should there be voting and non-voting shares? Is equal ownership amongst successors fair? If one of the successors gets a divorce, will company shares end up in the hands of an angry, estranged spouse? How will the successors be able to afford to buy the shares of the company? All of these tough questions directly affect the method selected to transfer ownership to the next generation of owners.

This section describes several basic strategies that may be employed to facilitate ownership transfer of a closely-held business.

# OWNERSHIP TRANSFER TECHNIQUES



## Outright sale to successors

The first option is to consider an outright sale to the successors – whether to family members or other interested parties. Buyers may purchase an interest in the entity, (i.e. shares in the case of a company) or the assets held by the entity. If an asset purchase is executed, future tax deductions in the form of depreciation will be available to the buyer. The tax effect on the seller must also be considered. For example, the sale of certain assets may result in ordinary gain treatment rather than capital gain treatment for the seller. The sale of shares will generally result in either a capital gain or capital loss to the vendor unless the shares are Pre-CGT but may be eligible for concessional CGT treatment, (i.e. 50% CGT discount). The money paid to acquire the shares will form part of the cost base of the shares to the purchaser. There are rules that restrict the amount of losses afforded on sales between related parties.

Sales transactions may take on various forms depending on the financial resources of the parties and their tax situations. Some examples include:

### Sale for cash

This method can be impractical, because younger successors often do not have the financial resources or access to enough capital to buy the business for cash.

## Instalment sale

Where younger successors do not have the financial resources to buy the business for cash, some form of an instalment sale may be used. Basically, the seller gives up ownership in exchange for a promissory note or other form of vendor finance. If the buyer funds the note obligations from successful business operations, there may be no need to obtain outside financing in the transaction. The practical difficulty with this method is the seller no longer controls the company, but still has a significant stake in the continued success of future operations due to the instalment note. The ability of the company, or the new company owners, to pay the future note payments to the seller may be closely tied to the future success of the company. If the successors fail to manage the business profitability, the seller's note may become partially or completely worthless.

In addition, the problem with an instalment sale is that the seller has a potential CGT liability at the time that the contract is entered into. However the funds required to pay the tax liability will become available periodically as and when an instalment amount is paid by the purchaser.

## Gifts of ownership

Founders may gift their ownership interest, (i.e. company shares), to the successor/s for nil consideration. One of the overriding commercial considerations with this strategy is that the founders may not be able to gift the shares to the successors as the proceeds of the share sale are required for retirement purposes. The founder will be deemed (in this non-arm's length situation) to have received market value consideration for the transfer notwithstanding that no consideration has been paid. This will also create a liquidity issue as the founder may not have the required cash to fund the tax liability.

# SHAREHOLDER AGREEMENTS

A shareholder agreement, or buy-sell agreement, is a contract between shareholders of a privately-held business that establishes a procedure for redeeming or buying out an ownership interest in a closely-held business when a specific event occurs, (e.g. retirement, death, disability, divorce, termination of employment, etc.). A properly-developed shareholder agreement, as an integral component of a comprehensive business succession plan, can provide a business owner with protection and help ensure the owner's interest in the company does not end up in the wrong hands. Furthermore, the buy-sell agreement can create a guaranteed market for the sale of each shareholder's ownership interest. Buy-sell agreements are valuable in other ways as well. A number of scenarios listed below illustrate the types of circumstances in which consideration of a buy-sell agreement would be prudent.

## **What happens to the business if the owner dies?**

The shareholder agreement may provide a blueprint for the mechanics of the buy-out from the deceased estate which can help minimise the confusion that often results from the death of the business owner.

## **What happens if a business owner's equal partner dies?**

Usually, the shares are bequeathed to someone in the partner's immediate family. Suddenly and unexpectedly, the deceased partner's potentially inexperienced spouse, son or daughter is a 50% owner of the business. The new owners may desire to take a salaried position in the company and actively participate on the board of directors. The existing succession plan may be abandoned. Alternatively, the surviving spouse may choose to sell the 50% company interest to anyone, even a competitor, in order to get fast cash.

## **What happens to the business if the owner becomes permanently disabled and is no longer able to function?**

The family may be forced to sell their shares, to help pay medical expenses and other living expenses, but to whom and for what consideration? Should the family sell to another owner or to an outside interest? What would the disabled partner have wanted? What pricing formula would he/she have agreed upon?





# SHAREHOLDER AGREEMENTS

**What if a business owner has only a minority interest in a privately-held company? Is there any secondary market for such an interest?**

What if no third party is willing to buy a minority interest in the private business? How will the minority shareholder eventually receive value for his/her shares?

**What happens if one of the owner-employees becomes disenchanted with business partners and quits the business?**

Perhaps the disenchanted ex-employee will open a competing business, while remaining an owner of the original company. S/he will be privy to confidential strategic discussions at board meetings. Furthermore, that individual may be in a position to disrupt company operations by voting against the other owners on important board of director issues or bringing legal action against the other shareholders.

The solutions to all of these concerns may be contained in a well-crafted buy-sell agreement.

## Buy-out price

How much is a fair buy-out price? This is a key issue to resolve. Sometimes, the buy-sell agreement refers to a valuation formula the shareholders previously agreed on. The formula may be a multiple of the company book value, cash flows, or both. Some agreements require an appraisal by a qualified professional to determine the fair price of the shares. Other agreements allow the selling shareholder to offer shares on the open market to third-party investors or strategic purchasers first, while allowing the remaining shareholders the right to match the third-party offer before any outside sale can take place.

There is a lot of flexibility in defining the buy-out price. The key is to address the valuation issue specifically in the agreement. If the buy-out price is not clearly defined and understood by all the owners, the result may be a long, painful, and expensive legal dispute over a fair price.

The ATO will not allow the valuation formula in a buy-sell agreement to be used as a mechanism to transfer ownership in a closely-held business from one generation to the next at discounted prices, in order to avoid or reduce CGT.



# SHAREHOLDER AGREEMENTS

## Funding the buy-out

How do shareholders make sure there is cash available to execute the buy-out? There are two common alternatives to provide liquidity to implement the buy-sell agreement provisions: (1) establish a sinking fund, (i.e. a sum set aside periodically from the income of a business and allowed to accumulate) or (2) purchase insurance. Usually, funding a buy-sell agreement using insurance is a more practical alternative. Sinking funds may take years to establish an amount equal to the required buy-out price, and if one of the shareholders suddenly dies before the sinking fund reaches adequate levels, there may not be sufficient funds available for the buy-out. From a practical perspective, it can be very difficult to resist tapping into a 'buy-out sinking fund' when the company's cash flow is tight. In addition, the extraction of the sinking fund by the shareholders can have various tax implications.

For these reasons, life and disability insurance policies are often purchased on each shareholder in order to provide cash for the buy-out. When the shareholder dies or becomes disabled, the policy benefit is used to buy the shares from the selling shareholder or the estate. Generally, the insurance premium payments are not deductible, and the insurance proceeds are not taxable. When funding a buy-out resulting from a triggering event other than death or disability, the required cash must come from a shareholder's personal assets, company cash reserves, or loan proceeds. There are many options, and the best selection depends on the fact and circumstances in each distinct situation.

## Types of buy-sell agreements

The most common types of buy-sell agreements are cross-purchase, redemption and hybrid cross- purchase/redemption agreements.



# SHAREHOLDER AGREEMENTS

## Cross-purchase agreement

In a cross-purchase agreement, the remaining shareholders purchase the shares from the selling shareholder or the selling shareholder's estate directly. Accordingly, a cross-purchase agreement may require that each of the individual shareholders maintain liquidity in amounts sufficient to buy out the other shareholders at any time.

An advantage of a cross-purchase agreement is the surviving owners receive a 'step up' in tax base to the extent of the purchase price paid for the shares. This means eventually, when the acquiring shareholders sell their shares, the capital gain on the sale of the shares will be less than it would otherwise be if a step up was not achieved.

Disadvantages of a cross-purchase agreement are complexity and risk. A cross-purchase agreement is only as good as the ability of the parties to satisfy its terms. The selling shareholder must trust that applicable partners will be able to pay cash for the shares. If they have not adequately reserved cash, or kept up with insurance premiums, the seller may not be able to cash out according to the terms of the agreement. The greater the number of owners in a closely-held business, the more difficult a cross-purchase agreement is to administer.

## Redemption agreement

With a redemption agreement, the company, rather than the individual shareholders, buys the shares of the company from the selling shareholder. In this case, it is the company that must have the needed liquidity.

An advantage of the redemption approach is control, liquidity, and administrative ease. With a redemption agreement, the shareholders do not have to depend on each other individually to maintain cash reserves or insurance policies on each other's lives. The company has this responsibility. It is much easier for the board

of directors to monitor and control adequate buy-out cash reserves and/or insurance on the company's records than it is for them to monitor the financial records of each individual shareholder. Remember that with a cross-purchase agreement, the ability to sell shares for a stated price is only as good as the personal financial condition of the other shareholders. For some owners, the risk that the partners will not be able to come up with the needed cash on a buy-out date makes a redemption agreement preferable.

A disadvantage of the redemption approach is that when the company redeems the selling owner's shares, the other shareholders do not receive any step up in the tax basis of their shares, because the company, not the shareholders, bought the shares. Thus, each remaining shareholder's shares cost base remains unchanged, although the ownership percentages will increase proportionately.

In addition, the redemption of a shareholder's shares (in preference to the other shareholders' shares) can invoke various tax implications not the least the potential application of the dividend and capital streaming provisions.

## Hybrid cross-purchase/redemption agreement

The hybrid approach to a buy-sell agreement provides the greatest flexibility. This approach is set up so the shareholders may choose to cross-purchase, or execute a corporate redemption – whichever makes the most sense at the time. It can be referred to as a 'wait-and-see' approach. A hybrid agreement will generally allow the corporation to have a first option to purchase any or all of a shareholder's shares upon a triggering event. If the corporation elects not to redeem the shares, the existing shareholders have a secondary option to purchase any or all remaining shares.

## HOW SHOULD THE BUY OUT BE FUNDED?

- Self-funding may not be satisfactory to the potential seller since it might not provide adequate security
- Life insurance can provide an immediate source of funds that can be used to purchase a deceased owner's interest. If the triggering event is something other than death, the policy surrender value can be used to partially fund the buy-out
- Consider disability insurance to fund buy-out if disability is a triggering event
- If disability insurance is desired, consider a pre-established waiting period, (e.g. Two years) during which the extent of the disability can be assessed
- If a cross-purchase agreement is funded with insurance, there will be many policies to monitor and administer and premium outlays will differ among shareholders due to differences in age and ownership interests
- The number of policies in a cross-purchase agreement may be reduced by establishing a business insurance trust. In this situation, the trust owns the life insurance policy on each shareholder

If insurance is not desired for funding purposes or if the triggering event is something other than death or disability, the corporation may maintain a sinking fund to make necessary payments. This sinking fund may not have sufficient deposits made by the time it is needed to purchase the shares.





# GENERATION PRIVATE

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