A ROUNDTABLE DISCUSSION

SUCCESSION PLANNING:

PREPARING FOR BUSINESS TRANSITIONS

>>> Succession planning is a must-do for organizations of all types and sizes, and the earlier executives start thinking about it the better. With record numbers of baby boomers retiring, the next decade is predicted to generate a tidal wave of business sales and other ownership changes, further underscoring the need.

Four professionals involved with succession planning shared best practices and other insights with Crain's Content Studio.

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>>How is your organization involved with succession planning?

Andrew P. Tanner: Bank of America assists business owner clients as they plan for and execute on their business succession plans, including plans to pass the company to the next generation, transition to insiders of the company or a sale to a third party. Early in the process we ensure a deep understanding of our clients' overall financial picture to ensure that their personal financial goals are in sync with the intended exit strategy. We devise an integrated plan to ensure that both personal and business objectives are achieved.

Lawrence I. Richman: Succession planning informs the way we at Neal Gerber Eisenberg craft estate plans for our clients. As part of that process, we help clients define their succession goals and prioritize what their planning is intended to achieve. Where appropriate, we facilitate family meetings so that the next generation better understands the process and has the opportunity to ask questions. We work collaboratively with families and within the family structure.

Kerry M. Lavelle: Many Lavelle Law clients are owners of privately held companies who need to consider transitioning their business to a second-generation ownership team. We step in to document and provide advice and guidance on the succession plan. From initial planning, to creating and protecting intellectual property rights, and to drafting the transfer agreements, we provide ongoing legal support.

Donald D. Duncan: Savant helps business owners navigate, plan and make informed decisions related to exiting their business. A successful succession plan leads to a successful financial plan.

>>When's the best time to start planning for the succession of a business?

Duncan: In theory, the best time to start planning for the succession of the business is when you formalize the initial business plan. The exit strategy is the manner in which an owner extracts wealth from the business to achieve the other goals in his or her life. Planning with the end in mind is always more successful than letting the end become your plan.

Lavelle: In most cases, and depending on the business owner's retirement goals, we advise people to start planning around age 55 to 60. However, changes in the market and the economy affect this generalization. Everyone is different, but you can't leave your succession planning to the last minute.

Tanner: Transitions to family or insiders via a management buyout or an ESOP generally have fairly flexible timelines. Sales to third parties, on the other hand, require careful preparation by the company to avoid loss of value and elevated risk. At the same time, many tax minimization strategies take considerable time to execute, so an expedited sale can rob the owner or owners of these opportunities. A general rule of thumb is that two to three years provides a solid timeframe to prepare the company and allow for effective planning at the ownership level.

>>Why is it important to have a plan in place?

Lavelle: Without a well-visioned plan in place documented with enforceable agreements, generational family disputes occur, which damage family relationships forever. Just like a will or trust that transitions your assets to the next generation, a succession plan needs to be documented, leaving nothing to chance and transitioning your business ownership and assets while you're still alive to maximize value, and to consider the legacy effects of the business.

Tanner: Just as an owner has a business plan for managing the business, there should be a written plan as an owner/investor. The exit plan should detail a primary objective of transitioning to family, insiders or a third party along with the transactional plan. For example, transitioning to family is a start, but knowing whether it will be sold, gifted during lifetime or transferred at death is a more complete answer. Of course, each of these outcomes has assumptions about taxes and liquidity that must be taken into account.

Duncan: Business owners spend their lives creating value in their business. Their business is often their life. Without a well-thought-out and uniquely crafted succession plan, the value they created could dissipate, evaporate or disappear.

>>What types of advisors are typically involved, and what's the best way to find them?

Duncan: CPAs and lawyers are usually involved since all businesses have accounting, tax and legal requirements. Many CPA firms and law firms specialize in these types of activities. For more general strategy planning there are specialty designations, such as Certified Exit Planning Advisor®. Many CEPAs have the breadth of knowledge to help with succession planning. The best way to find these professionals is through their trade associations, through the business's trade association or, even better, referrals from other businesses in the industry.

Tanner: An appraiser may be hired to opine on valuation issues or property appraisals. A transactional attorney who lives in the deal world is critical for their current knowledge of deal terms and as an effective counterparty to buyers' counsel. A wealth manager is often in the best position to help the owner understand what they need to yield from a transition to cover downstream lifestyle, family gifting, and philanthropic goals. Many owners find these advisors through their attorneys and accountants.

Lavelle: Companies should consider involving a CPA and an M&A broker/consultant. If they don't already have a connection with one, they can start by asking for referrals and interview people that are recommended. Also, reading great publications like Crain's may identify individuals who can offer guidance on important topics such as succession planning. It's important for business owners to hire professionals who have documented succession plans on a regular basis. The process can be very nuanced. Experienced professionals can add value with guidance and a level of fairness for all parties involved.

>>What are some priorities that should be considered throughout the process?

Duncan: Goals of the business owner are the most important priority. Are they to keep the business in the family, or pass it on to key employees? A total exit, phase out or liquidation? Is the dollar amount extracted from the business enough to accomplish all of the goals of the owner?

Lavelle: Most people believe that the number one priority should be selling a business for the highest possible price. While that might be the case for a few sellers, a better approach is to assess post-sale considerations for both the seller's family and the business. Working to sell the business to the "right buyer," is also important, as is considering the relationships the sellers made with employees and vendors and how they've led to the business's success. And of course, the desire to take care of the seller's family post-closing.

Tanner: Owners of private companies frequently have long-deferred charitable goals that can finally be consummated before, during or after the sale. Funding family gifts or trusts for next or subsequent generations may be another priority. Finally, lifestyle issues are a priority; ensuring that adequate funds are set aside for the sellers to live as they wish. A qualified wealth manager should have sophisticated financial tools that can illustrate for a seller what transactional proceeds will be necessary, assuming market factors, to balance and achieve all these priorities.

>>What options are typically considered?

Duncan: The most commonly used options include sale, merger, key employee/s buy in, ESOP or gift to family members.

Lavelle: The main three options, and there are hybrids of these, are a staged or immediate sale to employees, a sale to a portfolio or strategic buyer, or a sale to an ESOP. These three options, or some variation, provide for a proper transition for the business owner. Certainly, finding out what the seller's main priorities are for the succession of his or her business is the primary starting point.

Tanner: Many exit alternatives allow owners to remain investors or leaders as they take some chips off the table. The management team of the company will almost always be part of the internal deal team. This group will often be interviewed by buyers as part of their due diligence effort and/or part of the buyer determining their own leadership team going forward. Many owners set aside some portion of the transaction proceeds to reward key people for their efforts on the transaction and over their tenure. Other options include pre-sale gifting to family members at a discounted value before any sale is contemplated, and then, perhaps the most uncommon yet perhaps the most powerful from a financial standpoint, integrating charitable intent into pre-sale financial planning.

>>What are the biggest impediments to getting a company sold?

Lavelle: Unfortunately, the largest impediment we see is the procrastination of the business owner. Procrastination may be rooted in indecision, not wanting to confront family members, unwillingness to give up control or a potential digression from the business owner's current lifestyle. Whatever the reason, the business owner should still engage professionals to start the fact-finding process because ultimately, the owner has the right to decline a sale.

Tanner: One of the most common is uncertainty about the path of succession. Even very mature owners will often put off these critical decisions if they're still hopeful that a next generation manager will emerge. Another is customer concentrations, wherein a disproportionate proportion of revenue and/or profit for

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ABOUT THE PANELISTS

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KERRY M. LAVELLE is a founding partner and shareholder of **Lavelle Law**, Ltd., a Schaumburg-based firm of over 30 attorneys representing more than a dozen practice groups serving the Chicagoland area. He implemented the firm's succession plan on Jan. 1, 2010. He has been an adjunct faculty member teaching courses on IRS practice and procedure (at John Marshall Law School), business law, economics and starting new businesses. He has received numerous awards and commendations for his commitment to charities, community projects and pro bono work.

LAWRENCE I. RICHMAN is a partner and chair of the private wealth services practice at **Neal Gerber Eisenberg**, a Chicago-based law firm serving clients involved with domestic and global business transactions and litigation. He facilitates legal strategies for entrepreneurs, high-net worth families and individuals, tax-exempt organizations and fiduciaries. Clients nationwide retain him to advise on sensitive or high-exposure matters because of his extensive experience in estate and trust and tax law in addition to his experience dealing with the complex factors that motivate the affluent in managing their affairs.

ANDREW P. TANNER is a managing director and the private business executive in the specialty asset management group at **Bank of America.** He leads a team that manages equity investments in private companies that are held in trust, estate and investment management accounts. Prior to joining Bank of America, he was director of specialty assets and fiduciary investments for First National of Nebraska. He also worked for Bank One Corp. as a regional director of closely held asset management and investment manager for all Employee Stock Ownership Plans (ESOPs).

the selling company stems from one or just a few key customers. Undocumented procedures within a company or the dependence on unsecured intellectual property can dissuade a buyer from investing. Dependence on single sources of raw material or fabrication can also be an impediment, as is a weak or undeveloped management team. Despite the performance of the company, buyers are investing in sustainable revenue streams that they can grow—not one or two critical people.

Duncan: I went through this with my company. For entrepreneurs, it's can the owner give up control and take direction from others? Can the owner emotionally give up the day-to-day decision making and watch someone else put their mark on the business that they raised from inception? Another impediment is that the owner thinks the business is worth much more than the buyer does.

>>What are some mistakes commonly made by C-suite executives that adversely affect company value in the transition process?

Lavelle: We've seen C-suite executives recapitalize the business by adding debt in order to take cash out; such additional debt hurts the value of the business. Also, we've seen executives become anxious and not properly vet the buyer, only to find that the buyer isn't committed to growing the business and customer and client relationships suffer. This creates unattainable post-closing goals that may cost the seller or worse, result in a buyer who defaults on its obligations to the seller.

Duncan: The most common mistake is not managing the ownership transition to avoid clients being negatively impacted. For example, if a company replaces a bespoke client service model with a cookie-cutter approach, revenues will be negatively impacted. The success of the transition initially is maintaining the revenue stream; that's what drives the valuation.

Tanner: One thing we see is ownership failing to pay attention to quality of earnings. This has to do with the quality and diversification of the customer base of the company. Buyers will expect to see growth, which can be challenging to large, successful companies that have dominated their market. Another common mistake is failing to prepare adequately for the rigors of due diligence. When potential buyers find first-impression problems in the target, the result is lower prices, higher escrows or both.

>>How can family businesses plan for succession if there's no clear heir apparent?

Duncan: Groom trusted employees or hire professional management. You don't have to be a good manager to be a good owner. In fact, the best managers aren't necessarily the majority owners, who may have more of an emotional attachment to the business. Owners can still extract wealth from the business. In fact, it's likely they'll extract more with good management.

Lavelle: Working through advisors, determine whether the ideal purchaser should be a group of employees, a more formalized ESOP, or sale to a strategic purchaser in the market. An owner should continue to build value while looking for a buyer. Having no clear heir apparent shouldn't be a detriment to begin thinking about business succession.

Tanner: Absent a family path or insider path, the remaining plan is to keep the company in a saleable condition at all times. Keeping the company in a salable condition at all times is essentially keeping the company agile and resilient—a timeless strategy.

>>How can family businesses, especially "next gens," address their values as they construct their succession plans?

Tanner: Most multi-generational family businesses have adopted a family constitution that defines the roles and responsibility of the company to the family and the family to the company. No company's growth can keep up with expanding generations of a family, so these agreements are necessary to keep the company healthy and the family pursuing diverse, rewarding career tracks.

Richman: Each family, and often members within a family, have different attitudes toward money. Some are savers, some are spenders. Most families fall somewhere in between that continuum of savers who focus on investment and capital accumulation and the spenders who find in their wealth the opportunity for unique philanthropic contributions to our society. Understanding these attitudes towards wealth and the underlying values they represent is critical to designing a meaningful estate plan.

Lavelle: We recommend that the next generation be brought in when they're ready to participate in the decision-making process and working through problems. At the same time, they must realize that decisions are made by "putting the business first" and setting aside personal agendas and personal economic benefits.

Duncan: Write down the values of the next generation and make an honest assessment of how they align with the mission of the business. Then develop the roadmap to move the business from where it is today to the value-oriented business of the future, while making sure that these new values only enhance the business prospects in the future. Often the business will need to bring in planners or strategy consultants to help think everything through. If there's no alignment, it's likely the next generation will be disenfranchised and the best outcome may be to exit the business or hire professional management that will be more engaged.

>>What's the relationship between personal estate planning and succession planning for a business?

Tanner: Estate planning is the process of determining whether upon your death, specific property is to be sold, transferred to a specific person, or funded into a trust for one or more beneficiaries. Estate planning also involves estimating the anticipated estate taxes and determining the source of cash to pay the tax bill. Succession planning is the process of determining and executing on both management succession—who will next run the business—and ownership succession, who will next own the business. When selling to a third party, the buyer is both owner and manager. When transitioning to family or to insiders, there's often a difference between those who own the company and those who are running the company.

Duncan: Estate planning is focused on the goals a person has after death, and succession planning focuses on the goals a person has after owning and running a business. Often the timing of the two coincide and even if they don't, more often than not the biggest asset in a business owner's estate is the value of the business, and the estate plan has to revolve around that fact.

Richman: For business owners, the development of a successful succession plan is critical to a well-rounded estate plan. Integral to that success is understanding the family's priorities and values. Also significant are the talents and engagement of the next generations. Plans that allow for the autonomy of family members, flexibility in tax strategy and respect for what the family has achieved facilitate multigenerational success and succession.

Lavelle: Remember, it's not how much money is in the business, it's how much value passes through to the business owner personally. The interplay between business taxation—whether it be for a corporation or a limited liability company—and estate and gift taxation needs to be carefully monitored and analyzed to maximize after-tax benefits for the business owner.

>>How have low interest rates impacted succession planning?

Richman: Low interest rates enable intrafamily transfers to occur in a tax- and price-advantaged manner. Given our ability to structure intrafamily sales on an income-tax-free basis, the fact that interest rates are low make these transactions more affordable for the next generation. In addition, low interest rates provide a fixed-income asset that can be transferred in a tax-advantaged manner to family members who aren't active in the business, thereby furthering the efficiency and effectiveness of the succession plan.

Tanner: Low interest rates fuel a robust M&A market, making the leveraged purchase of a company cheaper. This can translate into higher implied EBITDA multiples and a "seller's market." Another impact involves transfers of equity within the family through one of a number of sophisticated transfer transactions for which interest rates are a factor. Generally speaking, these transactions are more effective in a low-interest rate environment, and they become less beneficial as interest rates rise.

Duncan: Businesses are valued for the net-present value of the cash flow they generate. There's a discount rate or a capitalization rate used in these calculations, which are directly related to interest rates because of the opportunity cost of investing in bonds versus buying a company. Just like valuing bonds, the lower the discount rate, the higher the value of the business.

>>What unique challenges do Chicago and the state of Illinois bring to succession planning?

Richman: The tax and economic climate in our city and state is causing wealthy taxpayers to deploy their capital elsewhere. Innovative legislation and no-tax-environment states like South Dakota, Nevada and Wyoming offer opportunities for Illinois taxpayers looking to relocate their wealth. Examples of these sophisticated solutions include the private family trust companies that we've established in South Dakota, Nevada and Wyoming, marrying family-succession-based structures with financial flexibility.

Duncan: There's uncertainty in the tax situation in both Illinois (income) and Chicago (property). Uncertainty increases potential future expenses incurred by the business—and the owner—and it also often increases the discount rate used by acquirers. As a general rule, uncertainty leads to lower valuations.

Tanner: Governmental interaction has to be anticipated in any change-of-control transaction. If a company is subject to permitting or approval for transfer of licenses from federal, state or local jurisdictions, then these requirements have to be part of the overall transactional plan. Often these approvals take longer than anticipated. On the financial planning front, the State of Illinois estate tax begins at $4 million as opposed to more than $11 million for federal estate tax purposes. In Illinois, prior taxable gifts can be reviewed as part of the calculation of Illinois estate tax liability. Reviewing regulatory requirements and tax matters with advisors is always a best practice.

Lavelle: Notwithstanding anyone's opinion about our state's leadership in Springfield and a new regime in the city of Chicago, the region is a vibrant business community with a national and international presence within the city limits. Chicago has been an international business hub for many years. Buyers from all around the country and the world are available to businesses here. There's no question that if you have a great business, you'll find a great buyer.