Succession Planning for Business Owners

Sean Sebold, CFA
President
Sebold Capital Management
Naperville, Illinois

The importance of succession planning arises from two major needs: (1) business continuity and (2) obtaining and transferring value. Succession planning can be accomplished with either a transactional approach or a wealth management approach. Although transactional planning typically begins with a timely need, such as the owner retiring or receiving an offer to sell his or her business, wealth management succession planning is a more holistic approach focused on the owner and intergenerational wealth transfer.

In this presentation, I will concentrate on a relatively small segment of the private wealth market, the business owner. Specifically, I will address succession planning. Although I will focus on the concerns that arise in this context, keep in mind that succession planning is only part of a holistic wealth management approach. That is, some of the points I will discuss are intertwined with other aspects of a client's life and financial circumstances. Done correctly, it is nearly impossible to separate wealth management from succession planning.

The two distinctive approaches I will discuss are transactional planning and wealth management planning. Neither of these techniques is inherently superior, but as advisors, it is incumbent upon us to clearly explain to clients the approach we are taking and the services we are providing.

Importance of Succession Planning

The importance of succession planning arises from two major needs: (1) business continuity and (2) obtaining and transferring value. Despite the importance of business continuity in the context of wealth management, the frequency at which it is ignored in the marketplace is rather staggering. Owners of restaurants, consulting firms, distributorships, and others seem to have an inferiority complex as far as the value they have created in building their businesses over their lifetimes. All too often at Sebold Capital Management, we have seen opportunities disappear as a result of an owner closing a business for what we consider to be invalid reasons and not moving through the succession planning process.

Obtaining and transferring value, conversely, is what most advisors tend to think about in succession planning. Business owners have spent a tremendous amount of time creating value and a business. At some point, it is time for them to leave the business and receive their rewards. In addition, they may wish to transfer some of the value they have created to someone they believe to be deserving, either a key employee or family member.

I would argue that the end game or exit strategy for any business should not be left to the end or to the middle. The exit strategy should be thought out well in advance, during the building stages of the business. In the end, an exit strategy in the form of a transaction should be an almost insignificant event because it has been planned for and prepared for long before its execution. It is in this planning and preparation that we, as advisors, can create true value.

The succession planning process may begin for the business owner for several reasons. The most common reason, by far, is retirement. Therefore, I will work from a common definition of retirement. Certainly, a lot of different definitions of retirement exist. Some of the definitions I hear are "not working" and "perpetual golf." Those definitions certainly describe what most people think about as retirement. At my firm, however, we define retirement a little bit differently. We see retirement merely as a change in priorities. Ultimately, retirement is a change from an economic priority to a life priority.

This distinction is important to us for the simple fact that by our definition, most of our clients are already retired. Does this mean they no longer work?

No, it does not. What it means is the motivation behind what our clients do on a daily basis is different. The business is no longer just a tool that can create economic sustenance for them to survive. Instead, it is a tool that can provide greater things to them. It can provide a greater lifestyle. It can provide a means to change an industry. It can even provide a means to change society.

Some might say that this is a matter of semantics, but the distinction is important. As behavioral finance shows, the way that we look at an issue can affect the outcome. Just thinking about retirement from this alternative perspective can change how we achieve the end results. Using our definition, we see that business owners have a different set of goals, aside from money, that drive them through their business lives. If their economic goals have been completed, their life goals are the driving considerations for their wealth.

Buyout offers are another common situation that triggers succession planning. These offers are usually unsolicited and are what I call "offers that cannot be refused." From a transaction perspective, buyout offers are typically the best option for a few reasons. First, the owner of the business does not have to go out and look for someone to buy the business; the buyer is coming to the owner. Second, the buyer usually names a price. It might not be the right or appropriate value, but at least it is a starting point. Third, a buyout offer frequently includes a premium within the price to encourage the business owner to act quickly.

From a transaction perspective, a buyout offer is a great scenario for business owners: They created the business; now it is time to get out. An offer comes in the door, it is more than what would have been expected, they take the money, and they are done.

Although financially this is seemingly a great outcome, we see several personal challenges to this scenario. Imagine this is your business. For the past several years, you have been focused on building it. The vast majority of your time has been spent in deciding how you can create value in the business for the products and services that you offer to customers. Everything you do is focused on growing the business and creating value. One day someone walks in your door, wants to write you a check in acknowledgment for everything you have done in the past several years, and then asks you to step aside.

In this situation, you have to ask yourself a few critical questions, the answers to which could affect the rest of your life. First, is it a fair value? Second, is it enough? Third, are you willing to give it up? And fourth, what do you do then?

Yet another trigger for succession planning is when the business landscape changes. A change in landscape comes about when developments are made in technologies, products, and services. As a result, the owner's skill set may fall out of sync with what is required for success in the new environment.

For example, my grandfather was a stockbroker on the NYSE in 1930. He had one set of skills, which involved telling people about stocks and making transactions happen. If we were to suddenly drop him into today's environment where he would be a trusted advisor, he would fail miserably without significant retraining. The landscape has changed, and the required skill set is different. If a business owner is unwilling or unable to make this transition, succession is a viable exit option.

An additional scenario that brings succession planning to the forefront involves the desire to create opportunities for others. This area encapsulates two different scenarios. The first involves creating opportunities to give greater management and ownership responsibilities to family members. Many companies are created solely for this reason, and at some point, the "letting go of the reins" must occur. The second involves transferring value to a key stakeholder, such as an employee. For example, often a business owner has one or more key employees who were instrumental in building the business. The owner may wish to give these employees the opportunity to "show their stuff," create equity, and build value as they see fit.

The final reason for turning one's attention to the succession plan simply is that the owner is not having "fun." Many business owners come into my office and tell me they are sick of the business and sick of the problems. They want out. This situation can pose some value and succession challenges. If the business owner is not having fun, will sales and profitability be up or down? Does the business have the best people on staff, or is the staff a little bit challenged? Will the future prospects of the business be great or small? Generally speaking, business owners who want out because they are not having fun will probably not get the maximum value from the businesses they are exiting. It is thus critical in creating value to sell "at the top" rather than in a depressed state.

Transactional Planning

Transactional planning usually starts when one of the aforementioned events occurs. So, the first step is to consider what started the transaction. Was it something that the business owner initiated, or did some external force cause the owner to act? This is an important consideration because the time when an owner sells a business has a great deal to do with the ultimate value achieved in the sale.

The second step is to evaluate the transaction: Does this transaction create maximum value? What are the current tax ramifications? What do we have to do to create maximum value?

The remaining steps can be broken down into (3) planning, (4) preparing the company, and (5) executing.

Planning. The planning begins with determining a few key issues. The first issue is whom to involve in this discussion. Depending on the size of the transaction and the type of business, various people might be needed to help complete the transaction: investment bankers, commercial bankers, lawyers, accountants, management consultants, or information technology consultants.

Another important planning consideration is the type of strategy used to transfer value. Five common strategies that can be used in the transfer of the business are an asset or stock sale, employee stock option plans (ESOPs), stock recapitalizations, partnerships and gifts, and seller financing.

- *Asset or stock sale*. In an asset sale, the assets of the company—buildings, equipment, inventory, and so on—are simply sold to the buyer. In a stock sale, the buyer acquires all assets as well as all liabilities. The choice of approach can result in different accounting, legal, and tax treatments.

Of the two options, we tend to lean toward stock sales. Stock sales often result in more favorable tax treatment because the seller may be able to treat the entire gain at the more favorable long-term capital gains rate, whereas a portion of the gains may be taxed at the less favorable income tax rates in asset sales. Perhaps more important, though, is that a stock sale enables the seller to eliminate many of the liability issues that can come about well after the business has been transferred to the new owner.

Although the tax and liability issues of a transaction can be critical, from a wealth management perspective, personal issues can also rear their head long after the transaction has been completed. For example, one of our clients ran a business that was in a high-liability industry. He died suddenly before a lot of the planning work could be completed, so the business was left to his wife. She decided that the sale of this business would be to a key employee who spent a lot of time building the business with her husband. When we started talking about valuations and strategies, she was much less interested in the value she would obtain from the business than in making the transfer as easy as possible and on the best economic terms for the key employee. The key employee wanted an asset sale, which would stop all past liabilities and start the business afresh. Fortunately, we were able to purchase sufficient insurance to cover all past claims against this business. Of course, this transaction did not generate the best value for the seller, but we acquiesced and moved forward on what we considered to be a suboptimal transaction.

Three years after the transaction was done, a lawsuit was filed against the company. Economically, the original owner's wife was covered through the insurance. But the emotional impact on her was tremendous. She thought her husband had done a wonderful job running the business and never expected an issue like this to come up. So, because of the way this deal was structured, something came back a few years down the road that she would have preferred not to have known about.

- *ESOP*. An ESOP is another tool to transfer the value of a business. An ESOP is essentially a trust established by the business that makes employees partial owners of the business through contributions of company stock. According to the ESOP Association, more than two-thirds of all ESOPs are created for transferring closely held businesses to key employees. They are great tools for a lot of different reasons. For instance, they create liquidity, marketability, tax advantages, and business continuity. They can also add value to a company through lower turnover and ultimately more highly valued employees who have a stake in the company, which aligns their interests with the business owner's interests.

- *Stock recapitalization.* A stock recapitalization is a fairly straightforward strategy. The owner creates two separate classes of stock, one voting and one nonvoting. The owner then keeps the voting stock while giving or selling the nonvoting stock to others. This approach is really more of an estate-planning tool, but I have included it in this discussion because it is another method by which an owner can transfer value and ultimately ownership of a closely held company.

- *Partnership/gift.* As with stock recapitalizations, granting partnerships and gifts is often thought of as an estate-planning tool for reducing the value of an estate. The creation of LLCs (limited liability companies) is useful for transferring portions of a company outside the owner's estate and ultimately for implementing a succession plan.

- *Seller financing*. Seller financing of a business sale often comes up in cases where the owner wishes to transfer a business to a key employee or family member but the buyer is unable to procure appropriate financing for one reason or another. In these cases, the seller can certainly finance the sale and affect the succession plan in that way.

- *Summary*. These five strategies by no means constitute an exhaustive list. The key takeaway is that a lot of different tools and methods can be used in achieving a succession plan; we are not limited to a few. As a result, we can and should focus our efforts clearly on the desired results for the client, not necessarily on which strategy should be used.

Preparing the Company. Preparing the company involves giving some thought to the operations of the company and the people involved so as to uncover possible issues, such as key management personnel moving out. We are also concerned with aligning the operations and the people with the exit strategy. For example, if a large company is taking over a smaller company, will their systems be integrated going forward? Or, will the smaller company be maintained on a stand-alone basis?

Executing. The last step is the execution, with value transference taking place and operations management changing. If the planning work has been done well, execution should be straightforward: All of a sudden, the business owner has value, whether it is cash, stock, or a note; the operations and management have changed; and the deal is done.

Example. An example can illustrate this entire process. Jim started a medical billing company from scratch with four employees. Within about five years of rapid growth, the company had 150 people on staff and tens of millions in revenue. Things were looking very good for this company.

One day, Jim was approached by a publicly traded company that wanted to buy his company. This is Step 1 of the five steps I outlined earlier. That external force, the buyout offer, was what started the transaction. The value of that offer got Jim's attention because it was more than he had ever expected to get out of this company. So, in Step 2, he decided that the offer made sense. Next is Step 3: Jim, along with his advisor, began the planning and decided on a strategy. This was going to be a stock-for-stock strategy. In evaluating their decisions, Jim and the buying company confirmed that the chosen strategy appeared to be the most economical from a value perspective while serving them well from a tax perspective.

Preparation of the company was done (Step 4). And succession was completed, documents were signed, and value was transferred (Step 5). At the end of the transaction, Jim had stock in the new company.

The stock that Jim acquired in the publicly traded company had a lockup period of 12 months, meaning that Jim was unable to sell his shares during that one-year period. By the end of the 12 months, the stock had declined by about 60 percent. Jim, however, believed in the new management and in the company, so he held the stock for another 12 months. But the market did not like the shares of the combined company. The stock dropped another 20 percent.

After looking at this scenario, my question becomes: Did this transactional approach achieve the greatest value in wealth for Jim? For the answer, let me quote one of my accounting professors at the Kellogg School of Management. He said: "The answer for every accounting question is always, 'It depends.' " I will come back to Jim at the end of this presentation, but suffice it to say that the correct answer right now is, "It depends."

Wealth Management Succession Planning

In contrast to transactional planning, wealth management succession planning is completely focused on the owner and intergenerational wealth transfer. Ideally, it begins with the founding of the business rather than with some event that suddenly triggers the need.

The transactional approach can be a good solution for the short term, but we believe that wealth management succession planning can ultimately provide greater value for the client. As I outline the steps involved, keep in mind that I am discussing an ideal process. The actual terms of each client engagement will vary based on the client, the size of the company, and what the client hopes to achieve. Despite these differences, we strive for a consistent philosophy with each client. We embrace the ideal but implement the practical.

In the remainder of this section, I will talk about three steps in our wealth management process. This is not an exhaustive list of our process, but these three steps most clearly identify the role of the business in the wealth management process. The first step involves setting goals, both personal and business. Second, we examine the role of investments in the context of the business owner's situation. And third, we plan for what will happen after the business owner exits—the evaluation of estate-planning issues.

Goals. The wealth management process for the business owner begins with our gaining an understanding of the owner's short-term as well as long-term goals. But note that our definition of short-term goals is those goals sought during the client's lifetime; long-term goals are those occurring after the client's lifetime.

We start this process with all our clients by asking a lot of questions. Many of the questions may seem odd at first, but they get to the heart of what we do. We begin with personal questions. We start by asking our client to describe an ideal day: "What does it look like? What does it feel like? What are you doing? How are you being challenged? Where are you? Are you traveling? Do you have responsibility? Do you have risk?" The answers to these questions give us insight into who the client is and what the client is striving for personally and emotionally.

Next question: "If you were given $25 million today, how would it change your life? Would you do anything differently?" It is a critical question for us because it gets back to the question I posed earlier about what retirement is. If retirement is a change from economic priorities to life priorities, then once that economic priority has been accomplished (in this case by receiving $25 million), what will drive this client for the rest of his or her life? We see a lot of issues arise when people suddenly come into money. They spend their entire life working for an economic goal, but they are not sure what to do once they have achieved it. This question helps clients determine what they will do with their life when they achieve all their economic goals.

Another line of questioning helps establish what thoughts a client has regarding long-term (post-lifetime) goals: "How would you like to be remembered when you are gone? What is your legacy? What do you want to leave? What do you want to leave to your family? What is important to you from a charity perspective? What is important to you from a societal perspective?"

We also try to establish how much a particular business owner has thought through the steps needed to accomplish the goals currently at his or her forefront with a different question: "What would you like to accomplish in the next five years, and what are the obstacles?" This question helps us identify how action oriented this client is and what role we will need to play in the wealth management process.

A final line of questions attempts to establish the client's priorities: "What does the phrase 'make a difference' mean to you?" The answer helps us from the perspective of having the client prioritize what is important to him or her. We can begin to determine how the client thinks, how money is involved, and how family and the community are involved in this goal.

After the personal goals questions come the business questions: "Why did you start the business? You are going to get paid less, work more, have more headaches, and have more work than you can ever imagine. Why are you doing this?" We want to find out if the decision is economic, or is it based on wanting to change the industry or the way people look at things? The answer gives us an idea as to where the client is going with this business, and it certainly helps in deciding a lot of other issues, especially an investment policy.

This line of questioning continues with: "How do you want to get out of the business?" We try to get this question answered up front because the answer drives our strategy going forward. Although many clients do not like thinking about the answer to this question, we really press hard for an answer because it is so important to establish the exit plan up front.

We then ask: "What is the role of the business? Is it purely economic? Is it to provide a family business that you can use to transfer wealth to future generations? How do you go about achieving your stated business goals?"

Once we have come this far, we look at the answers for both the personal and business goals and we work to reconcile them. We look for consistency and congruency wherever possible. If a client says she wants to build her business and will do whatever it takes to get there but on a personal level she wants to spend more time with her family, we have to try to reconcile those potentially conflicting goals in advance. What good is wealth if we lose 50 percent to a divorce proceeding?

Role of Investments. A client can easily have 80–90 percent of his or her net worth tied up in the business. Think about that situation for a moment. How many investment managers would write an investment policy statement with 80–90 percent invested in one stock?

The heart of this question revolves around whether the wealth associated with the private company should be included in the investment policy statement. Some advisors think it should, and some think it should not. Even among those who think it should be included, many do not include it because of the difficulty managing it and implementing it within the policy statement in a practical way.

At Sebold Capital Management, our stance is that the business asset absolutely must be in the investment policy statement. The largest asset that a business owner holds is usually the business. It is a high-return, high-risk investment that the client is holding over a very long period of time. This should be the highest rate of return investment that the client has. As a result, the client's other investments should be supportive of this "asset." They should not be based solely on return but on how they perform relative to the business. How are the returns of the investments correlated with the business? If the business falters, will there be money available from other investments to take up the slack?

After-Exit Estate-Planning Issues. Typically, succession planning is completed from a transactional perspective. Once that transaction is completed, then a wealth manager's job begins. Estate taxes are onerous and complicated. Tax rates can be as high as 55 percent, and every single one of our clients has estate tax issues. If these issues are not carefully considered, we could do a fantastic job of managing assets and creating a succession plan only to promptly lose 50 percent to taxes. Thus, a tremendous amount of value can be added in this area.

We believe that the succession planning perspective should be started at the absolute earliest time possible. Essentially, the earlier we get involved in the succession plan, the more easily we can drive the business toward that succession plan. In addition, the earlier the succession plan is developed, the more easily we can integrate the plan into the estate plan. In this manner, we will not only be identifying and working toward our exit strategy, but we will also lower our overall estate-planning costs.

A quick example of this is a simple strategy of gift shares of a rapidly growing company. It is possible to gift $11,000 a year tax free, or up to $22,000 as a split gift from each spouse. If a gifting program (of shares of the company) starts 10 years earlier, then 10 years of additional value transfer can be accomplished without any cost, except for the small cost of the actual transfer. Not only does this strategy lower overall estate taxes by removing a highly appreciating asset from the estate; it can also be coordinated with the succession plan.

This strategy, and other strategies like it, must be planned for. We do not know how the market will behave, but we know the goal we are trying to achieve. We do not know how the company will do, but we can make reasoned expectations. We ultimately get our client where he or she needs to be by adapting: We adapt to tax laws. We adapt to changes in the investment process. And we adapt to changes in investment returns.

Therefore, we think that the succession planning starts the minute we begin working with a client. The sooner we start that strategy, the lower the cost and the better the implementation going forward, from a short-term perspective during life and from a long-term perspective after life.

Conclusion

The biggest difference between the transactional approach and the wealth management approach is that transactional planning is shorter term and in the moment, whereas the wealth management process is continual. It is a process, not a product.

Going back to my early example of Jim and the medical billing company, remember that I posed the question: Did this transactional approach achieve the greatest value in wealth for Jim? The reason I said the answer is "it depends" is because I did not tell the whole story about Jim. I said he was in the medical billing business, because that is what he created. Actually, he is an entrepreneur who likes to create companies. He built the company, and five years later, he sold the company. With regard to his losing money on the transaction from a value perspective, he viewed it the same way a fund manager might see a bad stock trade. Since then, he has created two other companies. One of them he has already sold, and he is looking for an offer on the other. In that context, Jim's stock-for-stock transaction is perfectly consistent and congruent with what he is trying to achieve. For other clients, the situation is rarely so clear-cut.

Succession planning in the wealth management process is difficult to pull apart. The wealth management process is so closely tied to the client's hopes, dreams, goals, and desires that it is almost impossible to tackle the issues relating to the business without simultaneously understanding their effects on the client's wealth circumstance. It is for this reason that we do not try to separate them. We try to integrate them as a lifelong process that continues for generations. We believe that in helping business owners identify their own path and destination, we can ultimately create more value for them, their families, and their communities through this process.

Question and Answer Session

Sean Sebold, CFA

Question: How do you get a business owner to start thinking about succession planning before he or she is ready?

Sebold: We ask our clients to meet with us on a quarterly basis, and we press the issue at every opportunity. It is extremely important. If we create $50 million of wealth but half of it goes to taxes, does that make sense? Would it similarly make sense to create $50 million of wealth that ultimately goes to an 18-year-old kid after a death?

There are a lot of very powerful reasons why these issues must be brought up and talked about. The consequences for inaction can be dire. So, if the client is not ready, we continue to press until we make progress.

Question: Does the client sometimes say: "This approach is not for me"?

Sebold: Yes, some clients react that way. We are in the position that if we can't help a client with his or her wealth management planning, then we have to think about the relationship we have because that is the value proposition that we provide. Being an independent firm certainly helps our position. It helps us really talk to the client in terms of what he or she has hired us to accomplish. Ultimately, if a client is not willing to talk about these wealth management issues, we may have to help him or her look for somebody else because we are not in a position to help.

Question: How do you charge fees?

Sebold: With regard to the fee structure, for anything outside the business we have a basis points approach in terms of our management fees. We also have a retainer fee structure in place that varies depending on the complexity of the client engagement and the work we are doing for the client. Usually, we charge a larger fee up front for the first year because of all the initial work that must be done. In subsequent years, the fee is lower unless circumstances change.

