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Taking Stock (of Your Stock) - The Importance of Business Succession

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It is sometimes difficult for today's business owner to focus on planning for the distant future or the unexpected. It is easy enough, especially these days, to focus on accounts receivable, the availability of credit, and a changed economic landscape. But the importance of business continuity planning is difficult to overstate. The very health of the business, and the well-being of the principals and their families, is at stake. This article discusses why the principals of a business should take the time, or make the time, to consider exactly what will happen to the business and their families in the event that one of them should die or become disabled.

The importance of business succession planning is highlighted through a simple hypothetical: what would happen if you woke up this morning and one of your business partners had been replaced with his family and their advisers? What if, in addition to that abrupt change, your business partner's families and their advisers were telling you that they needed to come up with a large amount of cash within nine months in order to pay federal and state estate taxes? For any thoughtful and careful businessperson the answer to this question should be "whatever the documents say." And hopefully those documents are fair, both to the business and to the family, as well as efficient from a tax and cash flow perspective.

The worst possible answers to those questions are "I don't know" or "We'll work it out." That is because the needs and sensitivities of the family are rarely if ever going to be aligned with the interests and constraints of the business. Parties will also very often have significantly different concepts of the value of the deceased partner's interest. This disconnect, and the potential for disruption and acrimony that it could create, is the reason that business owners should ensure that they have a succession plan in place to clearly delineate the rights and obligations of the stakeholders in the event of the death or disability of a partner. For business owners who have no such plan in place, there is no time like the present to "take stock" of their stock by coming up with a solid plan for the inevitable death or disability of one of the partners.

There are a number of different ways that business owners can go about planning for the death or disability of a partner. In the most general terms, each of the techniques will provide basic economic protections for both the business and the family. For the business, succession planning will ensure that the interests of the deceased partner do not pass into undesirable hands. For example, it's unlikely that the surviving partners would much like the deceased partner's interest to be acquired by an investment bank or venture capital fund without their consent. For the family, succession planning will ensure that the family will not be forced into fire sales or near-usurious credit arrangements to come up with the funds for estate taxes. The agreements will in general terms provide the family with an avenue to liquidity (e.g., for estate tax payments) and perhaps a means to enjoy a portion of the company's cash flow going forward.

There are a number of techniques available to accomplish these objectives. Two popular techniques that accomplish both of these objectives are a cross-purchase agreement and a redemption agreement.

A cross-purchase agreement is an agreement whereby the remaining partner or partners in the company agree to purchase the interests of the deceased or disabled partner. The principal advantages of this type of agreement include the fact that it can be very tax efficient for the remaining partners, as they will receive a tax "cost" basis in any shares acquired from the deceased or disabled partner. The principal disadvantages of this technique include the fact that the remaining partners must coordinate how they will each come up with the cash necessary to fund the required payments under the agreement.

A redemption agreement is different from a cross-purchase agreement in that the company itself, as opposed to the individual partners, agrees to purchase the interests of a deceased or disabled partner. The principal advantages of this technique include the fact that the company, as opposed to the remaining partners individually, will come up with the cash necessary for the payment; it may often be easier, and cheaper, for the company to hold and/or negotiate the insurance or other financing necessary for the purchase of the deceased or disabled partner's share in the company. The principal disadvantages of this technique include the fact that the company will not acquire a tax cost basis in the acquired shares.

Regardless of the technique used to acquire the deceased or disabled partner's interest, two key aspects of the buyout must be settled in advance. First, the parties must settle the price and terms of payment. Second, the parties must ensure that they have a means to fund the buyout.

There are a number of ways to determine the purchase price for the deceased or disabled partner's interests. A popular method, in particular for manufacturing businesses, is the use of a formula that reflects "market" standards within the relevant industry. The parties may also agree to hire a mutually acceptable valuation expert upon the death or disability of the relevant partner. The terms of payment can be negotiated taking into account the business's cash flow needs and capabilities and the likely estate tax obligations of the deceased partner's family. As for funding, most often the remaining partners (in the case of a buy-sell agreement) or the company (in the case of a redemption agreement) will come up with the cash necessary to make any payments required under the agreement, through insurance proceeds received in connection with the death or disability of the relevant partner. In rarer cases, the purchasing party will be in a position to finance the purchase. In either case, the funding source (e.g., the amount of insurance cover obtained by the company or by the remaining partners) should be coordinated with the buyout price specified by the relevant agreement. In addition, because the buyout price specified in a particular agreement may be a moving target, the parties to the agreement should be careful to review their funding periodically to ensure that it remains sufficient despite potentially changed circumstances.

While this article discusses the importance of succession planning primarily in the context of businesses with multiple owners, it should be noted that advanced planning is no less important in the context of businesses with one key owner or shareholder. In fact, the risks in the context of a business with a single owner may be even higher, because these types of companies often lack the management depth and direction needed to succeed if the owner dies or becomes disabled. In those cases, the owner must carefully balance the dual objectives of maximizing the asset value for his or her family and securing the future viability of the business. The potentially hard choices that need to be made are no reason to shy away from the process – oftentimes preparation of the owner's succession plan can present a perfect opportunity to protect the owner's family while incentivizing key employees and strengthening the long-term viability of the business.

There are, of course, variations on each of the general elements highlighted in this article. In essence, however, a well-designed succession plan will accomplish the basic objective described above, i.e., the business will have legal protection against the deceased or disabled partner's interest's passing into unwanted hands or bypassing the best candidates for the company's stewardship, and the family will have legal protection to make sure that they will be able to realize cash in a timely manner and in an amount reflective of a reasonable value of their family member's interest. For any business or business owner that lacks these basic protections, it is time to "take stock" of your stock.