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Succession Planning for Family-Owned Banks and Businesses

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Succession Planning for Family-Owned Banks and Businesses

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Executive Summary

You are gone tomorrow. What happens to the business you poured years of blood, sweat and countless sleepless nights into? Will your family take it over? Is there an outside buyer for the business? What income will your loved ones use to survive? These are questions the people you care about will ask if you do not take time to develop a detailed, well communicated business succession plan.

Whether you pass away unexpectedly, or simply are ready to move on to the next stage of life filled with grandchildren and golf, having a plan is more crucial now than ever before. Communication is critical-- not only can a lack of communication cause suspicion among family members and key employees, but what good is a plan that no one knows about?

As a business owner, it is easy to get caught up in the day to day minutia—from conference calls to deadlines—but taking time to work on the business is what creates a legacy as both business owner and leader of a community. At the end of the day, two fundamental questions need to be answered: (1) who is the right person to run the business when you cannot, and (2) who are the people you want taken care of?

The answers to these two questions will determine the structure of your succession plan. These answers help develop two of the four parts of the succession plan: the leadership succession plan and the estate plan. Your retirement plan and the family harmony plan round out the succession plan. It is important to look at each of these four parts:

"Who is the right person to run the business when you cannot?"

I. Leadership Succession– Who is Going to Steer the Ship?

The first, and most important objective, is leadership succession– who is going to steer the ship? It is the most important objective because without leadership succession, the other parts of the plan become irrelevant. Unless your business is incredibly unique, its value will be determined primarily by who is making the critical decisions.

Good decisions lead to strong business value, and business value leads to the need to have a solid plan—a plan that protects that value from creditors and uses that value to take care of the people you care about (including yourself!). Bad decisions reduce, and ultimately eliminate value. If the business is worthless, it cannot provide for your retirement, so there is no need to plan for your retirement. Therefore, a failure of leadership succession means you cannot retire. If there is no viable successor, there is no need to develop a plan to use its value to care for the people you care about (otherwise known as an estate plan). With no value, there is no caring. Family harmony will not be an issue; no one will be fighting over a worthless asset. Having the right person to run the business and maximize its value is critical.

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This person will dictate the structure of the plan. If it is a family member, the succession of leadership will most likely be incorporated into the overall estate plan. However, if the successor is an employee or another current owner, then buy/sell planning will be the mechanism to execute the succession plan. If the business will be run by an outsider (a competitor or a professional private equity company), then a sale of the business will be way the succession plan comes to fruition.

Step one is to determine who should run the business. Is this the same as who should own the business? Generally, the answer to that question is "Yes". Having the right decision-maker working for the wrong decision maker tends to lead to irresolvable conflict in closely held businesses. For example, if Dad leaves his business to his five children, only one who is capable of running the business, the decision makers are the five children; four of five have no idea how to make optimal decisions. Eventually, that will lead to conflict: the one child gets tired of "working for his or her siblings", the other four get tired of counting on their brother or sister to maximize the value of their investment.

Therefore, a key to succession planning is not to separate ownership and leadership. If necessity requires this separation, a thoughtful plan to avoid conflict must be developed.

"An estate plan is a strategy to take care of the people you care about."

II. Estate Planning—Tax Friendly Options

The second step is to develop the estate plan. As mentioned above, an estate plan is a strategy to take care of the people you care about. This is done in two ways: (1) transferring the right property to the right people at the right time, and (2) making sure the right people are making decisions when you cannot.

Part of making sure the right people get the right property is to make sure your property (including your business) is going to your family and not to the government or creditors. For this reason, tax planning and asset protection planning are critical components of a succession plan. However, you need to build a plan that puts the government and creditors in their "correct place"—as impediments to plan execution that need to be handled, but not as the central focus of the plan itself.

Business owners that want to give a highly valuable business to their children will find the estate tax to be an obstacle. For example, a couple that works together and builds an estate tax sensitive plan can essentially pass a $10.7 million business to their children without concerning themselves with the estate tax. However, if they are trying to pass a $25 million business to their children, the estate tax system will tax every dollar of value in excess of $10.7 million at a 40% rate.

The problem for business owners is that they oftentimes reinvest all of the business' income back into business expansion. The result: they are rich from a net worth perspective, BUT they are cash poor. Cash is what will be needed ($6 million to be precise) within 90 days of death to pay the estate tax.

Fortunately, life insurance owned outside of your estate can prove to be a dynamic solution to liquidity. Life insurance gives the children exactly what they need (cash) at the exact time they need it (the death of a parent that triggers the estate tax). The plan can be designed to avoid creating a greater estate tax problem than the parents currently have.

The tools that help resolve estate tax issues are numerous: trust, buy/sell arrangement, lease, charitable planning, etc. These tools help to coordinate the right people, the right property and the right timing– allowing the business owner time to focus on retirement and the people he or she cares most about.

III. Retirement Planning—Money, Money, Money

The third step in the planning process is retirement planning. Some business owners place no priority on retirement planning—they cannot foresee a scenario where they would not be involved in the business. Other business owners want to leave the business vertically either for their own peace of mind, or for the good of the business to be run by fresh blood with fresh ideas. Most closely held business owners reinvest all of the business' profits back into the business. This can be a challenge, because the only source of retirement income is the business itself. But the businesses' income also has to provide for the new owner as well as future expansion and reinvestment.

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Oftentimes, business owners are so frustrated when it comes time to retire that their business focused retirement plan gets in the way of successful ownership succession of the business. Stated another way, the children are less excited to take over and run a business burdened by Mom and Dad's retirement needs.

Business owners should begin early saving for retirement outside of the business. These savings will probably not get the same rate of return as reinvesting in the business, but the outside investments do serve a purpose.

Outside investments will give the business owner something incredibly valuable: choices. The owner will be glad for these choices when retiring and when transitioning leadership.

"Business owners should begin early saving for retirement *outside* of the business."

IV. Family Harmony—How to "Keep the Peace"

Step one to maintaining family harmony involves Mom and Dad being honest with themselves in leadership succession. It is rare that the right persons to run the company are "all of the children." Picking the right leader is critical, and it is the only way that we have the means to take care of the people we care about. If that right person is only one of the children, then Mom and Dad need to give ownership to that child.

In step two, Mom and Dad need to determine what people WANT in putting the plan together. All things being equal, family harmony is maximized when everyone is happy, and people tend to be happy when they get what they want. For the child who already works at the business, chances are that child wants the business. But what about the "uninvolved children?" Do they want the business? Do they want its risk and responsibility? No, they probably want cash instead. Life insurance can be a great tool to "equalize" the estate, get everyone what they want, and help Mom and Dad make the right decisions.

"The main fallacy that hinders family harmony is mistaking fair and equal."

Last but not least—what about the concept of equalizing the estate? One of the main fallacies that hinders family harmony is mistaking fair and equal. If Mom and Dad have three children, one involved and two not, and own a business worth $2 million, they can equalize the estate by purchasing $4 million of insurance and leaving those proceeds to the uninvolved children. What if they do not want to pay the premiums to purchase a 4 million policy? What if they are willing to pay only the premiums on a $2 million policy?

If Mom and Dad focus on treating the children equally, then they will need to leave part of the company to the uninvolved children, which creates potential future conflict and disharmony. What about what people want? Would the uninvolved children value $1 million (each) of income tax free cash they could spend in any way they want?

It is fair to leave the more valuable business interests to the child who is adding to that value and taking on the risk. The most successful succession plans focus on what people want and what is fair, and they disregard the math problem focused on equality.

Moral of the Story

The bottom line is to have a plan that incorporates everyone from start to finish. This will lessen the likelihood of fighting among family, while keeping your key employees and clients from looking elsewhere to conduct business. Working with an experienced team of attorneys, CPA's, financial advisors and bankers that you trust will make this process go significantly smoother.

"[Succession Plans] should be reviewed and revised periodically."

A business succession plan is much like that of a financial plan-- it should be reviewed and revised periodically. Life is not stagnant, and changes will inevitably need to be made to stay current with your goals and dreams. Even if you decide not to consciously create and implement a succession plan, you still have one. Unfortunately it will likely not provide the options and outcomes that you desire, so communication is key.

In summary:

- Communicate. A plan is no good is if no one knows it exists.
- Do not separate ownership and leadership.
- Trusts, buy/sell arrangements, leases, charitable planning, etc. are tools that can help resolve estate tax issues.
- Investing outside the business will give the owner choices when retirement and ownership changes occur.
- Focus on what people want and what is fair.

"Communication is key."

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