Houser Henry & Syron LLP

What's Your Game Plan? Planning for a Successful Succession

Sooner or later, every business leader hands over the reins. But for founders and owners of family businesses, managing a successful transition is both difficult and risky. Whether you're planning to keep your business in the family or to usher it in a favoured direction, here are some important succession considerations.

Family Business Transition Options

Family business owners have three basic options when exiting a business:

- **Sale to an outsider**, an arm's-length individual or business. This offers the greatest opportunity for wealth capture—but takes discipline and effort.
- **Transfer to the next generation**, referred to by management expert Peter Drucker as "the final test of greatness" for businesses leaders. This transfer is successful in only 30% of cases. Just 10% successfully reach the third generation.
- **Sale to management**, the least common event, in part because of financing difficulties.

Whichever option an owner chooses, the chances of success are greatly improved if the business follows a clear succession plan. Yet a 2005 Canadian Federation of Independent Business (CFIB) survey reported that just over one-third of small business owners have a succession plan, and less than 10% have a formal plan.

Benefits and Challenges in Succession Planning for a Family Business

Among the many **benefits of succession planning** are the opportunity to maximize the sale price and owner's retirement income, to optimize personal and business tax planning and to enhance financial stability for the business.

But **succession planning also has its challenges**, often reflecting the complex personalities of entrepreneurs and equally convoluted family dynamics. Many owners are unwilling or unable to give up control and/or to decide on a successor. Entire families, including those not active in the business, often depend on the enterprise to provide incomes far above those attainable on their own.

In these situations, mere discussion of succession is difficult, let alone reaching a fair decision and then tackling the equally daunting task of grooming an internal successor or positioning the company to be attractive to an external buyer.

A solid succession plan, developed using an inclusive process, can help resolve many of these issues.

Keys to a Successful Succession Plan

Experience with several family businesses suggests the following principles for successful succession planning:

- **Start now:** Planning and executing a succession plan always takes more time than expected. Consult with legal and financial advisors at least 10 years before the transfer. Involve family members, including those not directly involved in the business. Use an experienced facilitator if necessary to keep meetings on track and productive.
- **Communicate:** Communicate about the succession plan and process with both active and non-active stakeholders, so everyone feels informed. This will help to build realistic expectations and develop consensus for the succession.

- **Be fair and realistic:** Fairness helps avoid tension and mistrust in the family. But being fair to children and other stakeholders does not mean treating them all equally. Compensate fairly those who work in the business. Make realistic assessments—with outside expertise, if needed—to decide if a child is competent to run the business, or if it should be sold to an outsider.
- **Work together:** Develop a shared vision within the family for where the business is going and what it will look like in 5 or 10 years.
- **Make it flexible:** Build a succession plan that can accommodate changes in the family, including deaths, changes of heart, new opportunities and other unexpected events.
- **Be comprehensive:** Try to anticipate and plan for all the impacts of succession. One helpful tool for this is the Three Circles model developed by John Davis of Harvard University. The circles represent the related perspectives of ownership, management and family. Each of these areas needs to be managed differently. Think also about your own retirement and how it will be funded. Ideally a departing owner will not have to depend on the business for future income. If this is not possible, work with your financial advisor to determine whether your plan will meet your needs.

Grooming a Business for Sale to an Outsider

Selling his or her business to an outsider is an owner's best option for maximizing value. Sadly, most family businesses are eventually sold in distress or bankruptcy. Usually this is because the family lacks either the know-how or discipline (or both) to groom the business for a successful sale.

According to the Canadian Institute of Chartered Accountants, buyers are attracted to businesses with most or all of the following attributes. Even if your plan is to transfer your business within the family, these items provide a helpful checklist in determining a realistic value:

- **History of revenue, profitability and strong cash flows:** Consistent profits demonstrate momentum and stability. Positive cash flow makes a business self-supporting and capable of funding further growth and investment.
- **Competent management and a clear succession plan:** Buyers want to see professional management with ability and experience—but also with clear planning, accountability and reporting processes. This is the single biggest challenge for family businesses, especially smaller ones, since most founders find it difficult to attract talent and to give managers enough scope to demonstrate their ability to run and grow the business once the owner has departed.
- **Consistent reinvestment of earnings into operations:** This provides evidence of the seller's faith in the business and its future. Reinvestment is also an indicator that the business has current technology and IT and that any equipment has been well maintained.
- **Reputable brand name:** A well-recognized brand is evidence of customer satisfaction and provides opportunities for expansion into new product lines and markets.
- **Technological capability and expertise:** Superior technology and expertise provide competitive advantage and enable a business to be the low cost producer.
- **Quality customers and pipeline:** Forward orders from solid customers provide financial stability and evidence of competitive products and pricing.
- **Strong customer/supplier relationships:** Companies that are part of strong value chains can be more strategic in product development and in adopting new technologies and processes.
- **Strong strategic partnerships:** A history of successfully partnering on projects or large sales, or more formal sales channel relationships provide companies with marketing leverage and greater reach.
- **Existence of intangible assets:** This broad category of non-monetary assets includes customer lists, copyrights, patents, trademarks, goodwill, know-how, etc.—all of which create competitive advantage.

Family Business Succession Challenges

A succession plan is equally important for a business being transferred within the family. Especially challenging in these cases is selecting and grooming the person who will take over.

It can be difficult for a founder to stand aside and allow a family successor to take charge and prove him or herself. Family members will often tolerate a level of interference unacceptable to an outsider. Old rivalries and jealousies can interfere with an orderly process. And, of course, being clear-eyed about the competence of a successor is especially difficult when the individual is also a son or daughter. The best advice in this case is to involve trusted outside advisors.

Another challenge in family successions is dealing with all the closing details an outside buyer would require. Although a family successor might not insist on these items, fairness demands that he or she starts with as few loose ends as possible.

Examples of these items include:

- An independent valuation to support any payout
- Well-organized financial and legal records
- Resolution of any litigation, liens, etc.
- Current employee records and contracts, supplier contracts, etc.
- Current and transferable licenses, permits, etc.

Summary

Whatever an owner's intention for transferring a business, starting early to develop a clear succession plan is the first step. It's not easy—as the fact that most owners have not made formal succession plans demonstrates.

But with good accounting and legal advice and specialized coaching as needed, successful succession planning can be accomplished.

And the payoff for success is huge

About Houser Henry & Syron LLP

For over 75 years, Houser Henry & Syron has helped entrepreneurs and private companies of all sizes grow and prosper. We provide a range of business law services - from assisting with day-to-day legal requirements to providing strategic counsel on highly complex transactions. We are uniquely positioned to provide high-quality legal advice, tailored to the specific needs of our clients, at a reasonable price. Read what our clients have to say about working with our firm.