# Succession Planning for Business Owners

MB Wealth Management is a brand name used by MB Financial Bank, N.A. and its subsidiaries.

Having worked with businesses and their owners for over 100 years, we understand how essential proper succession planning is to the continuity of a business with multiple owners and key employees. Through the use of buy-sell agreements, key person insurance, or the creation of an Employee Stock Ownership Plan (ESOP), a business owner can prepare for the smooth transition of their company in the event of ownership or key employee disruption.

*Proper pre-planning may help insulate a company from the stress, uncertainty and damage, such as the decline in a business's value, that may arise when unforeseen and unexpected events take place.*

### What Happens When…

What happens to the business and the other owners when one of them becomes disabled, wishes to retire, has a falling-out or passes away? Does the company want to work with an unrelated owner from a third-party sale, an ex-spouse in the event of divorce or someone that succeeds a deceased owner's interest?

What happens to the business when that departing owner is also a key employee responsible for significant revenue generation? How does losing that employee's talent, experience and business acumen impact the enterprise? And, how much would it cost to find a replacement?

Having a well-drafted buy-sell agreement, key person insurance or an ESOP helps proactively address such events before they occur. Much like purchasing an insurance policy to protect a home or car, proper pre-planning may help insulate a company from the stress, uncertainty and damage, such as the decline in a business's value, that may arise when unforeseen and unexpected events take place.

### Buy-Sell Agreements

Buy-sell agreements are contracts that address the handling of an owner's share in a business. Also referred to as shareholder agreements, operating agreements or partnership agreements, these documents establish the rules for how owners will interact with one another when key events occur regarding their business interest. Typically, the most common events addressed under a buy-sell agreement include retirement, disability or death of an owner.

Additionally, the agreement should contain provisions for handling ownership transferability, a sale to a third party, funding sources, non-compete and valuation methodology.

As an example, assume one owner has a falling-out with the others, is no longer interested in continuing to participate in the business and is looking to "withdraw" or redeem their interest.

Without a buy-sell agreement in place, this scenario can escalate into a drawn-out, stressful and costly process. The lack of a clear documented plan will most certainly impact the owners and could possibly jeopardize employee morale and retention, client relationships and the financial health of the business. And if shares were given to a key employee as a performance award, without a buy-sell agreement in place, the reward may lose its intended effect.

With a proper buy-sell agreement, a contract would be in place that defines the circumstances under which a withdrawal is permitted and the specific mechanism for valuing the interest to be redeemed from the company. With a non-compete provision in the agreement, the company may reasonably seek to restrict the former owner from creating a new competing business after their withdrawal.

## Buy-Sell Structure

One typical approach in setting up a buy-sell structure is through a stock redemption or entity buy-sell agreement.

This involves the business purchasing the interest of an owner, typically through the use of insurance. Upon the passing of an owner, life insurance proceeds become available to the company for use in buying out the deceased owner's share. An exit for reasons other than an owner's death may be financed by corporate borrowing or funded over time.

This allows for a smooth transition of the business for the other owners and protects the business from a liquidation scenario.

A variation of the entity buy-sell structure involves the individual owners entering into a cross-purchase buy-sell agreement. In this arrangement, each owner agrees to buy the business interests of another owner subject to a triggering event such as retirement, disability or death of an owner. These agreements are also typically funded with insurance.

Generally, a cross-purchase structure is suitable for businesses with only a few owners of roughly similar age. Once there are numerous owners with varying ages, the cross-purchase structure could become unwieldy and expensive.

## Key Person Insurance

While buy-sell agreements address situations that involve buying out an owner's share in the business, these agreements do not address the financial impact that can result from the departure of a key person. A key person is someone who is crucial to the organization's success and whose absence would negatively affect the business's future prospects. A key person is often the owner, but a key person can also be someone in senior management, operations or sales. Whether it's the key person's ability to generate revenue or provide valuable industry expertise, a business that is highly dependent on one or a few individuals for its success should be protected in the event a key person becomes disabled or dies.

At its basic level, the business itself takes out a life insurance policy on the designated key person, as both the owner and the beneficiary. The company makes the premium payments, which are not tax deductible, but the insurance proceeds are received by the business on a tax-free basis in the event the insured individual dies. In addition to life insurance, a business should also consider purchasing disability insurance on key persons. Individuals are more likely to become disabled over their lifetimes than they are to have an untimely death.

## ESOP

An ESOP may be an effective solution for many owners, especially those who want to implement a succession plan or hedge the appreciated value of their business by monetizing all or a portion of their ownership interest, while remaining at the helm of their company for the foreseeable future. Because ownership passes to the employee stock ownership trust when the ESOP is implemented, the subsequent retirement, death or disability of one or more of the business's owners does not trigger an urgent need to value and sell the business.

As a qualified defined contribution employee benefit plan, an ESOP is similar to a profit-sharing or 401(k) plan. However, in this case it is the employer company's own stock that the plan primarily invests in. The plan is established through the creation of a trust that purchases shares of newly issued stock from the company after the company has redeemed the selling shareholders' interests. The shares are then allocated to eligible employee-participants' accounts over time. Subject to vesting and other requirements, participating employees may sell their shares upon reaching a certain age, becoming disabled, leaving the company or retiring.

Transferring shares into an ESOP can be financed in two different ways. In the first, or "nonleveraged" way, the company may contribute newly issued or treasury shares of its own stock, or it can use its cash to buy the stock directly from the current owners over time. The other way is for the company to borrow the money to be used to buy company stock; plans that take this route are considered leveraged ESOPs and are unique because an ESOP is the only qualified employee benefit plan which may borrow money.

*The lack of a clear documented plan will most certainly impact the owners and could possibly jeopardize employee morale and retention, client relationships and the financial health of the business.*

An ESOP structure permits a business to thrive long after its founders or current owners cease to be involved. An ESOP also helps with individual estate planning or with hedging the increase in the value of the business by monetizing all or a portion of the business interests for eventual heirs, while also creating some tax savings. An additional benefit is that ESOPs help attract new employees and retain those critical to the viability of the firm by heightening employee engagement through the alignment of employees' financial interests with the ongoing success of the business.

An ESOP is also useful when one or more owners wish to exit the business, but other owners wish to retain ownership. An ESOP helps address a situation in which the owners have not entered into a buy-sell agreement or when the circumstances do not fit within the terms of an existing buy-sell agreement.

Given the different plan options as well as legal, tax and other considerations, establishing an ESOP is best accomplished by working with a team of legal and financial professionals with extensive experience helping owners set up ESOPs.

## Future Forward

Through the use of buy-sell agreements, key person insurance, or ESOPs, a company is able to clearly spell out the protocol for addressing the expected and unexpected events that can meaningfully impact the business.

A business owner devotes their life to establishing, nourishing and growing their business. Through proper succession planning, that effort can be preserved by providing the roadmap for transitioning the business through a change in leadership. ■

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