Protecting Your Business from the Unexpected

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Building a successful business requires a significant amount of time and energy. Many business owners are so invested in the business that they do not think about a succession plan until they approach retirement. Succession planning is not just for retirement, however. What would happen to your business if you were suddenly to pass away or become disabled?

According to a 2017 Wilmington Trust survey of 200 business owners, 58% of those surveyed do not have a specific transition plan in place, and 31% have not thought about succession planning at all. The reasons are many, but these results demonstrate a significant gap in planning. In this article, we discuss the importance of creating a business succession plan early, and outline the most common options for protecting your business from the unexpected.

Creating a business succession plan provides protection in case of unexpected death or disability, and allows for a smooth transition at retirement. Doing this early is beneficial in that it eliminates the need for a valuation after death, since the price is agreed upon at the time the succession agreement is drafted. This also helps to avoid liquidity or time constraints, and can prevent the possibility of an unwanted external takeover due to cash flow problems. Like with estate plans, succession plans should be reviewed and updated periodically to reflect changes in valuation or circumstances.

The first step in creating a succession plan is to identify your ideal successor. This could be an existing co-owner, a family member, a key employee, or an outside third party. Regardless of who your successor will be, planning for the unexpected is a necessity. Each option has advantages and disadvantages. It's important to thoughtfully consider all available options and choose the best fit for your business, which may differ from what your choice would be if based on emotion.

Once you've chosen your successor, the next step is to determine the best type of buy/sell agreement to use. A buy/sell agreement is a legally binding contract that describes how business interests are to be reallocated at the retirement, death or disability of an owner. It should include an agreed upon sale price, the value of each owner's share, and any restrictions regarding who can or cannot be a buyer. The most commonly used buy/sell agreements are:

- **Cross-Purchase** – In this type of agreement, each owner agrees to purchase the other's business interest at the time of retirement, death or disability.
- **Entity-Purchase** – In this type of agreement, each owner agrees to sell his or her ownership interest back to the business upon retirement, death or disability.

A business valuation will also be needed. Depending on the type of business, this could be done by a Certified Public Accountant, an independently qualified appraiser, or even an arbitrary agreement between all owners. For a publicly traded company, valuation can be based on the current market price of the stock.

For the buyer of your business, having enough cash on hand to complete the purchase can be difficult. Because of this, there are several options for structuring a buy/sell agreement, including installment sales or acquisition loans. One of the most common options uses life insurance.

In a **cross-purchase agreement**, each owner buys an insurance policy on the life of each other owner, naming him or herself as beneficiary. Upon the death of an insured owner, the remaining owner(s) receive the death benefit, which is then used to buy the deceased owner's share of the business at a previously agreed upon price. The individual(s) buying out the shares of the deceased party will generally receive a step-up in cost basis on the business interests he or she is purchasing.

In an **entity-purchase agreement**, the business itself purchases a life insurance policy on each owner. The business owns the policies, and is the beneficiary on each. This type of agreement is typically used in instances where there are more than 2 – 3 owners, as it is a bit simpler than cross-purchase agreements in those situations. At the death of an owner, the business receives the death benefit from the insurance policy, and uses those funds to buy the deceased owner's share of the business from his or her estate. For this type of agreement, there is no step-up in cost basis, however, the cost of each insurance policy is generally deductible to the business.

Business succession planning can be a difficult topic for business owners. After many years of building a business, even thinking about transitioning out of the business can be emotional and stressful. The difficulty, however, does not make it any less important. Planning for the logistics can also bring peace of mind, knowing that your business and your family will both be taken care of in the event of unexpected death or disability.

Your Freestone Client Advisor can guide you in making thoughtful and informed decisions regarding succession planning, and can work with your attorney to get the agreement in place. We can also incorporate those decisions into your personal financial plan, ensuring that all aspects of your financial profile are addressed.