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Succession Planning Can Protect Business Value **Dwight Moldenhauer, CLU, ChFC**

If you own a small business, part of your job is to make sure that all of the company's employees and vendors are paid on time. But what about you? How can you make sure that you (or your heirs) will be paid for the value of the business you are building when the time comes? That time may arrive when you reach a planned retirement age, but it also could occur unexpectedly as a result of a death or disability.

Creating a "succession plan" can be a smart step for almost any business owner. Think of this as a process that will allow you to exit the business while maintaining its momentum and converting its value into cash that you or your heirs can enjoy. This article will help you understand how to start developing such a plan, step-by-step.

Three Important Questions

The first step is to ask important questions, including these:

- 1. What is your business worth now?** - Its "fair market value" is the amount that a willing buyer would pay a willing seller in an arm's-length negotiated transaction.
- 2. What will your business be worth when you exit?** - As your business grows, its value should increase. You also can add value by selecting one or more "successor managers" capable of assuming your responsibilities over time.
- 3. How will your heirs obtain value for the business?** - A form of agreement known a "buy/sell" can determine the terms under which another entity will buy out your interest. It also can specify the sources of cash that will be used to complete the transfer of ownership and pay related expenses and taxes.

Identify a Buy-Out Entity and Formula

The next step is to identify a buy-out entity that will purchase your interest in the business under specified "trigger events" – such as your death, disability or planned retirement. This entity may be a family member, partner, co-owner, successor manager or even the company itself.

A "buy-out" formula determines the amount that will be paid to you (or your heirs) by a specified counterparty when a "trigger event" occurs, and it usually is based on estimated business value. For most small private companies, several methods of business valuation are acceptable, including: 1) a multiple of revenues or book value, 2) the average price of comparable recent business sales in your market, or 3) calculation of future discounted net income or cash flow.

Hire an Attorney to Draft a Legal Agreement

The next step is to formalize the buy/sell arrangement through a written agreement with the help of an attorney experienced in succession planning. Ideally, this attorney also has proficiency in estate tax planning and business valuation. The most important terms that should be included in the written agreement are the "trigger events" that will require ownership to change hands and the buyout value or formula. Common trigger events include an owner's death, disability, retirement, divorce, or separation from employment.



Funding the Buy/Sell Agreement

Life insurance is an important component of most well designed succession plans, because it provides funding that meets terms of the buy/sell agreement—quickly, in cash, and with favorable tax consequences. One common arrangement is for the counterparty to be the policy’s owner and beneficiary, while the business owner is the insured person. Upon the business owner’s death, the death benefit is paid to the beneficiary and used to purchase the owner’s interest based on terms of the agreement. In a business with multiple owners each business owner is usually the owner and beneficiary of life insurance coverage on the other(s).

Permanent life insurance is used to fund buy/sell arrangements because at any age the coverage will continue and premiums will remain affordable. If an owner retires from the business, the policy's cash value can be used to fund a partial buyout.

In addition to an owner’s death, another trigger event that can be pre-funded with insurance is an owner’s long-term disability. In this case, disability income insurance can be used for funding. This insurance pays to the beneficiary a stated monthly income (after a waiting period) that can be used to fund a buyout, perhaps in combination with an installment note over time.

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