


HOW BUSINESS SUCCESSION PLANS HELP MITIGATE THE RISK OF BUSINESS FAILURE



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Businesses fail for a variety of reasons. In the case of a business owned by a corporation or LLC, one of those reasons is the shareholders’ or members’ failure to have a plan to replace the key decision maker(s). Even successful businesses can suffer crushing losses while their owners figure out who’s in charge.

A good business succession plan can help mitigate the risk of that happening. And lawyers with corporations and LLCs as their clients can encourage shareholders or members to plan for their business’ future—or face the possibility they may not have one.

What Kind of Company Needs a Business Succession Plan?

Every business is different, as is every corporation or LLC that owns and operates a business. A company with one owner has different succession concerns than a closely held company with several owners. And a closely held company where all owners participate in management has different concerns than a closely held company where only one of the owners runs the business. All of these companies’ succession concerns differ from those of a large privately held or publicly traded company which may have many owners but one person who is in control.

But one thing they all have in common is that the people who are running the company today will not run it forever. They may pass away, retire, or otherwise leave the company voluntarily or involuntarily. A business succession plan lets the current owners say what they want to happen in advance of the inevitable event. The goal is a smooth and quick transition with limited disruption to the business operations. A business succession plan benefits the owners, employees, customers, and other stakeholders of the company.

CONSIDERATIONS IN DRAFTING A BUSINESS SUCCESSION PLAN

Below are some of the considerations involved in drafting a business succession plan for three kinds of business entity clients a business lawyer may advise.

1. Solely Owned and Controlled Company

In the case of the solely owned and controlled company, what happens when the owner dies can differ depending upon whether the owner formed a corporation or LLC.

A corporation has perpetual existence. Upon the sole shareholder’s death, his or her shares become part of his or her estate, and in the absence of documents providing otherwise, will be inherited by his or her heirs. Those heirs will become the shareholders, but that might not be what the shareholder wants to happen.

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Perhaps the heirs are not interested in owning and running the company, or the shareholder doesn't think they can do a good job. In that case, the succession plan should include the drafting of documents providing for whoever the shareholder wants to own and run his or her corporation next.

In the case of an LLC, the statutory default rule in many states is that an LLC dissolves at a time there are no members. Therefore, the succession plan should include having a provision in the operating agreement for the appointment of a new member to prevent dissolution.

In the case of the sole shareholder's or member's eventual retirement, there is an additional consideration—making sure the business remains profitable enough to fund the owner's retirement. This often brings into play the need to start grooming someone to take over. Another option is to consider selling the company. The succession plan should include taking these steps within a reasonable period of time before the owner plans on retiring.

2. Closely Held Companies with Multiple Owners

Succession planning is more complicated when there are multiple owners. This is particularly true when the company is closely held.

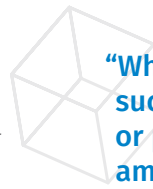
In closely held companies the owners may all participate in management and therefore depend upon each other for the success of the business. The shareholders or members who will remain after one of their fellow owners is gone will probably want some control over the choice of successor. Otherwise, they may be stuck co-owning and managing with people they don't know or like.

In developing the succession plan it is important to remember that the corporation statutes and LLC statutes treat the transferability of ownership interests differently.

In a corporation, the default rule is that corporate shares are freely transferable. The shareholder can freely sell his or her entire interest—financial and management rights—and the buyer becomes a shareholder with the same rights as the seller.

In an LLC, the default rule is that members can freely sell their financial rights but not their management rights. The person receiving the financial rights is an assignee, not a member, and can only become a member with the consent of the remaining members.

Those default rules can be avoided. A closely held corporation can have, as part of the succession plan, a shareholder agreement that provides for what will happen to the shares of an owner upon an event such as his or her death, disability, retirement, or termination. The agreement may, for example, give the corporation or remaining shareholders the right to buy the shares of the departing shareholder or buy them from the heirs. Or it might require the remaining shareholders' consent before the shares can be sold to a third party. An LLC can provide for similar transfer restrictions in its operating agreement.



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The succession plan for corporations and LLCs that are taxed under Subchapter S often include an additional restriction. Their plans will provide that the shareholders or members cannot sell to an ineligible owner—such as a business entity or non-United States citizen. That would make the corporation or LLC ineligible for S corporation tax status.

Not all closely held companies are managed by all owners. Some may have one shareholder or member who makes business decisions while the others have more of a passive role. The succession plan should also address selecting the person to replace this key decision maker. This may be a current owner or may be someone brought in from the outside. Grooming an insider to take over or taking steps to attract and retain skilled managers from outside the company may be part of the succession plan.

3. Large Privately Held or Publicly Traded Companies

In a large private or public company—in most cases a corporation—there will be a separation of ownership and management. The shareholders are passive investors with limited management rights and will be dependent on the board of directors and executive officers to make the decisions that will allow them to profit from their investment.

It is equally important for these companies to have a succession plan to replace the key decision makers. This is especially true where there is a controlling shareholder or a high-profile executive who is strongly identified with the

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company. Stock prices can fall dramatically when those types of leaders exit the company and there is no clear successor. We have seen this situation arise several times in recent years with key executives unexpectedly resigning or being fired due to assorted acts of bad behavior.

The succession plan for large corporations can include identifying people from within or outside the company with leadership potential and taking the steps to attract, groom, train, and retain those individuals.

WHEN SHOULD A BUSINESS SUCCESSION PLAN BE ADOPTED?

When is the right time to consider a succession plan? Optimally, when the person or persons first decide to go into business. For among other reasons, succession planning can be a factor in the choice of entity decision.

Corporations and LLCs differ in characteristics that affect succession strategies such as transferability of interests, duration, and management structures. It can also impact choice of formation state—as state laws that affect succession differ. In addition, it can be a factor in how the owners want the entity to be taxed for federal income tax purposes.

However, any existing company that does not yet have a business succession plan can benefit from implementing one.

Just as important is that the succession plan be reviewed periodically and updated when necessary. Circumstances change due to births, deaths, divorces, marriages, bankruptcies, terminations, and so on, involving the current owners or managers and their potential successors can require adjustments to succession plans. So too can changes to the corporation or LLC, such as a conversion to a different entity type, a redomestication, or a change in income tax status.

CONCLUSION

This article has discussed the importance for your corporation and LLC clients, and their owners, of having a business succession plan—as they need to replace key people. What that plan will consist of will be different for each client. No plan at all may seriously damage the current owners' hopes for their business to remain successful after they are gone. And a good business succession plan can help mitigate the risk of that happening.

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