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How A Succession Plan Can Save A Company During A Transition

By Ted Tafaro

As advisors we are the gatekeepers when it comes to protecting our clients from unseen forces that could potentially jeopardize their business. It's easy to sit back and watch Showtime's successful series *Succession*, which depicts an ailing media mogul (think Rupert Murdoch) ready to have his financial bones picked clean by siblings and children and believe "that could never happen to my company; we're not that big." But truth be told, no matter the size of a company, bad things can happen when a focused and well-thought-out succession plan isn't in place. And if your client's partners have spouses and children, the complexities grow exponentially.

Succession plans come into play when one of two major events occur: one inevitable, the other unpredictable. Death and disability are the two most common triggers in a succession plan, but as an advisor you should also note what your client's plan says about divorce, departure and disqualification.

No matter how successful the head of a company is, everyone has a sell-by date, and you need to plan for when that day will come. Who will step up? Few business owners want inexperienced and unqualified heirs of a deceased partner to have equity with a say in the management of the business. Nevertheless, this can happen when advanced preparations for such a possibility are not taken, and the business owners are in the difficult position of having to live with or buy out the heirs under a terrible set of circumstances. It's not uncommon for negotiations to become difficult to complete because the heirs don't typically have the same business background as the disabled or dead partner. If you and I are business partners and you say, "If I die then my spouse is going to take over," or "My college-aged son, Tommy, will take over because he's Mr. Personality," then things can quickly spiral out of control.

But the fact of the matter is that while we might always have death as the ultimate deciding factor, the truth is that there is a greater chance of becoming disabled than dying during their working years. And thus, the personal complexity of dealing with a disabled shareholder is often more complicated. They want to recover, the other shareholders want them to recover, but if they can't recover, the funding and the plan for dealing with a disabled partner needs to be established upfront to not only ease working through those issues, but to preserve the value of each partner's equity. And it's often a fallacy that people can still do their job effectively simply because their brain still works. A disability can cause chronic pain, concentration issues, limit travel and restrict one's ability to manage key customer, vendor and internal team relationships.

Fortunately, there are a variety of types of disability policies that should be considered, aside from ones that provide income for a period while injured. For business owners with several partners, we recommend examining disability insurance in a buy-sell agreement, which makes it possible for a disabled business owner who is entitled to a share of the businesses profits to be cost-effectively bought out, thus eliminating a disabling financial drain on the business or the other partners. Basic design provisions of buy-sell agreements may include:

• A lump-sum payment usually available after a waiting period often lasting typically one or two years.

• A series of annuity payments over a specified period, which is often two to five years after a waiting period of one to two years.

• A combination of the above two.

Cost: The cost of disability insurance is a function of the amount of the coverage, the risk of becoming disabled, the length of the waiting period and the length of the payout period. The longer the waiting period and the longer the payout period, the lower the premiums will be. The waiting period is defined as the period from the date of the accident or illness causing the disability to the time the benefit payments start.

Type: Business owners not only need to decide on the type of buy-sell agreement, but they must also decide whether to make the buy-out mandatory or optional. If the buy-out is optional the next question is, who has the option? For example, is the option given to the deceased or disabled business owner's family or the remaining business owners of the company?

life insurance marketplace. To illustrate, let's say Todd and Jennifer own a marketing agency where they both own 50% and the business is valued at $5,000,000. To fully fund their buy-sell agreement, they require $2,500,000 of life and disability on each partner. Easy work—the life and disability marketplace are robust, and the limit is very manageable. Now let's pretend that you are working with the same client five years later and the business has expanded tenfold, and the company is currently valued at $50,000,000. While the U.S. life market is filled with carriers that can underwrite a $25,000,000 term policy on each partner, U.S. disability insurance carriers have a benefit maximum of roughly $2 million per insured. This leaves advisors stuck doing only half the job and leaving a huge exposure to the company in the event Todd or Jennifer suffer a sudden disability.

Fortunately for advisors, there is a solution found in the excess lines market with underwriter's at Lloyd's of London. A Lloyd's of London coverholder in the U.S. can design buy-sell disability solutions with the individual limits exceeding $100 million per partner to fund a disability buy-out obligation for highly successful business, thus ending the reverse discrimination issue.

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Funding: Let's discuss funding that agreement. And how do you fund it appropriately? Is it funded with internal cash from the company? Is it cash that the company is going to utilize over the next decade and burden the company with essentially a significant debt load? What happens if the company can't take on or service the debt adequately? What's essential is to have the monies to buy the interests of the deceased or disabled partner at the critical time. When it comes to disability insurance, permanent disability is the most appropriate funding mechanism and the most cost-effective funding mechanism because it provides benefits in cash at the time it's needed. Permanent Disability insurance is also used because the trigger is permanency—most partners want to recover and return to work if they become ill or suffer trauma, therefore these agreements are written only to trigger a buy-out on disability in the event a partner cannot return to performing the material duties of their role.

What is unique to the disability insurance equation is the reverse discrimination that exists in the traditional disability insurance marketplace versus the traditional

Having worked in this industry for over 30 years, I would encourage all advisors to review your client base. Look at your 10 most successful business owner clients and ask them when was the last time they reviewed their legal agreements and funding mechanisms? Ironically, I know you will find that your best clients are most likely underinsured, and I can guarantee you that the largest asset on a business owners' personal balance sheet is the equity in their business.

Why do this? Here are three reasons:

1. It is the right thing to do for your best clients. They need to slow down and address these issues.

2. The disability planning area is grossly underserved and by bringing the exposure to their attention you've differentiated your firm.

3. It is the right thing for your business. The commission stakes are high.

The show *Succession* is meant to be viewed merely as a television program. But if you instead view it as a mirror showing what could potentially happen to your business without a solid plan in place, then now is the time to act.

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