Key guide

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Business succession planning

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Introduction

Be prepared

If you are a business owner, succession planning and insurance are important. Business succession planning is simply the process of planning for what you want to happen if you (or your co-owner) were to die or fall seriously ill.

If this happens, family and business partners can be left in a complex situation. In some instances, the business ends up in the wrong hands, or in worst cases can fail. This can all be avoided with sensible business succession planning.

Please note that all scenarios and examples included in this guide are fictitious.

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Succession planning for retirement

Retiring from your business as an owner or founder can be an emotional and difficult thing to do, especially if you have been in the driver's seat for many years. As difficult as it might be to tackle, it shouldn't be avoided.

Careful succession planning is key to securing the future continued expansion and profitability of your business. It secures the jobs of those who have loyally worked for the company for many years after you retire.

It can also offer you the opportunity to crystalise the value of the business and the blood, sweat and tears you put into it. That value could secure the wealth of your family for many years and for future generations, as well as give you a comfortable retirement.

Naming a successor

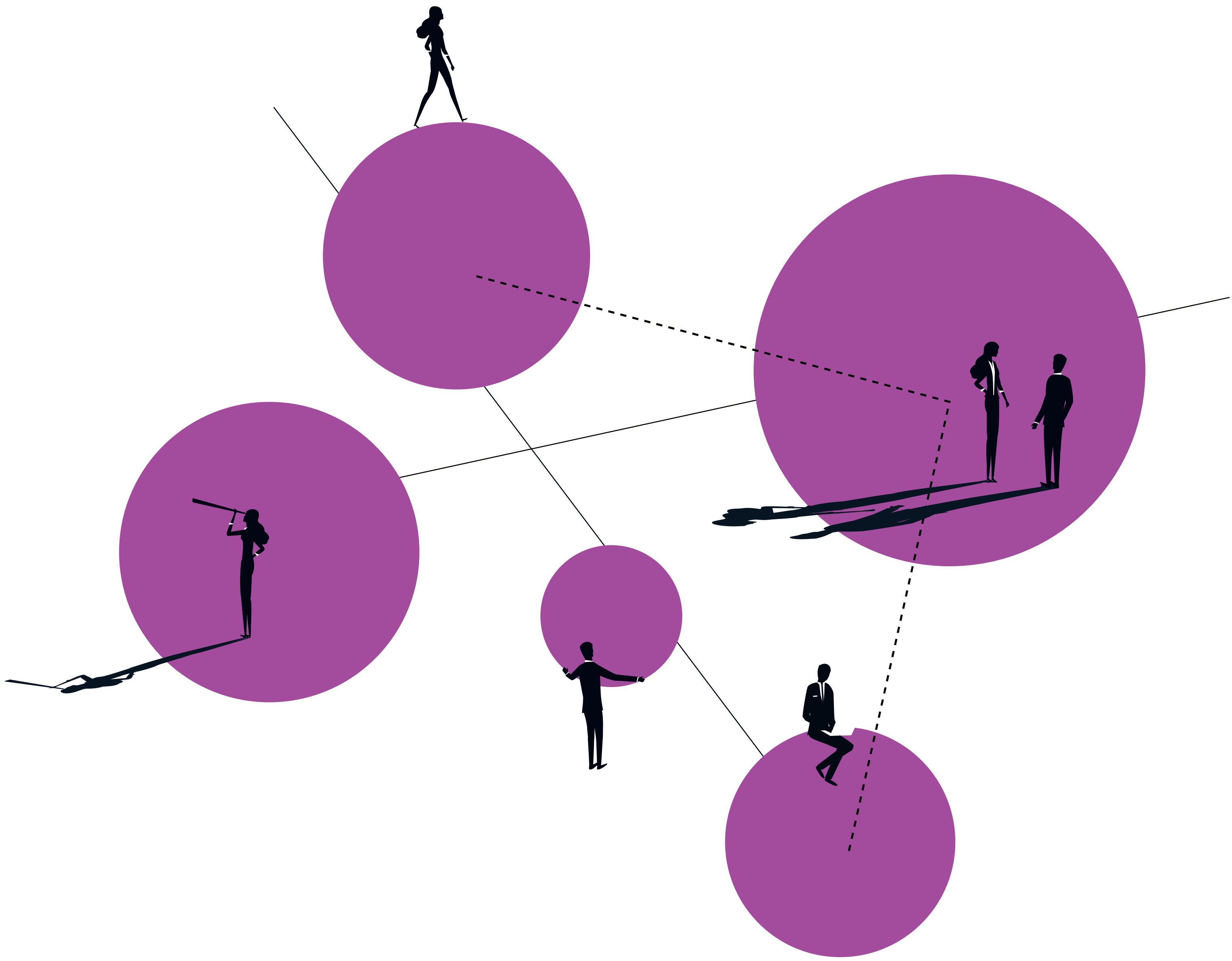
You could name a family member or manager in your company to be the successor of your business to step in after you retire.

Some advantages of this would be that it reduces third-party involvement and keeps your family business within the family if this is the case. There is also the possibility to maintain involvement and influence over the business when naming a successor you are close to. This could be a bonus if you're looking for a switched-on, active retirement.

It can however be difficult to identify and train the right successor, and there could also be some potential for conflicts at work and/or in the family. This option also does not provide an opportunity to crystalise the value of the business and de-risk your investment in it. You will be handing over the burden and responsibility for the business to the next generation, who may not want that burden.

If you own a family business it's wise to be mindful of your wider estate planning, especially if you have many children. You may have several children but only one that works within the business who would be the natural successor. Careful consideration is needed as to how to structure the succession of the business fairly and in the interests of all family members.

The first step when choosing this option is to establish the ideal profile for your successor. Then, identify and evaluate potential candidates using fair and measurable criteria. A legal adviser can help to facilitate discussions in a neutral and constructive space, helping to foster productive conversations.



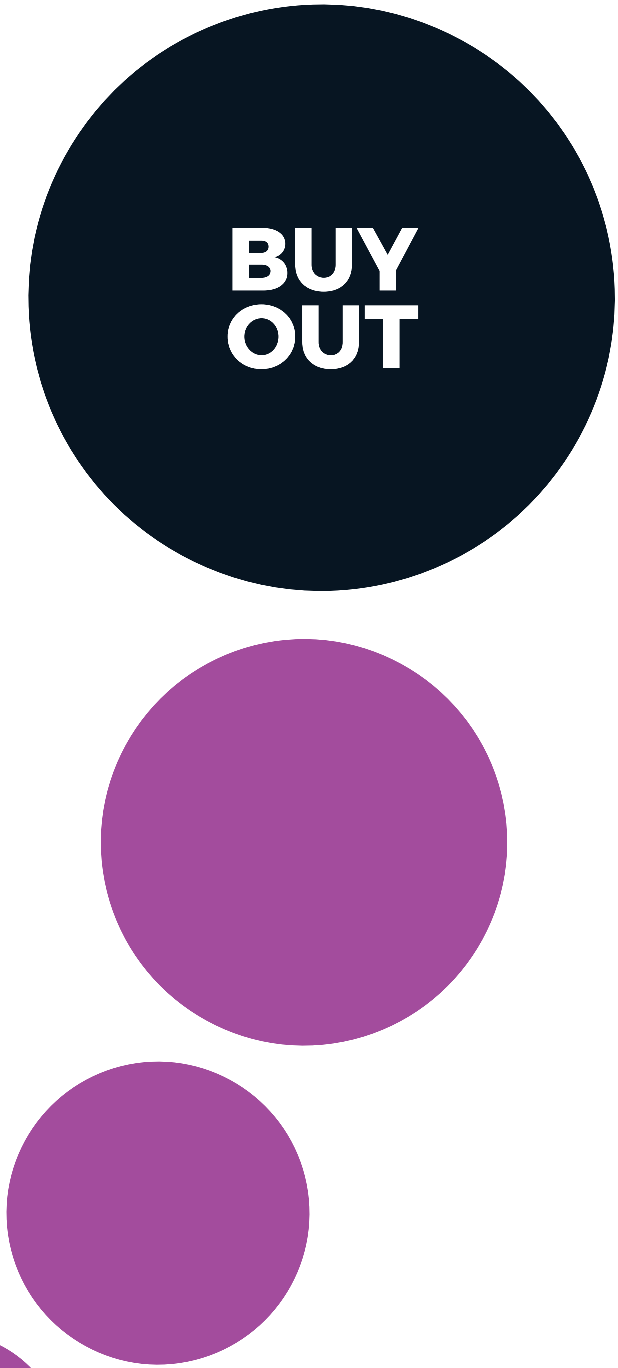
Management Buy Outs and Vendor Initiated Management Buy Outs

A different route for your retirement succession planning could be a Management Buy Out (MBO) or Vendor Initiated Management Buy Out (VIMBO). MBOs are when the senior management team acquire all or a part of the company often (but not always) by raising third party investment or debt. VIMBOs follow a similar process, with the difference that with VIMBOs the founder approaches the existing management team and enquires whether they would like to buy the company. This is commonly funded from the current cash on the balance sheet and future cash generated by the company rather than external funding.

This could be a good option if you are looking to retire but do not have a suitable candidate for succession within the family. It can also help to preserve the corporate culture of the business and allow you to crystalise some value from the business to secure the future of your family and your retirement.

Some of the advantages of a VIMBO is that very limited due diligence is required and minimal warranties are given by the founder, so it is a lower risk transaction. It also keeps third parties from investing in the business (i.e. maintaining its independence) and rewards the management team by giving them an opportunity to own and manage their own business with relatively little personal financial risk.

A MBO tends to be more complicated and can involve third-party investors (e.g. private equity) and debt. The personal risk for the management can be higher and the risk (i.e. warranties) and reward (i.e. higher price) can be higher for the founder.



Selling the business to a third-party

Another option you could take is to sell your business to a third-party such as a competitor, supplier, or customer.

When you're considering selling your business to retire, you need to plan ahead and prepare the business for sale. Any third-party buyer will scrutinise the historic and current performance of the business in great detail as they will be paying a higher price than your management team. You also need to consider your pre-sale tax planning.

There are several options for business owners who are looking to sell their business depending on the size of the business and the appetite of the marketplace.

Initial Public Offering (IPO) – The sale and/or issuance of shares in a private company on a public stock exchange. This is for larger businesses only.

Private equity – The sale and/or issuance of shares to a financial investor.

Sale to another business – The sale of shares to another trading business. This is a good option for shareholders looking for a clean exit and the highest possible value.

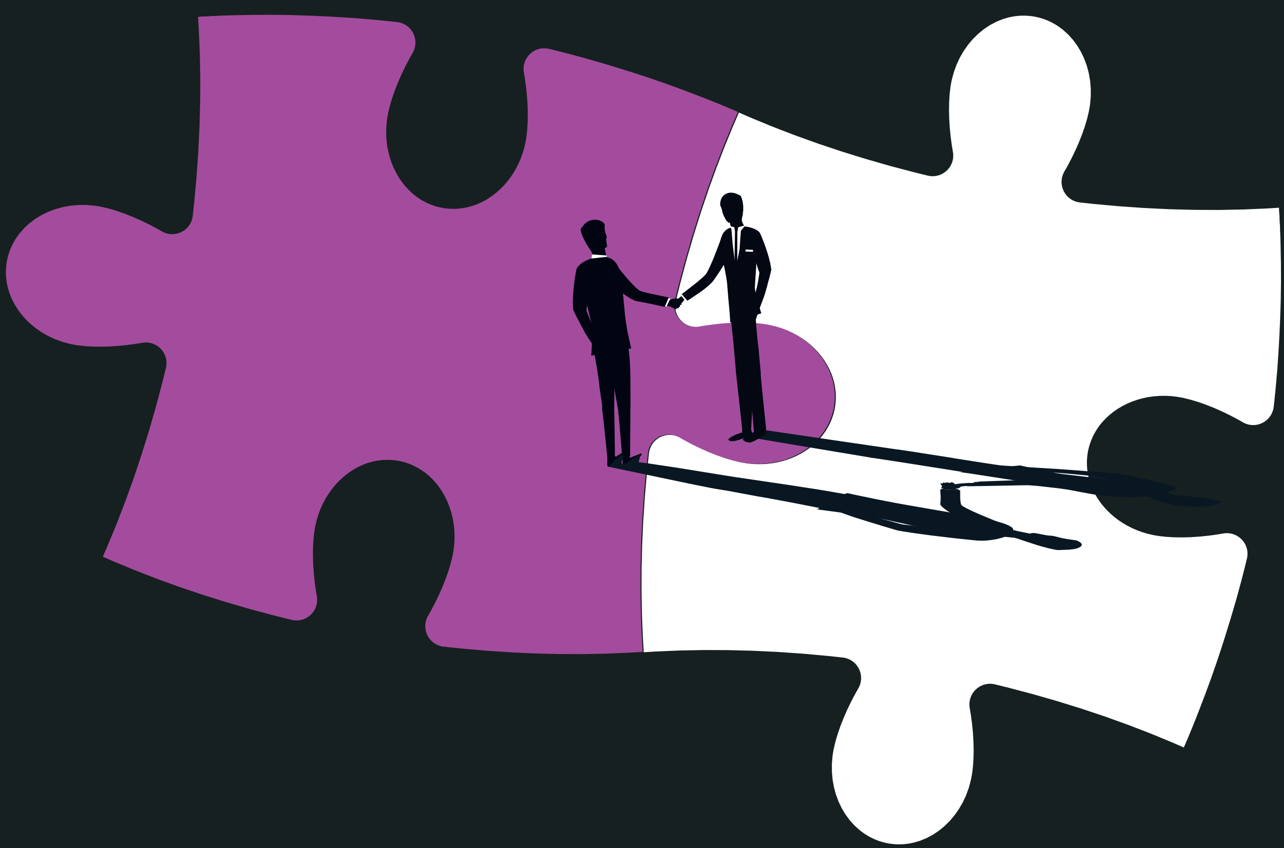
This could mean a fresh start for your company and a clean break for yourself as a business owner, setting you up to retire and focus on other things. Depending on your financial circumstances you could comfortably retire on the sale proceeds from the sale and secure the financial future of your family.

Selling the business to an Employee Ownership Trust (EOT)

The final option, which is a fairly recent development, is the sale of the business to the employees of the business. This involves the sale of more than 50% of the shares to an EOT who holds the shares on trust for the employees.

The two key benefits of this option are rewarding loyal employees by passing ownership and control to them and also paying no tax on the sale proceeds. However, this option is only appropriate for businesses with a strong second tier management team and a workforce that can work collaboratively. There are also a large number of HMRC requirements that need to be met in order to qualify for the beneficial tax treatment – legal and tax advice is imperative.

Similar to an VIMBO, it can be a low risk way to crystalise the value of your business using the cash on the balance sheet and the future earnings of the business, but you need to be prepared to let go of control.



Succession planning for death of a business owner

Having a succession plan in place is vital for when a business owner passes away. The legal position on the death of a business owner will depend on the type of business entity.

A limited company continues but the owner's shares will pass to the beneficiaries of their estate in line with their will, or the intestacy rules if no will is in place.

Companies continue after a shareholder's death, so the key to good succession planning is to ensure the shares end up with the surviving shareholders and the deceased shareholder's family receives compensation.

The issues

Generally, the deceased shareholder's beneficiaries will want financial compensation in return for their shares, assuming they do not plan to continue in the business. There may also be the need to pay off creditors on an owner-director's death and this should be dealt with separately.

Example:

Jane and John are co-owners of a limited company and Jane dies.

Jane's sole beneficiary, her daughter Kylie, is keen for the business to continue, and so is John, who could not afford to buy out Kylie's interest anyway. Unfortunately, Kylie is unable to play any active part in the business and John resents having to split the company's income with a sleeping partner who contributes nothing other than capital to the business.

John would probably still want to be able to run the business without having to worry about Kylie being involved, and Kylie would want to be compensated for giving up the share of the business she inherited.

The solution

A double option or cross option agreement is often used for company shareholder succession planning. If a shareholder dies, their beneficiaries can require the remaining shareholders to buy them out or the remaining shareholders can require the beneficiaries to sell their shares.

This means that John could insist that Kylie sells him the shares she inherited from Jane. It also means that Kylie could insist that John buys her shares. If neither of them exercises this option, however, the business continues to run with John and Kylie now being joint owners.

One advantage of a double option agreement is that it does not affect entitlement to IHT business relief. So, the deceased person's shares in a trading business can usually pass down to the beneficiaries free of IHT – unlike most other assets.

To provide the funds, each shareholder takes out an own life policy written under a special business trust for the benefit of the other shareholders.

Take expert advice as soon as possible. Planning for the unexpected now can help you work out what you want to happen to your business after your death.

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Succession planning for serious illness

Of course, it is not just the death of a business owner that can stop a business.

If a business owner suffers a critical illness such as a heart attack or cancer, it may not be possible for them to continue in the business, either temporarily or permanently.

Good planning can ensure that, should serious illness strike, the needs of the ill business owner, their family, business partners and co-shareholders can all be protected.

Let's consider a couple of examples:

Scenario one – Sanjeev

Sanjeev is a partner in a small engineering firm. He is diagnosed with cancer and is unable to continue to work.

His business partner, Chris, would like to carry on running the business and buy Sanjeev out. Unfortunately, he cannot afford to do this, and they end up with no choice but to dissolve the partnership and split the assets of the business.

Sanjeev gets less than he would have hoped for his share of what was previously very much a going concern and Chris is, in effect, left having to start again.

Scenario two – Anita

Anita is the managing director of a small retail company. She jointly owns the business with her brother David and sister Jenny.

Unfortunately, Anita suffers a heart attack and is strongly advised to work less from now on. She would like to step back from the business and ideally sell her shares to her siblings, but with no arrangements in place there is no mechanism for this to happen.

More importantly, David and Jenny have no funds to buy her shares.

In both these situations, a solution was available. Had they taken expert advice before the event, arrangements could have been made to ensure that both ended up with the outcome they desired.

A suitable critical illness insurance policy would have been the best way to provide protection against the financial consequences of having a serious illness in both cases. These policies pay a tax-free cash lump sum on diagnosis of a specified critical illness or disability. Critical illness policies do not cover everything although the latest version of the Guide to Minimum Standards of Critical Illness Cover published by the ABI states that new policies must cover at least cancer, heart attack and stroke.

When using critical illness insurance in these contexts, the policies are normally written in trust for the other business owners, along with an agreement between them about the circumstances in which the share in the business should be transferred. In this case a 'single option' agreement would allow the unwell owner the option of selling their shares to the others (who would have to buy) but would not allow the others to force the unwell owner to sell.

Businesses should ensure that their shareholder agreement is both current and relevant. In addition there should be a plan in place which sets out how the business will be managed in an emergency situation should owners or key members of staff become ill.

Scenario one – solution

Sanjeev and Chris could each have had a critical illness policy in place. Depending on how this had been structured, it could either have allowed Chris to buy out Sanjeev's share of the partnership, or simply provided Sanjeev with a cash lump sum, with the business automatically passing to Chris. In either case they would have achieved their desired objective.

Scenario two – solution

Had Anita and her co-directors each had a critical illness policy in place, it would have been possible for Anita to step back from the business without financial disaster for her or her siblings.

The business would have ended up in the hands of David and Jenny, whilst Anita would have been left with a cash lump sum to provide for her needs.

How we can help

When we advise clients about business insurance and succession planning, we start by finding out the most important issues in each specific case.

Once the structure of your business and your aspirations have been identified and prioritised, we can then recommend a suitable way forward.

In doing so, we can help you to understand:

- The options available and their costs.
- The tax implications.
- The methods of valuing a business.

The death or critical illness of a business owner can lead to unexpected or undesirable consequences for those left behind. Taking the opportunity to plan can help bring into focus what you want to happen to the business after a death or during temporary or permanent incapacity and to identify how best to ensure that this will actually come about. The Covid-19 pandemic has particularly highlighted how vital a contingency plan is to protect your business against the long-term impact of unforeseen circumstances such as these.

The senior team

Alistair Scott-Somers

Executive Director, General Counsel
and Director of Progeny Law & Tax

Prior to joining Progeny, Alistair worked for Eversheds, before being recruited by Premier Farnell pl (FTSE 250) to lead its M&A activity. Alistair also spent 8 years as a partner at national law firm, Bond Dickinson, and led the Corporate team in its Leeds office.

Alistair is an M&A lawyer with particular focus on private equity transactions, business angel investments and high growth owner-managed businesses and he has extensive experience of the transactions in the pharma, technology, fintech, food, leisure and chemicals sectors.

Zee Hussain

Director, Corporate Law

Zee is an experienced and trusted solicitor providing commercially focused advice to businesses, directors and senior executives, throughout the UK, on all aspects of employment law.

Zee provides pragmatic advice on a broad range of issues including executive severance and exit negotiations, disciplinary and grievance procedures, discrimination complaints, business reorganisations and TUPE. He has considerable experience of dealing with the employment aspects of corporate transactions and commercial contracts as well as advising on contractual disputes. As an accredited mediator he also undertakes workplace and commercial mediation.

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