Keys to Effective Succession Planning

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Succession Planning: A Vital Need Often Overlooked
Continuing the legacy of successful businesses, and especially privately owned or family owned businesses, is a key value and goal of succession planning. Owners of these businesses, however, who typically spend most of their days worried about gaining market share, hiring and retaining motivated employees, and outrunning the competition, usually fail to give succession planning any thought, much less seek advice about the subject. The reasons for their inattention to succession planning include: It requires business owners to confront their own mortality—which is the same reason many people defer or delay writing a will. Successful and energetic managers find it hard to imagine letting anyone else take charge, including a family member or key employee. For most business owners, maintaining control is central to their identity.

- Succession planning, a multi-faceted and complex subject, can appear daunting.
- Owners know any succession choice will likely alienate those who are passed over, potentially upsetting key people in the organization—who may leave.
- If employees include the owner's family members, family dynamics—good and bad—will be involved, making most owners dread succession planning.
- Most business owners simply don't know how to approach it.

Benefits of Effective Succession Planning Succession does not always unfold as the owner envisioned—for example with a trusted successor stepping in once the owner reaches a ripe old age. Instead, the owner may suddenly die, become incapacitated, or receive an employment offer too good to refuse—perhaps to become a university president or take a high-level government post. In these cases, business owners or their families may enter crisis mode, making hasty, and often ill-advised, decisions. Effective succession planning creates a stable and sustainable platform that helps to guide the company forward with a solid management team to assure management succession and an ownership structure that removes uncertainty about ownership succession. As we will see, ownership succession and management succession are two very different matters.

An added benefit of effective succession planning is the stability it offers lenders, investors, suppliers, vendors, and customers. It also preserves and protects one of the most critical, expensive, and often overlooked assets of any business—its people, who possess a wealth of experience, knowledge, and intellect. Partly because effective succession planning can serve as a powerful hiring and retention tool, it can perform double duty by also helping to address challenges that seem more pressing, like growing the business and beating the competition.

Like any other business strategy, succession planning is a tool and a process, not a cure-all. Effective succession plans will not singlehandedly bring a business new customers, greater profitability and market share, or improved employee relationships. **Succession Plan Components** A succession plan must clearly communicate a series of decisions that specify, among other things, how ownership and management will transition when certain events occur. While ownership transition and management succession are usually synonymous, they are not always linked. The owner should not blur the two concepts, which involve separate and distinct considerations.

Other key succession plan components include creating equity or equity-based incentives for key employees and effective evaluation processes—for the plan itself and for personnel.

An effective succession plan for companies that lack outside or independent directors, should consider adding this component to the corporate governance structure. The primary distinction between a succession plan and an effective succession plan is that the latter incorporates most of these components, creating a more holistic solution. Above all, an effective succession plan must be flexible, changing as the business evolves. **The Succession Planning Process** Every owner, business, and situation is unique—there is no such thing as one-size-fits-all succession planning. But effective succession plans share enough elements to suggest basic steps that can be adapted to meet the needs of a given business or owner.

- **Consider the various constituents.** To create an effective succession plan, the owner must first set the stage by considering the abilities of present management; the incentives, if any, that exist to hire and retain talent; and whether future leaders are already in place.

- **Identify the main characteristics a successor should possess.** No successor can, or should, be the owner's clone. New skills and ideas contribute to an effective succession plan and help the business progress. Current owners should work with their advisors to determine the talents and qualities most critical in a successor.

- **Determine how to find those most likely to fit the established criteria.** Options include an initial search by the company's board, both within and outside the organization; and the use of a professional search firm. The owner may also identify promising potential successors within the company.

- **Ensure a rigorous and inclusive selection process.** Even if the owner wants a particular child or another relative to take over the business, it is crucial to conduct a rigorous examination that assesses the strengths and weaknesses of several potential candidates. Key employees and others with intelligence about the business must be brought into the process, and included in the universe of potential candidates.

- **Make a decision.** Once criteria have been set and the search conducted, the owner must make a choice. Many succession plans fail because the owner goes through the process only to decide that no candidate is sufficiently talented, bright, or experienced. So, no decision is made. This demoralizes employees, increasing their sense of being disenfranchised. It also costs the owner credibility, making it extremely difficult to repeat the process.

- **Communicate the decision companywide.** This step involves a risk that someone who was passed over may leave. But the risk can be minimized if the plan is effectively communicated and a team approach is taken. For example, the risk of undesired attrition can be reduced by using the equity and equity-based compensation techniques described below.

- **Ensure periodic review of the plan's components and ultimate succession decision.** Simply anointing a successor does not end the process. As business circumstances change, the succession plan and its effectiveness must be reassessed. This is not an opportunity for owners to simply change their minds. Rather, it is a chance to refresh the plan's vitality and confirm the decisions made. The selection should change only if there is a significant modification in performance or business circumstances.

- **Address ownership succession.** The succession plan should include, or at least reference, other strategies the company will implement that go beyond management succession to address ownership succession.

- **Provide for emergencies.** Effective succession planning should identify processes or strategies for handling emergency situations, including death, incapacity, or unanticipated departure. Just contemplating these situations will help the owner, or the board, be prepared to make informed decisions as opposed to frantic ones.

Who to Involve in the Succession Planning Process A business owner should consult with a number of resources to help create an effective succession plan. Usually, over time, business owners develop relationships with trusted financial advisors, bankers, legal counsel, accountants, and colleagues. Additionally, the board of directors should play a strong role in creating and implementing the succession plan. However, it is dangerous to involve too many people. The result can be too much noise and not enough action. It is most important to include people with different perspectives so the resulting succession plan reflects a comprehensive approach.

It is also important to ensure that there is a formal method, which includes specific goals, objectives, and defined timelines, that allows the process to be monitored and evaluated as it proceeds. Specific tasks may be delegated to smaller groups. For example, some people may be tasked with determining how other similarly situated companies, perhaps including competitors, handle succession planning. An effective succession planning process must be subject to adjustments, modifications, and revisions as it evolves. **Succession Planning and Incentives** One significant byproduct of the succession planning process is learning that the company may need more depth and experience in certain areas. This realization may require making hires or exerting stronger efforts to retain key people. Creating successful incentives is extremely important for an effective succession plan.

The owner should consider both cash and equity-based incentives. The latter are often used to attract new hires and retain key executives while simultaneously allowing the current owner to effect a gradual change of the organization's control.

An employee stock ownership plan, or ESOP, might be appropriate for business owners who want to ensure their employees retain a significant stake in the enterprise. A detailed discussion of ESOPs is beyond the scope of these materials. Essentially, ESOP's are tax-advantaged structures that allow a company's employees to acquire ownership from the current owner. Numerous issues determine an ESOP's viability, and ESOPs are not solutions for many businesses. But in the right circumstances, they can be part of an effective succession plan.

Several other equity or equity-based plans can provide incentives to hire and retain key personnel. They include stock options, restricted stock purchases, stock appreciation rights, and phantom stock plans.

With the exception of ESOPs, the incentives described above involve incremental, as opposed to one-time, changes of control. They provide a platform that creates a group of enterprise owners who are presumably vested in the company's success. Because in most cases their ownership vests over time, these owners develop an increasing stake in the company.

In addition to these plans, which generally prove highly effective, an owner can use other techniques to shift ownership to a designated successor, whether family member or key executive. These strategies usually involve a direct sale of equity over time and with appropriate vesting schedules. As a result, the equity is effectively earned and paid for with cash, services, or both.

There are also numerous estate-planning techniques that involve transfer of ownership to grantor trusts and the use of single member limited liability companies. These are useful as part of an effective succession plan. These sophisticated, complex transactions can provide meaningful and effective strategies for succession planning.

All of these plans can be structured in combination. Many companies employ a variety of them, creating a wide spectrum of equity-based incentives for key employees. Each strategy involves significant legal, tax, and accounting issues. Owners should consult their tax and legal advisors to assure that these plans are structured and implemented in the most efficient and cost effective way. **Evaluation and Documentation** An effective succession plan should be in writing and rigorously referenced during the plan's implementation phase. This helps those responsible for implementation, keeps the process sustainable, and assists when evaluating the plan's success.

Senior management and the board should regularly review the plan to determine whether it remains effective or requires revisions. The succession plan itself must be as dynamic as the selection process. It cannot be viewed as an immutable, irrevocable document. Rather, it is an evolving expression of the future needs and goals of the enterprise.

It is equally important that ancillary aspects of the succession plan, especially those addressing ownership transfers, be thoroughly and carefully documented. This results in clarity and mutual understanding of the terms and conditions of ownership transfers. It also enables future beneficiaries to understand the plan's components, expectations, and mandate. This is especially important when addressing issues like performance criteria and vesting schedules.

When direct equity transfers—as opposed to deferred compensation plans such as stock appreciation rights or phantom stock plans—are involved, it is critical to execute a written shareholders agreement (or operating agreement in the case of a limited liability company). These agreements typically address issues related to management, governance, and equity transferability. They are essential to avoid, or at least minimize, future disputes over ownership, management and control.

Last, if the company lacks an effective personnel evaluation policy, it should consider implementing one as part of its succession plan. These policies help identify potential leaders and successors. They also provide a guide to successfully mentoring talent, and developing a broader, more inclusive management team.

Common Mistakes

Succession plan horror stories abound. Most succession planning mistakes, which can produce a host of unintended consequences, can be attributed to poor planning, lack of foresight, and inattention to detail. Others can be chalked up to owners who lack commitment to the process. They fuel dissension by wavering and failing to follow through.

In many ways, succession planning resembles any other strategic or business plan that companies undertake to identify new customers or markets. All require analysis, planning, commitment to implementation, monitoring, periodic evaluation, and adaptability, as well as buy-in from owners, family members, and key employees. Failed plans lack these components or inadequately focus on them.

An effective succession plan should not be considered an end. Rather, its continued success requires that it be viewed as a beginning.

Conclusion

An effective succession plan can guide a business owner, creating a roadmap for success. It can also help owners attract and motivate successful employees. When owners commit to creating and implementing effective succession plans that embrace comprehensive programs for transferring management responsibility and equity ownership, they can experience the rewards of creating lasting legacies for their businesses. Moreover, in emergency situations, an effective succession plan can literally save the company’s life.