

## **Business Succession Planning – Case Study**

Larry, Moe and Curly are the driving force with a small business with a total value of \$600,000.00. The break up of their interests as follows:

Larry \$200,000.00

Moe \$150,000.00

Curly \$250,000.00

The interest is owned in partnership.

### **Scenario One – No Business Succession Plan**

As many people do, they have not considered the consequences to the business should one of them die. They have no business succession plan and they have no life insurance in place.

The business is a growing entity, all participants have invested all their energies for the past 10 years to develop the business and is their primary source of income.

The unforeseen, Larry's death, unfortunately occurs.

#### *What happens now?*

As Larry, Moe and Curly did not have a partnership agreement which specifically stated that the business was to continue to trade after the death of one of them, by operation of law, the partnership is dissolved.

Larry's interest in the business, which they estimated to be worth approximately \$200,000.00, is now owned by his personal representative (Executor) for his beneficiaries pursuant to his Will.

The personal representative has many strict obligations in administering Larry's deceased estate. Briefly they are to collect in, sell and distribute the proceeds of the business interest to the beneficiaries, without consideration to the financial well being of the continuing participants.

As in most Wills, Larry's personal representative does not have the power to carry on business. The personal representative, on behalf of the beneficiaries, has the right to receive full profit distributions that derive from the business even though the personal representative does not, and can not, contribute to the running of the business.

**The business has become paralyzed.** Curly and Moe's income is drying up fast. The business value has plummeted. Larry's wife and children receive nothing like the \$200,000.00 his share of the business was worth before his death.

As regards to the distribution of the business interest, there are 2 likely possibilities:

1. Obviously Curly and Moe would like to be able to continue to carry on the business without the intermeddling of Larry's family and share the profits which they should receive by reason of their continuing efforts. Unfortunately Larry's personal representative must answer to the beneficiaries and can not give the business to Curly and Moe because the hand shake agreement between Larry, Moe and Curly is not good enough; and
2. Even if Moe and Curly convinced the personal representative to sell them the share of the business, how is the business going to sustain the funding of finance to purchase Larry's interest?

In short, because Larry, Moe and Curly have not considered the possibility that one of them may die, the business has been brought to a stand still for the surviving people, the income to support their families has dried up, and their primary asset has fallen in value. Imagine what would happen if a dispute were to arise.

Fortunately, these problems can be avoided entirely by planning for this eventuality.

#### **Scenario Two – A Business Succession Plan**

Larry, Moe and Curly are smarter than most and they have been fortunate that they have had professional advisors knowledgeable in the pitfalls and solutions of business succession planning.

With the co-operation of their accountant, a solicitor and a risk advisor they have put in place a business succession plan. The primary purpose of this document is to cater for the situation where one of the parties dies.

The scheme funds the transfer by the use of life insurance which is paid to the surviving parties to fund the rights which the document gives them to complete the transaction.

Again, it is Larry that suffers his unfortunate fate.

#### *What happens now is clear.*

Consistent with the insurance policies that Moe and Curly had in place, Larry had a life insurance policy sufficient to cover his interest of the business, plus an amount to cover transfer costs and any capital gains tax that may be payable. In accordance with the policy of life insurance that Larry had, Moe paid \$75,000.00 and Curly paid \$125,000.00. The difference in the payment directly reflects the size of the interest which they have in the business.

In accordance with the terms of the business succession document, Larry's interest, worth \$200,000.00 will be transferred to Moe and Curly being 62½ % to Moe and 37 ½ % to Curly.

Moe is now the owner of that share of the business worth \$225,000.00 and Curly is the owner of that share of the business worth \$375,000.00. This has permitted the business to be redistributed between the partners in a fair and equitable way without strain on the cash flow of the business or indeed any need to delve into their resources at all.

Larry's family is now looked after as his estate has received the full benefit of the value of the business which will be distributed in accordance with the terms of his Will.

This scope for dispute between his family and the participants of the business has been dramatically reduced.

Every interested party got what they wanted, the business was not jeopardised and the possibility of dispute at a stressful time lessened.

*The above case study involves a business run in partnership. This same principle can be applied to a business run through a unit trust or a company. There may be as few as two or as many as ten or more participants.*