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How to Prepare Your Business for Succession

By Ian Mount
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Allen Frechter took over the family business, Plexi-Craft Quality Products, after his father passed away.

Piotr Redlinski for The New York Times

WHEN his father died in 2006, Allen Frechter thought that his work as executor of the estate would be fairly straightforward.

But then he looked under the hood of his father's firm, Plexi-Craft Quality Products, a manufacturer in New York City of acrylic furniture. Mr. Frechter's father, George, had worked until the day before his death, at 86, and like many small-business owners, he had made no plans for what followed.

Purchase orders were still handwritten. There was no list of best customers or products. There was no data and no way to analyze the company's performance. So Mr. Frechter, 49, wound down his own home-improvement firm in Boston and started commuting to New York to run Plexi-Craft. He moved it to a cheaper location and had an employee spend 250 hours entering six years' worth of customer data.

Not only did the firm survive, but Mr. Frechter expects it to double its annual revenue to $5 million by 2012. But many are not so lucky. Business owners who do not form a succession plan create a time bomb that can not only destroy their companies but tear apart their families. "A lot of families fight and fight until the business is gone," said Jim Clay, who heads the trusts and estates department at the law firm of Morrison Fenske & Sund in Minnetonka, Minn. "It eats up everyone's inheritances."

Here are some suggestions to avoid a succession disaster:

IDENTIFY YOUR SUCCESSORS Deciding which child or relative will sit in the corner office is often so emotional that it can stop succession planning before it starts. But it is the necessary first step. "You have to make an honest assessment of your children," said Robert W. O'Hara, owner of O'Hara & Company, a financial planning firm in Chelmsford, Mass., that specializes in exit planning for entrepreneurs. "Don't assume the next generation has the same skills."

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Succession specialists advise business owners who can afford it to put their possible successors through rigorous outside analysis. Steve Swartz, a family-business consultant based in Minneapolis, has them answer career and management questionnaires and then sit for interviews and testing with industrial psychologists. Each candidate goes over the results with the psychologist to put together a skill-development plan.

The advantage to creating a scientific and merit-based process, Mr. Swartz said, is that it not only finds the best job for each member of the next generation, it takes the emphasis off family politics like birth order and gender.

Mr. Swartz recently finished this process with seven siblings and cousins who were vying to take over a family business and wound up choosing the new leader among themselves. "They decided one of the nephews should be C.E.O., not one of the children of the C.E.O," Mr. Swartz said. "And they were quite pleased that this was evidence that they had relied on business criteria."

PREPARE THE NEW BOSS If a child or other relative expresses interest in taking over the family business, the owner should set up a formal system of hurdles to make sure the child gets the skills required of any other prospective manager.

"Send your kids to work somewhere else for some time until they get a raise and promotion," said Bernard H. Tenenbaum, the founder of China Cat Capital, a consulting firm in Princeton, N.J., focused on family-owned consumer products companies. "It gives them self-respect and brings fresh blood and ideas into the family business."

Before Jos Zamzow and Callie Zamzow Novak, a brother and sister in the fourth generation of family ownership, came to work at their family's specialty products company, Dynamite Marketing of Meridian, Idaho, their father told them to work outside the business. The two spent about five years working in stock brokering, insurance sales and retail before they put in résumés at the family firm. "We took regular jobs at the company, jobs that we had to apply for," said Jos Zamzow, who is 36 and now the vice president for manufacturing.

"It wasn't a foregone conclusion that they would have a place," said their father, Jim Zamzow, 62. "Our family way has been that you have to earn your way in. I haven't found there's much value if you're gifted something."

When a family has finally decided who will get the company's reins, it can also avoid sibling power struggles by not passing on shares — especially voting ones — to children and other heirs who will not be directly involved in the business. Instead, they should receive houses, retirement accounts or life insurance.

DEAL WITH CRUCIAL EMPLOYEES Often there is no family member who is interested in and capable of taking over the business. And even if there is one, tensions can drive out important nonfamily employees who feel overlooked. To ensure that a new leader does not lose top lieutenants, it can be smart to offer them a piece of the pie. Personality-based consultancies and similar firms can be particularly devastated when a top partner takes his clients elsewhere.

In 2003, as Michael H. Bill Jr. was taking over MJ Insurance from his father, he brought in five top employees of the Indianapolis-based company as minority owners. He still owns 88 percent of the voting stock in the 130-employee company, which makes $23 million a year, but top employees now have a 30 percent nonvoting stake and 15 percent more is in a stock-buying program. "The goal," said Mr. Bill, 42, "is to create a good platform for long-term succession beyond myself."

Keep in mind: If there are no family members or employees who are willing and able to take over the business, a sale may be the best option.

COVER YOUR TAX EXPOSURE Until this year, a spouse could inherit a business tax-free, but any other relative had to pay up to 45 percent on any estate valued greater than $3.5 million (the estate tax lapsed at the end of 2009, and its extension is unresolved).

To avoid a tax hit and keep the business in the hands of its partners, owners should have their business valued by a neutral source — to assign each owner's share a dollar value — and then buy "key person" life and disability insurance policies on each partner.

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When a partner dies, this money is used to buy the stake from his or her spouse — who should be obligated to sell through a legal “buy/sell agreement” — and to pay estate taxes.

In addition, the buy/sell agreement should cover how partners who leave through retirement or disputes will be paid. Mr. O’Hara of O’Hara & Company says a typical agreement spreads the payments over at least five years at the current prime rate — to avoid crippling the company because of a business dispute.

There are other options. When the fifth-generation family owners of Schoedinger Funeral and Cremation Service, a chain of 11 funeral homes based in Columbus, Ohio, prepared a 15-year plan to pass on the company to the next generation, they used a mix of grantor retained annuity trusts and family limited partnerships.

These accounting vehicles lower tax liabilities by letting a family discount the value of the shares and real estate being given, sometimes by more than 25 percent.

When there are no heirs, family business owners who want to cash out without selling the firm to an outside buyer can set up an employee stock ownership plan.

This kind of plan creates a market for the company where employees buy shares from the owner, thus giving the owner liquid wealth while keeping the company in employee control. These programs can cost up to $100,000 to set up, said Mr. O’Hara, and might not be appropriate for the smallest of firms.

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