

be prepared

Succession planning is central for all professional businesses to avoid problems should the unexpected occur.

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The effectiveness of a professional's business plan is directly related to the quality of advice provided. The team of Chartered Accountant/financial adviser, specialist lawyer and the risk specialist must work together to structure an effective plan. But even with great advice, the implementation is actually more important.

Succession is not simply about retirement. The main options to exit a business are by way of a planned exit or an exit due to critical illness or death. Some of the typical benefits of having a well-constructed and implemented succession plan include:

- > providing the practice with certainty and the finances for survival
- > providing the exiting partner or their estate with their agreed value
- > retention of key management and staff in the practice
- > ensuring the bank and guarantor issues are appropriately managed
- > considering the tax efficiency of the insurances and payouts
- > allowing for an orderly change of ownership, with less emotional distress.

Whether it is a business owner or a partner in a professional practice, the needs are essentially the same. Both require choices on how to best manage the business and its future, to ensure it survives after a key principal exits via retirement, critical illness or death.

The ramifications can be daunting. Many professionals and business owners are failing to protect their business and the financial security of their family.

A CASE STUDY

Paul was the senior partner and a major shareholder with three others in an expanding accounting practice with a total equity value of \$2.8 million and business loans and overdraft of \$800,000. The facilities are the subject of personal guarantees by the partners.

Paul and his spouse Alison who both had previously been married and between them were raising and caring for four dependent children. They had some personal insurance to protect the outstanding home loan debt and provide some funds for the family in the event of Paul's death. The partnership had no formal business succession agreement in place. The partners had discussed many times over the years the importance of doing this, but never got around to actually doing it.

Paul was killed in a motor vehicle accident with a current will leaving everything to Alison. This included his share of the business.

Alison found herself effectively having a majority interest with the remaining three partners. The practice continues to operate. Alison, however, doesn't want involvement in the business but wants the equity/goodwill in cash. She will gladly give up her shareholding for this, although she is considering holding the asset if the price is not fair, as she needs the money for her family.

The problem of course is that the desired outcome for Alison and especially the remaining partners cannot be resolved easily. The practice is now in survival mode with Paul's clients to contact and assure that they will be looked after by the practice even though many would only deal with Paul. Current matters that Paul was handling have

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to be reallocated, staff will need to be reassured and possibly found different positions in the company. During all this Alison is grieving and devastated and is effectively now the major owner of the practice with an unacceptable degree of control.



With no agreement on the value of Paul's shares, arguments as to the valuation may arise. Verbal undertakings by Paul to his fellow partners that "I will look after you when I sell down" are undocumented and worthless. Additional costs will be incurred to determine an amicable result. Arbitration may be needed and what will be the value now that Paul, who was the senior partner and a key person, is no longer around? The remaining partners will have to borrow funds to buy Alison's equity, find a suitable buyer or leave Alison as a shareholder.

Alison's need for a substantial payout is not what the partners want to hear as their current concern is to address the management of the business.

BANK ISSUES

Further, the bank has raised gentle concerns about the impact on the business. They have indicated they want additional security from all remaining shareholders (including Alison) or will consider calling in the debt.

Death or disability of a guarantor to a business loan/overdraft is often listed in the loan guarantee clauses on security as a default event that permits the lending institution to request new or additional security. Paul's partners are already heavily geared and may struggle to meet the bank's requirements.

The bank is also looking at Alison's proceeds from Paul's self-owned life insurance to secure the business debt rather than allowing Alison to extinguish the home loan and provide a nest egg for her and the children. Alison is not only facing the tragedy of losing Paul but at the same time suffering further financial hardship with the real possibility of having to sell the family home just to survive. The bank also has security over the home.

This sounds like a real nightmare for all concerned - sadly it is also real. The situations above could have been avoided.

Succession agreements are designed to allow the outgoing partner to sell and the continuing partners to buy the equity in the business. Most importantly it allows for the orderly management of the transition when the

outgoing partner leaves the practice. It also avoids the financial stress if that plan is accelerated because of an unexpected death, disablement or critical illness.

The above situations would have been very different with a proper plan in place. Alison would have received the agreed value of Paul's equity via life insurance. No dispute over the value would arise. The other insurances would have been kept for the family. The bank would have little concern as a key-man policy on Paul would have reduced the debt. The remaining partners would incur little financial pain and own the share of the practice as Paul intended.

Consider your own practice arrangements. Are you one of the few who have formally addressed succession planning? Many people avoid the topic. It is considered as a negative, complicated and expensive discussion that is difficult to get started. It needs to be dealt with in a structured and sensitive manner by an independent and experienced professional or risks falling flat.

The role of the Chartered Accountant/ advisor is to ensure that the practice

is valued, the method of value documented and to look at related tax issues. The solicitor will prepare agreements for all parties to join in that will give certainty that there will be a smooth exchange of equity and control.

The risk adviser is providing advice as to what funding mechanisms can be put in place to meet unplanned events, cost comparisons and the type of business insurance contract to evaluate. Expertise is also required in placing insurance and ensuring underwriting is managed for competitive costs. It is simply about an insurance policy. The combination of insurance funding or vendor funding payouts is really a cost/benefit analysis that is decided by the parties.

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