Legal Perspective

Leaving the Legacy You Choose

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You have built your business from the ground up. You have nurtured and grown a legacy for your family. You want to retire. What will happen to your business when you leave it? We should start with a few statistics for those of you who think you've "got it covered."

- 12% of all family businesses are construction related
- 80-90% of all construction businesses are family-owned
- Only 33% of family-owned businesses survive into the second generation
- Only 20% of closely-held construction companies survive to the next generation
- 60% of business owners that plan to retire in the next five years do not have a succession plan in place

Succession planning is more than a simple will

Ask yourself the tough questions. What are your retirement needs? Do you have a realistic perspective of your financials? What do you plan to do after retirement? Do you want to maintain your current lifestyle?

Keep in mind that any owner must be independent from his or her business in order to have a secure financial future. You will never actually retire if your economic future is dependent on the continued success of your business. Workable succession requires an independent new owner who is ready to transition into the company. In the construction industry, that means you will no longer guarantee payment and performance bonds for your company—which might be good news for some readers. While considering your family's needs, the wishes of possible successors, family dynamics, the repercussions to your employees, your clients and business partners, also consider your retirement from the business.

The Gift that keeps on giving

There are many ways to transfer ownership of a business. Selling or gifting your business to family is popular, but it's usually not the best choice. It is estimated that 70% of construction companies are sold or gifted in some form to the owners' children or employees, 20% of companies are liquidated. Only 10% are sold to outside companies.

If you are considering passing your business on to your family, be aware that a sale or partial sale that results in immediate payment automatically incurs tax liability. Proceeds from the business sale are taxable to the owner's estate, which means you may owe more in taxes than your estate is actually worth. Usually a family member must acquire the funds necessary for the company's purchase from another source outside the estate, which could take the form of a new, and undesirable, business loan.

A better alternative is a transaction structured to remove the value of the company from the owner's taxable estate or a transaction that reduces the company's taxable value while providing a future stream of income for the owner. A trust is one way to maintain control over your company, while shifting the assets to another entity, the trust. You can then receive income, payments from the trust, for a specified term. During this term you can safely monitor your successor's management of the business. At the end of the term, the remainder of the trust and the business will go to the designated successor/family member. The trust will still pay taxes on the business assets, but at a much lower rate than estate taxes.

Managing the succession

Succession planning does not guarantee that the value of the business will withstand transfer of ownership, which is another reason new owners should not incur new debt. When management succession is ignored, the outcomes are frequently bad. You've probably heard stories of a business liquidated at a "fire sale" with the owner receiving a fraction of the value of the business.

The difficult decision regarding who will take control is often determinative of the business' continuing value. Choosing wisely does not mean automatically placing younger generation family members in management roles. Family-centric succession can leave even the most experienced and invested family members ill-prepared to handle company responsibilities. The dynamics of a family business are much different from a publicly traded company and special care must be given when naming a family member successor. The challenge is to select one or more children to successfully run the business before ownership changes while at the same time providing satisfying roles for other family and management members.

While publicly traded companies typically have committees or staff solely responsible for identifying future CEO's, small companies do not have this luxury. When there is no clear choice in the family, one option is to groom one or more key employees. Another option is to hire an outsider with industry experience and a solid reputation to manage the business. Bringing in outside management must be considered carefully and discussed with all important employees. You don't want your best to feel unjustly passed over; having your top team members quit puts the new company at risk.

One component of your company's value that should not be overlooked is your credit. Your reputation with your lenders and sureties is as crucial to the future of your construction business as your clients.

Training your successor

Once a successor management team has been chosen, it is important to continue training. Your wealth of knowledge is vital to the continued success of your business. It may take a substantial period of time before a successor is ready for a seamless transition. A long transition period is also important for employee morale and retention. As the successor works in the business and gains knowledge, he or she will also gain the respect of other employees. It is difficult enough transitioning from an original owner to a successor; it is even more difficult when your employees worry about the ability of future management to effectively run the business.

What's the REAL value of your business?

Valuation must be addressed prior to an ownership change. In the construction industry, there are special considerations that could cause the value of your business to be minimized. These variables include the competitive bidding process, a heavy dependence on only a few customers, the risky nature of the industry causing wide fluctuations in profitability, the importance placed on the personal relationships and knowledge of the individual rather than the company. These intangibles are hard to value in a numerical sense. As a result, selling owners often feel that their company is not fairly priced.

Don't forget about your credit

One component of your company's value that should not be overlooked is your credit. Your reputation with your lenders and sureties is as crucial to the future of your construction business as your clients. Lenders and bonding companies reward successful contractors with great credit and are rightly concerned when company ownership changes hands for any reason. Sureties know that when construction companies fail, most often it is due to succession problems. In an industry where knowledge and relationships are success indicators, lenders and bonding companies are wary of ownership changes.

As a result, many bonding companies require written business and succession plans before issuing credit; they may also require the owner to provide a personal guarantee as a condition of securing a bond. Roughly, 92% of business owners personally guarantee bond credit. Typically, minority shareholders, with 15% or more of the ownership, are also required by bonding companies to provide a personal guaranty. Unless your bonding company allows new management to issue a new personal guaranty releasing you, the liability for any personally guaranteed bond credit remains with you, even after you leave the business.

When several parties have personal liability for bond guaranties, succession planning can be even more challenging. New shareholders may be worried about signing guarantees; existing shareholders may be required by the bonding agency to continue their personal guarantees until the successor management is proven. Your risk of owner liability and successor default can be minimized by including terms in your business succession documents that provide you protection through liens on the company's assets. Liens, and other reservation of rights, allow you to set benchmarks that monitor the health of the company and its performance as it changes hands. With these precautionary steps, if the company fails under new management, you have rights and can take action to protect your company and assets.

Strengthen your business and your future

Part of planning succession is looking at what is vital to the continued success of your business and what can be changed or improved. A financially and functionally strong business is in a better position to withstand a management and ownership change. Early succession planning reduces taxes and helps you chose the right successor, lessening the financial impacts on your business and your risk upon retirement.

Planning enables you to build value, create an enviable retirement, and leave memorable legacy for your family. Build a strong and secure future for you and your family, start now.

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