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Succeeding in Succession: Grooming a Successor

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Succeeding in Succession: Grooming a Successor

Identifying potential successors to take over a business is often a monumental task. But the succession planning process should not end once potential successors have been identified. Developing potential successors so that they are capable of taking over once the owner is gone is a crucial next step.

The process of developing a successor should be just that - a process. A succession plan that merely consists of identifying the person who will run the company once the owner dies or retires is unlikely to be successful. Think of handing over your car keys to someone who has never driven before. Even if that person has been riding in your passenger seat for years, being behind the wheel is a completely different experience, and it can easily end in disaster. Although the process of teaching someone to drive is established and well known, the process of developing a successor to take over a business is generally obscure.

So the question for business owners is, once I've identified my successors, what should I do next?

Although there is no single process that will work for every business, developing successors should generally involve:

1. Communicating the succession plan
2. Getting successors committed to the plan
3. Evaluating the successors' abilities
4. Transitioning operational knowledge and skills concerning the business

Communicating the Succession Plan

Business owners are often concerned that once they communicate the succession plan they will lose the ability to change it. Losing flexibility is certainly a legitimate concern, but communicating the plan does not mean the owner can't change it, particularly if the owner appropriately sets expectations.

When the business owner communicates the plan, he or she should do so in such a way that it is clear that circumstances may change. The business owner may decide other persons within or outside of the company may ultimately take over, or the business owner may elect to sell the business to a third party. Retaining the services of an advisor who is experienced in succession planning can help ensure the plan is communicated appropriately. An advisor can also help business owners determine to whom the plan should be communicated and when.

Although business owners often feel that communicating the plan is risky, failing to communicate the plan is risky as well, and we have seen it have disastrous consequences or business owners both personally and professionally.

A business's constituents, particularly its employees and customers, thrive on clarity and stability. If the business undergoes a sudden and unexpected transition, the resulting uncertainty can sink the business quickly. Additionally, a potential successor who does not know that he or she is being considered to take over may leave the organization in search of such opportunities elsewhere. In the family business context, a family member who thinks he or she is going to be the successor will be stunned and angry if the owner suddenly exits and announces someone else is taking over.

Again, communication is key. The business owner does not have to give up the flexibility of changing his or her mind by telling the successor of the plan. Rather, the business owner can make it clear that this is the direction that seems best right now, but the situation may change due to a number of factors.

Getting Successors Committed to the Plan

Another key step is to get the successor to buy into the succession plan. A business owner does not want to invest time, effort, and money into training a successor only to have that person leave the company before taking over. Or in a potential disaster scenario - start a competing business. Engaging a lawyer who is experienced in succession planning can be particularly helpful in this area. There are numerous strategies and techniques that can be used - trusts, buy-sell agreements, and confidentiality agreements to name a few - that can be implemented to protect the business owner while incentivizing the successor. Indeed, business owners are often surprised at the flexibility and number of options a practitioner experienced in succession planning can offer.

One common and very useful method to get a successor committed to the succession planning process is to give him or her a stake in the company's profits.

We often recommend to business owners that they use phantom equity or another form of deferred compensation to incentivize their potential successors. Typically, the reaction to this recommendation is poor. Most people understand the concept of having an equity interest in a company, but they are unfamiliar with the concepts related to deferred compensation. (Referring to the technique as "phantom equity" doesn't help either.) The unfamiliarity makes people uncomfortable, and they are often afraid to ask questions or admit that they don't fully understand the concept before dismissing it in favor of the more comfortable "traditional" equity. But phantom equity is often a much better choice from the business owner's perspective because it provides the successor with a long-term incentive tied to the company's success while not providing the successor with voting or other statutory rights that owners of actual equity receive. Even "non-voting" equity often carries rights to certain information about the company and may be entitled to vote on critical transactions affecting the company.

If traditional equity is used, the most important thing to do is have a buy-sell agreement in place. The buy-sell agreement controls the transfer of the equity and can provide, for example, that if the successor dies, quits, or is fired, he or she must sell the equity back. Importantly, the terms of the buy-sell agreement do not have to be the same for the owner as the potential successor, meaning the owner can maintain the flexibility to give his or her shares to a spouse of family member if something happens to him or her without having to provide the same flexibility to the successor. Other common techniques when providing potential successors with equity include giving them non-voting interests, making the equity subject to vesting, and issuing the equity to trusts instead of individuals.

Evaluating the Successors' Abilities

A critical task for business owners is to identify potential successors' knowledge and performance gaps. In other words, areas where the successor needs to improve or fill the gap by hiring someone who does excel in that area. Although the business owner taking a critical look at the successor is important, it also important that the potential successor receive this feedback. In other words, the perceived gaps should be communicated to the successor, and the business owner and the successor should develop a plan to fill those gaps. Retaining an independent consultant to help the business owner with this process can be extremely valuable, particularly when the potential successor is a family member who may be sensitive to receiving this sort of critical feedback directly from the business owner.

Transitioning Operational Knowledge and Skills Concerning the Business

A business owner is likely to have trade secrets and relationships that have been key to a business's success, and it is essential that these secrets are shared with potential successors to increase the likelihood of a successful business transition. If, for example, the business's key customers do not have a relationship with the successor before the business owner steps aside, they will be less likely to stay with the company once the transition occurs. The business owner needs to effectively assist in developing rapport between the successor and key relationships. Often, business owners are concerned about sharing knowledge with successors, particularly those who are not family members, because they are concerned about the person leaving and competing. That risk can be mitigated by having confidentiality, non-competition, and similar agreements in place. An attorney can be extremely helpful to creating an environment where the business owner can share knowledge relatively safely.

Planning for Success

Preparing a successor is just one step in the succession planning process. And as can be seen by the many and varied issues discussed above, the succession planning process is multi-faceted and difficult to achieve successfully. The single best step business owners can take to increase the chances of successfully transitioning their businesses is to engage outside professionals who are experienced in the succession planning process to help them identify and avoid potential problems. These professionals have seen what can go wrong, and will help make the process work for your unique situation.