

Business Succession Topical Issues

We have all heard the noise around business succession, the ageing demographic and the wave of business sales to come. Interestingly, the predicted large numbers of business owners retiring and selling their business has not quite eventuated.

There are a number of reasons for this. Business owners are now working longer than previously. Sixty is the new fifty and seventy the new sixty. In addition, the Christchurch earthquakes impacted on many businesses both positively and negatively. Some business owners are seeking to "hang on" to their business to rebuild it post-earthquake, while others are retaining their business to "make hay while the sun shines". Business succession first became a topical issue with banks, accountants and lawyers prior to the earthquakes with a number of publications and workshops dedicated to the subject. In a way, business succession became a kind of "Y2k". There was supposed to be a wave of retirements and business sales but instead we have really only seen a steady trickle.

What is certain is that the issue has not gone away and the purpose of this article is to recap on some key points, options and pitfalls to consider.

Preparation and planning

Advisers and funders regularly emphasise the importance of planning for retirement and business succession. However, this often falls into the too hard basket given all of things a business owner needs to do to keep their business running. In our experience, a good way to engage clients on succession planning is to emphasise the opportunity it can provide and the

consequences of not doing so. If a business owner is too busy to engage then this is usually an early indication of the business being too dependent on the owner. Planning for a sale may involve expanding the business, through organic growth or acquisition, in order to take the business to another level where a higher multiplier will be paid. It might involve new systems, infrastructure or employees to de-risk the business so that it is not so dependent on the current owner. It can take up to 2 – 3 years to prepare a business for a new owner, especially if there are financial or accounting matters to work through during one or more accounting periods, or if there are important valuation and structuring considerations to work through.

Generally speaking it is a good idea for the business owner to put themselves in the shoes of a prospective purchaser doing due diligence. What concerns would they have? What can the owner do now to improve the attractiveness of the business to a prospective purchaser? Advisers can play an important role in this by conducting various forms of financial, tax or legal due diligence to identify the types of issues that prospective purchasers would be looking for.

Premises

The business premises can be both an opportunity and pitfall. If the business owner owns the premises and it is particularly valuable to the business, there is an opportunity to transfer the premises to a related entity (say a family trust) which then enters into an arm's-length lease with the business. On the sale of the business the owner retains an investment and income stream through the lease. Where the business owner leases the premises, the terms of the lease can represent an impediment to the sale of the business if the terms are not favourable. For example, if the rent is above market or the term of the lease is relatively short with no guarantee of renewal and the premises are in a key location. The business owner will also need to be aware that an assignment of the lease does not absolve them of their obligations under the lease and they will

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remain liable in the event the assignee defaults (at least for the balance of the term). Consideration of the premises, whether freehold or leasehold, is important in any succession exercise.

Current accounts and shareholder loans

If the sale is structured as a share sale, large current accounts or shareholder loans can be an impediment. This is because the purchaser will need to not only purchase the shares, but also purchase the current account or shareholder loan. These can be substantial where the business owner has left money in the business over the time to fund expansion. Of course, if the sale is structured as an asset sale, the issue does not arise as the shareholder current accounts are not acquired, so the proceeds from the sale are used to repay the shareholder current account advances and loans. An asset sale is often preferable from a purchaser point of view, as they will not inherit the liabilities of the business, but a share sale is usually the most simple and practical way to sell the entirety of the business (as all of the assets will simply go with the company when the shares are transferred). It is, however, important to ensure that all of the business assets sit in the company, and not with the owner, a related party or an employee. In particular, it is vital to ensure that all of the IP developed in the course of the growing the business actually sits with the business. If any IP was contributed to the business on start-up, this will need to be assigned to the company (which should also be the default position for employees).

Controlling the share register

It is important to consider the ownership structure and share register prior to selling the business. Regardless of whether it is an asset sale or a share sale, the sale will be a major transaction and the vendors will need to be able to obtain support from any other shareholders in the form of a special resolution approving sale. Where the vendor wants to sell the entirety of the business, it needs to deliver all of the shares to the purchaser and an unwilling minority could prove a stumbling block.

Preparation for sale may involve the buyout of a minority shareholder to tidy up share register prior to exit. Drag along rights are very beneficial in these situations, as they allow the majority shareholder to drag minorities into a sale to a third party. Pre-emptive rights (i.e. rights of first refusal) will be need considered and if there is an employee incentive scheme some consideration will need to be given to how this will be treated in a sale scenario.

Succession from within

Increasingly, business owners are looking within the business to a senior manager or managers as the natural successor or successors. If the business is highly profitable and likely to attract significant interest then a trade sale to an outside party is the preferred course to maximise value. But this is not always the case. For sentimental or commercial reasons it may be preferable to sell to management. This this is commonly structured as a gradual sell down over time and the vendor leaving money in the business. This does create risk to the vendor as there is not a clean exit, but the risk is usually outweighed by the desire to see the business left in good hands. The risks can be managed by the vendor remaining involved in the business until their investment is repaid (e.g. vendor finance). Sometimes a business owner will look to find a successor outside the business to introduce as a junior partner, with a view to that partner buying them out over time.

Half in, half out

Succession is not an all or nothing process. The vendor of a business may seek to sell some of their interest to a strategic investor, with a view to enjoying the growth and benefits that follow from this new relationship for a period of time before finally exiting the business at a later date. In this situation, it is important for both parties that there is certainty around the timeframes for the vendor's final exit. There should be arrangements around the ultimate buyout price, such as an agreed formula or a fair value determination mechanism).

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Death and disability – key man insurance

Despite the best laid plans for succession, an intervening health event can disrupt this with the death or permanent disability of a shareholder. Ideally there should be life insurance in place for the benefit of the remaining shareholder or shareholders to fund the buyout of the shares and current account of the deceased or permanently disabled shareholder. Sometimes the value of the buyout price and cost of insurance is too great for this to be practical. In this case, expert advice can be obtained to ensure at least part of the share parcel can be purchased with the insurance proceeds, with funding being obtained for the balance.

Important role of professional advisers and bank

The business owner's accountants, lawyers and bank play an important role in the succession process. The business owner needs to understand the advantages of planning and the options available. Early engagement with the bank is very beneficial as many of the options require bank support, particularly if there is a desire for succession to happen from within.

Want to know more?

For more information please contact our commercial law specialists [David Goodman](#) or [Josh Williams](#).