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Purdue Institute for Family Business

Quarterly Newsletter

Winter 2022: Succession Special Issue

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First Steps in Succession Planning

Krista Pullen, Renee Wiatt, and Maria Marshall

Succession planning is one of the most important pieces of the future of a business, yet it is often overlooked or created and placed on a shelf to be forgotten. The 2012 Intergenerational Farm & Non-Farm Family Business Survey showed that only 28% of respondents have identified a successor and 72% had not. If starting a succession plan has not been a priority for your farm or business, the best time to start is today.

There are 2 major goals that contribute to a succession plan being successful. The first goal is to keep the business strong enough and healthy enough to last to the next generation. The second goal is to continue a healthy family into the next generation. Initially it sounds easy, but these two goals are often difficult to manage at the same time because they can conflict with each other. Successful family businesses manage the interactions between the family and the business, and also know where to put boundaries.

There are 5 steps to think about when beginning to develop a succession plan.

1) Select the successor.

2) Create a survival kit for the successor.

3) Groom the successor.

4) Promote an environment of trust and respect.

5) Cope with the financial realities of estate and gift tax.

When thinking about adding a family member to the business, considerations must include management, policies and financial proficiencies. Once you add another family member, you have entered the realm of human resources. This often comes with conflict management, reviews, and increased need for communication. Its important to make sure that you have the proper management practices and policies in place to keep hiring policies, compensation upon hiring, advancement, hierarchy, review processes, job descriptions, and expectations consistent across employees. Without the proper financial proficiencies, family members hired in can quickly create conflict in the family and the business. It is much easier to address concerns when expectations have been set at the beginning of the working relationship than when the conflict arises.

Successors need a variety of skills to be prepared to take on ownership. They need financial abilities, technical knowledge, negotiating ability, leadership qualities, communication skills, juggling skills, and most importantly commitment to the business. Sometimes an owner will encourage the successor to take an off-farm job that will help develop their skills in a certain area before coming back to the farm. By taking an off-farm job, potential successors have the opportunity to manage people and work with mentors to develop management skills that they will bring back to the farm when the time is right.

Before selling the business, an owner must address some important questions to help the negotiation process move more smoothly. Questions could include:

- Do you want to continue your involvement in the business if the new owner asks you to stay on?
- If you decide to stay on to help in the transition, how involved do you wish to be, especially if the new owner has plans for significant changes?
- How much must the business sell for to earn you a comparable income?

The answers to these questions don't come easy as they impact all relationships involved. Family members might have different expectations upon selling of the business than what the owner had planned. A successful succession plan takes communication and work from all of the individuals involved. A carefully considered and thought-out succession plan can be helpful in creating expectations and in providing a framework for implementing the steps needed for an efficient transition.

Insuring Your Farm Assets to Value

Courtney Schmidt

As a successor, protecting the value of the assets to be handed down is a priority. One way of managing this risk is to be sure that your farm assets are properly insured. When was the last time you self-audited your farm insurance policy? Now would be a good time to look over the values placed on your implement sheds, livestock barns, and grain storage systems. Undervaluing these farm structures is a common issue on farm insurance policies. With the rising cost of building supplies, those insured values can get too low pretty quickly. The old insurance rule of thumb for valuing a grain bin was $1/bushel. Would that be enough to replace it today? Not likely.

So, what happens when you have replacement cost valuation written into your policy but have been insuring the structures for less than what it would take to rebuild? Nothing, until you have a claim. When you have a claim and the adjuster determines that you are not insuring that structure to the correct value, there will be a co-insurance penalty on the payout. Most insurance policies require the insured to maintain a certain percentage of the replacement cost value of their structures to avoid being penalized; this is usually 80-90%. To determine the payout on your claim, insurance companies use a formula:

Did Carry/Should Have Carried X *Loss Amount = Claim Payout (less deductible)*

Let's use an example. Straight line winds take apart some down spouts and a tower grain dryer on a grain system that is insured for a limit of $300,000. The accurate replacement cost value of the grain system is $500,000. The co-insurance percentage is 80% on the policy. This means that the farmer should carry a limit of at least $400,000 to get a full claim payout. Eighty percent of $500,000 is $400,000. The total cost to repair and replace the damage is $125,000.

Now you use the formula; "did carry limit" divided by "should have carried limit" multiplied

by "the loss amount" would yield the following: $300,000/$400,000 X $125,000 = $93,750. The claim payout will only be $93,750 less the deductible. Another way to say that is, you only insured your grain system to 75% of the value you should have, so your payout will only cover 75% of the loss. The rest of the cost to repair and replace the damaged grain system will come out of your pocket. It may be worth your time to take out the insurance policy and run a quick check over the limits just to see if you are comfortable with the values.

Barriers to Developing Your Succession Plan

Jenna Nees

Owning a farm or business can be stressful and cause you several headaches. One headache could be the result of thinking about the future of your business and wondering how to pass it on to your successor(s). Farm and business owners need to realize that they are not alone in feeling the stress related to developing a succession plan. This stress is caused by barriers that either prevent you from wanting to develop a plan, make it more difficult to start developing a plan, or may slow your progress down when updating the plan.

One of the first barriers we are going to talk about is getting buy-in from all interested parties. This means the current owners of the operation need to understand the reason behind having a succession plan and the potential implications if a plan is not in place. Likewise, all future heirs need to be brought into the conversation and understand how the succession plan could impact them. It may take time to get the initial buy-in from all interested parties, but it is needed in order for the plan to be successful.

Not only do you need buy-in from all interested parties, but you also need to have good lines of communication. Another common barrier to developing a succession plan is the breakdown of communication. To help prevent the breakdown of communication, schedule set times for meetings about the succession plan, have an agenda developed before the meetings, and set ground rules that ensure everyone will be given a chance to voice their opinion. Additionally, the ground rules should state that respect should be given to everyone and the meetings will not take place during family events or at the kitchen table.

The last barrier to succession planning is not knowing where to start. One of the easiest ways to get started is by setting the initial meeting where everyone can openly and honestly discuss their hopes, dreams, and wishes for the business. Again, part of this meeting should include setting ground rules for all future meetings. Once you have a better understanding of everyone's hopes, dreams, and wishes, you can move on to the next step which is forming your succession planning advisory team.

Potential advisory team members include an attorney, certified public accountant, certified financial planner, insurance agent, lender, and a facilitator (extension educator, management consultant, respected peer, etc.). Out of all potential advisory team members, the most important one to have is an attorney that you trust and understands your industry (i.e. agriculture vs. another industry) because they will be providing you legal advice and developing legal documents. As you develop your succession plan, it is important to make sure all advisory team members are on the same page and at least meet annually or bi-annually to ensure everyone is organized and understands your succession planning goals.

Overcoming the barriers and developing your succession plan can be a daunting task. However, it is a task that every farm and business owner needs to face in order to succeed the operation to the next generation. The earlier you can get started on developing the plan and overcoming the barriers, the better off you will be at a later time. It is important to realize you are not alone as you struggle to overcome these barriers and your advisory team is there to help you be successful.

Operating and Buy-Sell Agreements

Ed Farris

Transferring the farm from one generation to the next is often a tedious process. Working with an attorney to provide qualified legal advice is an important aspect of the succession planning steps. Prior to spending money on legal and financial advice, the owners and future owners should consider the following questions:

- Who can join the farm?
- How will they become owners?
- What terms are set on compensation if equity and contributions are not equal?

An operating agreement will address the owners' roles and responsibilities inside the business entity. When an entity such as a Limited Liability Company (LLC) is established, it is critical to formulate a formal business protocol. I have heard lenders express disappointment that an operating agreement was not established at the formation of an LLC. The parties involved simply did not take the time to outline roles and responsibilities in advance of seeking a line of credit.

Common provisions of operating agreements include:

- Business profile including names of shareholders, business address, proof of registration with Indiana Secretary of State
- Terms of capital contributions by shareholders
- Owner titles and responsibilities
- Liability – both personal and business
- Authority – owners' abilities to access LLC accounts, decision-making for specified responsibilities, voting rights, owner meeting schedule
- Personnel – HR decision-making protocol, new owner selection criteria
- Ownership and compensation
- Dissolution and non-compete protocols
- Signed and dated to execute

A buy-sell agreement should also be a part of an operating agreement. This document establishes entry and exit terms for concurrent owners and ensures business continuity. Key considerations include the condition of business at entry/exit date and the influence of market conditions. Determining a pricing method and price is critical for tax purposes. An arm's length contract must exist.

If times are good, many farm/small business owners believe reinvesting profits back into the business yields an especially good return. The challenge is how to extract that value upon retirement, disability, or death of shareholders. There are options for funding a buyout. This is typically set up with current cash flow, loans, life insurance proceeds, or through asset sales.

The option of life insurance is most appealing when purchased at the time the insured is young and healthy. A disadvantage is that there is no payout for voluntary exit of an owner. Funding with cash is simple, although there is uncertainty about timing and amount. For a loan, the parties must decide how much for how long and at what specific rate.

Consider the time/dollar cost of developing the operating and buy/sell agreements as an investment in your farm/small business. There is a huge upside potential and limited downside risk!

Four Common Issues in Succession Planning

Kyle Weaver

The most difficult decision that a family business has to make is to whom the family business will be transferred, or who will become the successor of the family business. The presence of a named and identified successor can greatly impact how the owner of a family business decides to operate the business and also how he or she makes decisions, both in relation to the family and the business.

The importance of an effective succession plan for farm families cannot be understated, however it is estimated that 72% of farm and non-farm family businesses have not identified a successor, according to the 2012 Intergenerational Farm and Non-Farm Family Business Survey. While there are many barriers that family businesses face when developing a succession plan, here is a brief look at some of the common obstacles that often get in the way of successful succession planning.

1. Avoidance of Issues Which are Uncomfortable to Discuss:
It is often difficult for families to speak about or imagine a scenario where their loved one has passed away or that the family farm is no longer in the family. These crucial conversations are typically uncomfortable for everyone involved and is a large factor for the avoidance of early succession planning.

2. Dividing the Family Business or Farm Assets between Heirs:
Fair isn't always equal. Parents are often hesitant when deciding how to keep the farm business stable while dividing their assets among their children.

3. Desire to Avoid Conflict among Family Members:
Conflict among family members while developing a succession plan can be nearly impossible to avoid, and can cause the planning sessions to become unproductive. To avoid conflict, strive to develop effective communication skills, establish regularly scheduled family meetings, and aspire to see succession planning as a lifelong continuous process.

4. Resistance to Change:
Transferring ownership and management of the family business requires change. Change for many farm families is an uneasy topic and the process of transferring to the successor can take several years. Intra-family succession is about 6.5 years for the transfer of ownership and management. An independent advisory team can help your family deal with the complex issues of succession planning and help ease the resistance to change.

COST: $49

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This material is based upon work supported by USDA/NIFA under Award Number 2018-70027-28586.

The PIFB team of Maria Marshall and Renee Wiatt have filmed videos to kick off the *Family Business Video Series.* The videos in the series are linked below. Continue to stay engaged with our Institute and our YouTube Channel as we release more videos.

- What is a Family Business?
- Social Structure of the Family
- Fairness and the Family Business
- Dealing with Conflict
- Measuring & Evaluating Family Functioning

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