Insurance smooths transitions

Business transitions are often the key to unlocking a company's enterprise value. No matter the type of transition – a merger, a leadership change, an equity investment, or the sale of a business – owners are expected to have thought through the risks that could threaten the business and its value as an ongoing concern. Insurance and insurance-funded benefits are powerful, yet underutilized, tools for mitigating risks and safeguarding the value of a business during a transition.

"When it comes to transitions, the expectation is that risks are actively managed and covered. There's really no room for surprises or unfunded events," says Duncan Moseley, managing director, Business Transition Advisory Group at Truist Wealth.

Value creation to value protection

Middle-market business leaders, whether shepherds of long-standing family businesses or managers of growth-oriented enterprises, rarely have risk mitigation as a core skill. Explains Ryan Clodfelter, regional insurance strategist at Truist Life Insurance Services, "Delicate events in a business's lifecycle – like transitions – have very specialized risks, and many leaders don't have a risk analysis mindset or experience dealing with these infrequent events. They miss the opportunity to use insurance and benefits to take those risks off the table and avoid the business disruption they can cause." In many cases, a bit of insurance can be a small price to pay for continuity and value protection through a transition.

There are many transition risks to consider. Three include: unplanned transitions, retention of vital managers and staff, and funding payouts.

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77%

Unplanned transitions

Transitions are common for middle-market businesses – 77% of businesses either experienced one in the past five years or expect one in the next five.[1] The key players in a business, those who create, grow, and sustain the company's value, can die or become incapacitated and trigger a transition.

Loss of a key player exposes a company to several risks. First the business can lose the talents of that person. If they are truly "key" to the organization, that can put the value of the business at risk. Second, that departure can be magnified by business disruption after the loss. Productivity can drop as employees experience shock and grief. Shifting responsibilities and an executive search to fill an important gap can sap momentum. Third, ownership governance can become an issue. A surviving spouse or partner can unexpectedly be thrust into a more active role. Moseley says, "A company can suddenly find itself with a partner they never chose and who may not even know the business. Ownership discord and divergent goals are a recipe for disaster in a closely held business trying to recover from a loss." To replace the deceased's income or to pay estate taxes, surviving family may need to secure cash at a time where the greatest asset is the business. "That can put pressure on the company to pay dividends or sell a portion of the company. The easiest way to reduce that friction is to buy the family's ownership," says Clodfelter.

In each of these situations, key person insurance can provide funds to make it through the unplanned transition. If the owner is the key employee, that often means funding share buyout payments to the surviving family (protecting against the potential loss in value due to the passing of the key-employee owner) and having enough operating cash to get the business through the transition. With the loss of a non-owner, insurance could be used to offset any decrease in company value without the key employee, cover added business disruption expenses or provide additional liquidity for an unplanned transition.

Attracting and retaining vital managers and staff

Businesses need to retain valuable managers and employees during a transition. Russell Sanders, managing director, Business Transition Advisory Group at Truist Wealth, explains, "A company's value rests with its people. Value is based on a business's continued generation of results and earnings, and it's the staff and management running the business who can react to the economic shocks, competitor initiatives and customer needs to keep results coming."

Sanders adds, "I recall a conversation with a client who recently went through an unsuccessful transition. The deal fell through because the buyer, a private equity firm, wanted the owner to stay on for five years. This was too long, and one of the things the owner learned was that he was too important to the day-to-day operations of the business. He needed to beef up management so that he could exit on his timeframe."

Carefully constructed benefit plans can help attract and hold onto staff. Executive benefits including restricted shares, phantom stock, and non-qualified deferred compensation and retirement plans can provide the upside that retains key managers and employees during a company transition like a sale or major investment. Clodfelter explains, "91% of large employers use supplemental executive retirement plans. 70% of these discriminatory, customized plans are used to recruit and keep key players. This is a terrific way to retain talent through a transition using upside and compensation as an incentive and without giving up equity."[2]

Funding payouts

Agreeing to a valuation at transition draws a sharp line between the value created by those leaving and the value managed by those staying. Funding some or all a buyout at transition provides cash for the departing owner to move on and makes for a clean break. Insurance can provide the funding discipline and payout funds to support these transactions.

Clodfelter offers an example, "Traditionally, law firms had junior partners buy out the departing senior partners. But, in today's world, more junior partners want flexibility to move, to match to a spouse or partner's career or to have a more lifestyle flexibility. They don't want to buy in. Using insurance, some firms structure a sinking fund to buy out the departing partners. This secures

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funds and guarantees that senior partners have a path out (and don't block the path of junior partners.)"

Professional practices provide another example of businesses that typically distribute most of their cash annually and can benefit from insurance-funded payouts. By establishing a funded exit plan, practices can better facilitate the smooth transition of a partner departing the practice without overburdening the business, while still maintaining an attractive offering for new partners.

It is not uncommon for owners to want to leave a business at different times. Taking on debt or tying up cash flow based on a buyout formula may provide liquidity to the exiting partner, but it can drain a business's cash going forward. Corporate-owned life insurance can be used to create a sinking fund for a potential future buy-out while also providing a death benefit.

The insurance also supplies an attractive pre-transition balance sheet asset. "Taking funding issues off the table goes a long way towards making sure transitions happen at the time that is best for the company," Mosley notes.

No surprises

The key to successful transitions and getting your company through the changing of the guard rests with planning. "Often buyers, particularly strategic acquirers and private equity investors, expect that you have covered key persons and set up benefit plans to retain managers through a transition," says Clodfelter.

The same goes for any significant businesses risks. Sanders warns, "When a buyer finds one chink in your business, they assume there are other uncovered areas. Unless you want to have endless due diligence, have everything buttoned up.".

Making insurance part of your transition. Talk to your relationship manager or Truist Wealth advisor for referral to an insurance strategist to determine whether insurance can best be used in your transition planning.

[1] National Center for Middle Market Report, 2019
[2] Plan Sponsor survey

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