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A smart perpetuation plan

Every professional, independent agency owner needs to answer perpetuation questions. Here are a few: When do I want to reduce my workload and transfer much of the day-to-day management to others?; When do I want to retire?; Do I want to pass ownership to a family member or key employee in the agency?; What should I do if no one in the agency is capable of assuming ownership?; If I sold the agency to a third party, what are the ramifications?; What are my other perpetuation options?; and Where do I begin?

These are challenging questions for any business owner to contemplate, which causes some owners to delay until they only have one option—to sell the business. However, if you learn about your options now, you will be better prepared to move forward and develop a plan that suits your needs. A good place to start is to examine internal versus external perpetuation. And, while every deal is different, outlined below are typical arrangements.

Internal perpetuation

Internal perpetuation is the sale of agency stock, ownership units or assets to producers, employees or family members now employed by the agency—or soon to be brought into the agency. Internal perpetuation arrangements include the following characteristics:

- Future agency cash flows will be used to repay the debt service to the selling owner.
- Deals are structured with a fixed price, to be paid out to the selling owner over seven to 10 years.
- An employment contract usually is provided for the selling owner, for whatever time frame the seller wants (and the agency can afford).

External perpetuation

External perpetuation is the sale of an agency to a third party, outside the agency. Third parties generally are a local agency, a regional agency, a national broker or a bank. External perpetuation arrangements include the following characteristics:

- Future cash flows of the purchaser will be used to repay the debt service to the selling owner.
- Deals have some retention or earn-out component, and are paid out to the selling owner over less than seven years.
- Either a short-term employment or consulting contract or an arrangement wherein the selling owner becomes a commission-only producer, is sometimes provided.

In order to be certain that external perpetuation makes sense to the selling owner, consider the issue of timing.

Timing considerations

For the agency principal who wants to slow down, before ceasing to work, internal perpetuation offers the most flexibility. In internal perpetuation, the owner of the agency sells the agency to his or her key employees or family members in the agency. Most new buyers are willing to give the seller a long-term employment agreement (e.g., five years), which can be tailored to the seller's wishes.

In the case of external perpetuation, long-term employment contracts are rarely the case. Often the employment contract is for only one or two years and then is renewable on a year-to-year basis at the option of the buyer. Often, buyers want to change the culture of the purchased agency, so sellers should not expect long-term employment beyond the original deal's stipulations.

Decide when to prepare the employee in the agency to assume management responsibilities. In internal perpetuation arrangements, the process is reasonably clear because the seller will make all the important decisions. He or she decides who should be trained for the ownership position. He or she decides when the person should assume a management position; what the scope of that position should be; what the necessary training is to prepare the candidate; and when the training should begin.

In an external perpetuation deal, the process is less clear. The seller does not know who is going to buy the agency or the needs of the buyer. Some potential buyers want a second line of management and some do not. The seller may spend time and resources to train someone to manage the agency, only to find that a third-party buyer does not need the person in a management position. Such a buyer might reduce the price offered if he or she plans to terminate the unnecessary manager and is concerned that the manager will pirate some business. On the other hand, if the seller does not position the agency for sale by developing a second-line manager, many other potential buyers will not consider purchasing the agency. These latter buyers often feel they need a trained second-line manager to take over the reins when the present owner leaves.

Quality-of-life considerations

How will the buyer treat the seller after the sale? If the seller wants to work, selling internally is much more predictable regarding how people will treat the seller after the sale. In internal perpetuation, the buyer/former employee (who purchased the agency) admires and respects the seller, which means the buyer and the agency employees are likely to treat the seller with respect after the sale. Additionally, since the seller is secured and guaranteed by all of the assets of the agency, he or she has implied power within the agency. In a well-structured internal sale, the seller secures the promissory note by the personal guaranty of the buyer, an agency guaranty and a pledge of all the stock and assets of the agency. For the employee who purchased the agency, this represents everything he or she owns.

However, when a third party buys an agency, the personality and behavior of the new owner is less predictable. The seller knows how he or she was treated by the buyer during the courting period, but has no assurance the treatment will be the same after the deal is closed and the honeymoon is over.

Financial considerations

For the seller who needs to get all of his or her money out of the agency in the shortest time possible, internal perpetuation may not be a viable option because agency employees rarely have the financial resources to pay the seller over less than a seven-year period. However, for most sellers, paid outs over a longer period that stretch out the tax consequences are a satisfactory option. In these cases, internal perpetuation can work well provided certain actions happen in advance. First, select the right ownership candidate. Next, work to assure the terms of the sale are affordable to the buyer based on projected future cash flows of the agency. Finally, the seller and his or her attorney must make certain that adequate security for the seller is written into the purchase and sale agreement. As mentioned earlier, typical security includes the personal guaranty of the buyer, the guaranty of the agency, and a pledge of all the stock and assets of the agency.

Internal perpetuation options

The most common internal perpetuation options involve a series of steps. Here is an example:

Step 1: Put some ownership in the hands of the selected employee who is the perpetuation candidate.

Step 2: Engage in a shareholder agreement with the employee/shareholder.

Step 3: Observe the performance of the minority shareholder/employee for a period.

Step 4: Sell the balance of the agency to the shareholder.

Once a selected employee, producer or family member owns a minority percentage of the agency, he or she can become a party to a shareholder agreement with the owner. Such shareholder stock redemption or cross-purchase agreements restrict the sale of stock to persons not in the agency and state in advance what happens when any shareholder dies, becomes disabled, retires or otherwise wishes to sell his or her shares. The agreements include the terms, stock-valuation method and process that applies. After the majority owner has the opportunity to observe how the new minority owner has performed as an owner, the majority owner can better decide on when he or she wants to go to the next step and sell the balance of the company to the minority owner.

Among the most common ways to enable some minority ownership immediately are:

Cash purchase of a minority interest by the employee, producer or family member. This method is used when the agency principal wants to be certain that the employee purchaser is willing to invest at least some of his or her own money in the future of the agency. People who pay for ownership tend to value it more highly than people to whom ownership is given.

Stock bonus or ownership bonus to the employee, producer or family member should be performance-based. This approach to ownership distribution involves paying periodic ownership bonuses to the perpetuation candidate. Ownership bonuses should be paid in some relationship to the employee's productivity and contribution to overall agency performance. Sometimes combining a performance-based stock bonus arrangement and cash purchase of some shares strikes a good balance and provides strong assurance that the employee believes in the future of the agency and has earned the right to be an owner.

Select the right candidates

The ideal ownership candidates would have these following attributes. They should be:

- highly valued, loyal employees;
- capable of growing the agency through production;
- capable of maintaining clients (especially the top 20 percent who typically generate most of the agency's revenue);

Potential internal buyers who possess all the necessary attributes often are difficult to find. However, a good candidate can learn them over time.

- cognizant of how to maintain profitable bottom-line results; and
- willing to employ the existing owner and be trusted to pay him or her out, over time, when the owner retires.

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Beginning the process

If you haven't yet begun to develop a perpetuation plan, as a first step create a rough timeline. On the timeline, estimate the dates that you want to do the following:

- Evaluate current staff as perpetuation candidates. If you don't have a good candidate, consider the ownership potential of any future hires or begin to search for management talent.
- Once you've identified the candidate. Develop a plan to train him or her on all aspects of management.
- Gradually transfer day-to-day management to the selected employee. Evaluate his or her performance and give feedback.
- Sell or bonus a small portion of your ownership of the agency to the employee.
- Create a shareholder cross-purchase or redemption agreement with the new minority owner.
- Sell the balance of your ownership to the employee.
- Set your retirement date and remove yourself from agency management.

This process will enable you to focus on taking small steps that will lead to the achievement of your perpetuation goals.

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