Constructing a Succession Plan

Historically, relatively few farm and ranch businesses have survived the generation of their founding. In most instances, farm businesses go through a family farm cycle with the firm peaking in efficiency about midway through the life cycle followed by a decline in efficiency in later years.

In recent years, an increasing but still relatively small proportion of farm and ranch firms have been pursuing an objective of continuation of the firm beyond the lifespan of those founding the firm. For those operations, a succession plan can provide helpful guidance as individuals move into and out of the firm in keeping with their own individual life cycle. The critical issues in succession planning are:

- planning for a gradual shift in management from one generation to the next;
- shifting ownership of the assets involved from generation to generation; and
- anticipating events that could disrupt management and ownership succession.

The seven major elements of a succession plan are discussed in this article.

Building a management team

As a practical matter, two or three generation operations only survive if the individuals involved are successful in building a management team. That typically involves:

- stressing the idea of a team approach to making decisions rather than deferring to the senior individuals;
- focusing on developing management skills in the younger members of the firm;
- emphasizing cross training so younger firm members gain experience throughout the firm; and
- developing a functioning and effective system of routine communication; and
- implementing routine, non-threatening evaluation so every member of the firm comes to understand their strengths and weaknesses.

Addressing the power issue

This aspect of succession planning involves the issue of who can control decision making. From a fundamental planning perspective, that involves, ideally, creation of an environment in which decision making power is secondary to the quality of decision making input. But the ideal is rarely achieved.

Depending upon the choice of organizational structure, with the corporation providing the most rigid decision making structure, a succession plan should contain a “power audit” to focus upon decision making under alternative scenarios.

Example: In 1968, a farmer died unexpectedly at age 48 leaving a spouse (who received 48 percent of the stock in the family farm corporation) and four sons (each of whom inherited 12 percent of the stock). The sons have generally voted as a block since that time to pursue an aggressive expansion strategy with no dividends declared. The mother is extremely unhappy that her stock, now worth more than $1 million, has produced no income in nearly 30 years. She is confident that her late husband never once thought about who would have the whip hand of control.

Anticipated disruptions

Related to the “power” issue, but involving a broader range of concerns, is the matter of anticipating disruptions in the gradual shift of ownership and control to the next generation. It may be that everyone will die on schedule, everyone’s marriage will remain intact and no serious disputes will arise.
But, a succession plan should focus on the “what if” possibilities. What if individuals were to die or retire prematurely? One or more marriages were to be dissolved with a consequent division of ownership of the business? Serious and fundamental disagreements were to arise? Or major tort or other liabilities were to rock the operation?

These types of developments are difficult to plan for but failure to plan can produce wrenching consequences.

**Assuring fair compensation**
Especially for younger generation individuals who have little decision making power, it is important to address the matter of compensation of individuals for their labor and management as well as their capital.

The hazards of delaying compensation adjustments, which is fairly common in family operations, are well known. It is important to compensate each individual fairly each year. If cash compensation would strain the cash flow from the business, part of the compensation could be paid in increased equity in the business.

**Valuing ownership interests**
Especially for those unable to force dissolution and liquidation of the business, periodic valuation of ownership interests on a fair and equitable basis is a key part of protecting owners, particularly minority owners. Several basic options are available including:

- book value,
- appraisal, or
- a periodically re-negotiated fixed price (set by the shareholders or directors annually based upon an inventory of all assets in the farm or ranch business).

**Protecting minority owners**
In addition to providing for a fair and equitable valuation of ownership interests, minority owners can be protected from the harshness of majority rule in other ways:

- Carefully drafted provisions for triggering first option and buy-sell agreements can be used to create a market for stock or other ownership interests.
- The traditional decision-making rules can be modified in various ways to provide greater protection for the minority owners by providing for:
  1. a greater than majority vote for decision making;
  2. a below-majority vote (in some states);
  3. key issues (such as an assured employment for a specified number of years or a designated minimum salary) to be predecided in a shareholders’ agreement, voting trust or pooling agreement;
  4. cumulative voting; or
  5. pre-emptive rights.

**Encouraging phased retirement**
The final element of a succession plan focuses on encouraging older individuals to retire and may include several components—

- An appropriate level of compensation should be assured during the retirement years.
- Access to retirement benefits should be assured and compensation arrangements should be compatible with receiving social security benefits, particularly for those under age 70.
- Reduced-responsibility positions on the management team should be established for those approaching the retirement years.

**In conclusion**
In the final analysis, a successful plan of succession in the farm or ranch business depends heavily on the personal chemistry of the individuals involved. However, a carefully considered and thought-out succession plan can be helpful in shaping expectations and in providing a framework for implementing the steps needed for an efficient and tranquil transition.