Reducing Risk Can Build Value

Building a successful business and minimizing risk may seem like opposite strategies, but typically, they go hand in hand. Once a business matures past the early, sometimes chaotic stages of development, business owners often turn toward actions that can protect them from the unexpected. Common examples of risk mitigation include purchasing life insurance on owners' lives and insuring any assets crucial to business success. These are valid ways to minimize risk, but rarely are they enough to protect owners and their businesses as they approach their business exits.

As you consider how to best protect yourself and your business from risks to your business exit, consider three often overlooked methods of risk minimization.

Management Incentive Plans: Well-designed incentive plans for top management personnel can minimize the risk that key employees will jump ship just as you are heading into the safety of the harbor. It's more likely that a key employee's departure will negatively affect your exit timeline than a death. This implies that having a plan to keep the employee with the company both during and through your transition to your next phase is valuable to minimizing risk. In addition to the risk-minimizing effects of incentive plans, you can also encourage actions that help grow the business in the same plan, thus potentially growing business value.
There are countless formulas you can use to incentivize your key employees to stay in the business as and after you leave (e.g., Stay Bonus Plan, Phantom Stock Plan). No matter which incentive plan you choose, your incentive plan should do four things:

1. Be specific.
2. Be substantial.
3. Handcuff employees.
4. Be based on a *written* performance standard.

Incentive planning can protect you and your business' value because properly incentivized key employees are less likely to leave the business and throw a wrench in your planning endeavors.

Key-Employee Life Insurance: An important aspect of successful business exits is the presence of key employees. Key employees are employees who have a tangible effect on the business' performance. Their absence would do potential harm to the business' operations, cash flow, or value to potential buyers. Given the importance of key employees, you might assume that many business owners take out life insurance on their key employees. However, many business owners don't do so, primarily for two reasons:

1. They don't know who their key employees are or mistake employees they like for key employees.
2. They assume that the business will be fine even if key employees die unexpectedly.

Most commonly, business owners don't examine or admit which employees are crucial to the business' value. Without that knowledge, it's impossible for owners to purchase life insurance on them. A proven way for owners to find out which of their employees are key employees is to consult with advisors to determine which employees impact business value and would be difficult, if not impossible, to replace. Typically, Exit Planning Advisors construct Advisor Teams to help business owners determine (a) which employees are key employees and (b) the most appropriate types of insurance to purchase to protect against their sudden death.

Contingency Plan: An Emergency Operating Plan is a written strategy that addresses how the business should react to a sudden death or departure of a co-owner, key employee, or yourself. Insurance proceeds cannot replace business functionality or know-how. Having a plan for how the business functions in the absence of an important person can protect you if a co-owner or key employee is suddenly unavailable. It can protect the business (and vicariously, your family and employees) if you suddenly become unavailable. A strong contingency plan can tie the funds you and your business receive from insurance to the operational strategy the business may need to overcome the absence of a crucial contributor.

Each of these aspects can more effectively minimize risk than simply hoping things go well. However, incorporating these methods into your business can be complex. If you'd like to talk more about ways you can minimize risk to your business exit, please contact us today.

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