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Business Succession Planning Part Two:

Business Succession Planning Process and Special Considerations Applicable to Family-Owned Businesses

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BUSINESS SUCCESSION PLANNING PROCESS

Steps in the Business Succession Planning Process

Gather information about the business and the family, including financial information about the company and each family member. Determine which advisors are necessary or desirable for the planning process, which may include:

- The family's attorney;
- The company's attorney;
- An attorney experienced in business succession planning if none of the other attorneys has such experience;
- An attorney experienced in estate planning if none of the other attorneys has such experience;
- Any other attorney that represents an individual family member;
- The CPA for the company;
- The CPA or CPAs for the family members;
- A qualified business appraiser;
- A banker;
- A trust officer;
- An investment banker if one of the options being considered is selling the business or seeking a merger;
- An M & A attorney for the same reasons;
- An insurance professional;
- A family business consultant; and
- A psychologist.

Determine a range of values of the business for planning purposes under various scenarios, including a leveraged buyout, an initial public offering, and the liquidation of the business.

Review the existing estate planning and succession planning documents, including wills, trusts, shareholders' agreements and other agreements concerning the business, charitable foundation documents, etc.

Interview family members to determine their goals, interests, and feelings about other family members, especially the role of each family member in the business. If it is the lawyer who is doing the interviewing, it should be clear that the lawyer is not representing any of the parties individually with regard to the business succession planning process. The lawyer's role in this case is not as an advocate, but more of a mediator or facilitator.

Discuss with the family the concepts of business succession planning, including the difference between transferring management and/or control, and transferring ownership.

Discuss the family's goals with the family members, which may include one or more of the following:

- Retain control with the existing owner or owners.
- Retain income to continue the lifestyle of owner and owner's spouse.
- Satisfy family's estate planning objectives.
- Provide for the continuity of the business, partly psychological.
- Satisfy concern for employees of the entity.
- Satisfy concern for the community in which the business is located.
- Satisfy dynasty concerns.
- Satisfy charitable desires.
- Reduce transfer taxes.
- Reduce income taxes.
- Reduce administration expenses.

Discuss the various exit strategies the family should consider, including some or all of the following:

Sale of assets. In the case of a C Corporation, a sale of assets will involve two levels of tax, once to the corporation on the unrealized appreciation of its assets and once to the shareholders on the excess of the value of the liquidating distribution over their basis in the stock.

Sale of stock. It is usually difficult to find a buyer of the stock of a closely held corporation because of potential unknown liabilities. In addition, the purchaser may not want the existing basis for the corporation's assets, although there are ways to have the basis reflect the purchase price for the corporation.

Taxfree acquisition—merger. A tax-free exchange will usually require that a significant number of the family members receive stock in the acquiring company rather than cash, and the stock will usually be subject to restrictions on resale for a period because of securities laws.

Tax-free division—splitup, splitoff, or spinoff. May be useful when there are sibling rivalries. A tax-free division could involve dividing the business geographically, by product line, or into retail and wholesale components.

Sale to employees. May be an appropriate strategy when no family members are interested or capable of taking over the management of the business and it is not practical to bifurcate the ownership and the management because the cash generated by the business does not enable the business to provide enough compensation to nonfamily members to entice them to assume major roles in running the business. The issue here is finding the necessary financing.

Give or sell to family members during lifetime. A sale will usually involve taxable gain. A sale may be a way to treat children equally when not all of them are active in the business. A taxable sale will avoid any gift tax, assuming it is for full and adequate consideration.

Sale to grantor trusts—family members as beneficiaries. This technique avoids both income and gift taxes if structured properly.

Transfer equity interests to one or more grantor retained annuity trusts (GRATs).

Give or sell to family members at death. Allowing family members to purchase the ownership interest of a decedent at a pre-established price may have unintended transfer tax and non-tax consequences because of I.R.C. § 2703 if the price is not equal to the fair market value of the interest as determined for federal estate tax purposes. It could affect qualifying for the marital deduction or the amount of the marital deduction. It could raise the issue as to who will pay the additional estate tax on the additional value. One way to deal with this issue is to have the purchasing family member pay the additional estate tax attributable to the increased value.

Liquidation of the business, including bankruptcy. The business succession plan has failed or one was never adopted or implemented. The forced liquidation or *bankruptcy* results in the loss of intangible value, including goodwill and going concern value.

Suggest an appropriate business succession plan with appropriate alternatives, setting forth the various tax and non-tax considerations and consequences resulting from the suggested plan and alternatives.

Determine cash needs of the business during the implementation of the suggested plan.

List and describe the steps, including the necessary documents, to carry out the suggested plan and coordinate the implementation of the plan, including the drafting of documents, with local counsel and other advisors, such as CPAs, trust officers, financial advisors, and insurance professionals. Put in place a procedure for ensuring at least an annual review of the plan and its implementation.

Evolution of the Family Business (Family Ownership)

Founding owner.

Usually this is the initial stage of the family business, unless two or more siblings started the business together. One or both parents will usually own all the equity in the company and have complete control over the company. The role of the founding owner in creating a situation where the business will successfully pass to the next generation is crucial. The entrepreneur can do this by setting policies while he or she is still active and in control. In addition, the entrepreneur can set an example by being transparent about the business and his or her estate plan. In addition, the spouse of the founder can also play an important role in ensuring the next generation—which will become a partnership of siblings in many situations—is able to function as a team.

Next generation.

If only one of the children assumes control of the company after the retirement or death of the founding owner, the structure of the business may remain the same as it was when the parent was in control. If more than one child is active in the business, the dynamics of the management of the business will change dramatically. No longer will the shots be called by one person. The potential for discord will be elevated. There are at least three paradigms for leadership at this stage: a single child as the CEO, more than one child as co-CEOs, or alternating CEOs. The business will revert to the founding owner stage if one child ends up buying out the other siblings or the business is split up into separate entities with each entity owned or controlled by a different child.

Third generation and beyond.

At this stage, it is likely that two or more cousins will be active in the business. Management will be more structured, and the board of directors or its counterpart in an LLC will take on more importance as the governing body of the company.

Termination of family ownership/control.

This stage could witness a favorable outcome for the family with a sale to a third party or an acquisition by a larger company in some type of tax-free exchange of ownership interests. This stage could also be the ultimate failure of the planning process or lack thereof, where either the assets of the company are sold in a liquidation sale without any consideration received for goodwill and other intangible value or the company goes into bankruptcy.

Steps to Prevent Disputes

Mission Statement.

Developing a mission statement for the family should involve all the adult family members in the process and will expose any significant differences of opinion about core values that will alert the advisors to potential problems when developing the strategic plan, business and family policies, and a business succession plan. The mission statement should set out the core values of the family and the role the family wishes to play in the community, including charitable desires.

A separate mission statement for the company will highlight the different considerations that go into the business relationships, as opposed to the family relationships. In addition to a mission statement for the company, a strategic plan for the company for the next five or ten years will also help in developing the business succession plan. All these documents should be reviewed periodically and amended as the circumstances and family's desires change.

Objectives.

In addition to mission statements for the family and the company, more detailed objectives should be agreed upon. Naturally, the objectives should be consistent with the mission statement, but will be statements of items the family and the business want to achieve or should accomplish.

Policies.

Specific policies should be adopted dealing with compensation, standards for family employment, distributions of profits to the equity owners, retirement of family members, redemption of equity interests, transferability of equity interests, and other matters that have the potential for conflict. These policies should be adopted before the issues arise, so that the family can reach a consensus while no one has a particular personal stake in the outcome. Of course, family members will have different viewpoints with regard to the various issues, depending upon their age, health, percentage of ownership interest, employment status, financial condition, and family situation (such as single, married, divorced, descendants or no descendants). Some of the issues that should be dealt with in these policies include the following:

Compensation of family employees. Best practice would be to pay family members what they would earn in a non-family controlled business. However, if two siblings have different positions, but similar responsibilities, it may be better not to differentiate.

Standards for family employment. Best practice would be to require family members to meet the same standard for employment and promotion that apply to non family members. It may be appropriate to require that a family member must have worked for a number of years, perhaps 3 to 5, for another company before he or she will be considered for employment by the family business. This will give the family member an opportunity to see what it is like to work in a business that his or her family does not control. It will also give the family member a different perspective on how the business should be run. Also, family members should not be hired if there is no position that he or she is qualified to fill. This may mean that not all family members will be assured of working for the family business, which is likely to cause tension.

Distributions of profits to equity owners. Best practice would be to make distributions to equity owners based on profits rather than what family members need. Perhaps providing for a minimum distribution, including an amount to pay taxes in the case of a pass-through entity, may be appropriate so that family members could be assured of at least some amount of annual distribution from the family business over and above what he or she needs to pay taxes on the earnings allocated to him or her.

Retirement of family employees. Although the entrepreneur who founded the business will likely object to being forced to retire, best practice would be to require family members, including the founding entrepreneur, to retire at a certain age. This allows younger family and non-family employees to move up in the company, and will help to keep highly qualified non family employees from leaving the company because of not knowing whether there was opportunity for advancement because they are not family members.

Redemption of equity interests. A policy that allows disgruntled family members to “cash-out” may nip disputes before they become unmanageable. The policy should spell out very specific provisions regarding valuation and payment terms to limit further disputes; for example, the board should have discretion to pay for the equity interest over time depending on excess cash flow. However, a policy that does not allow for family members to sell their interests in any event can lead to litigation.

Transfers of equity interests. The policy should state who are permitted transferees and whether transfers to permitted transferees can be made outright or must be made in trust, and who can be the trustee of trusts that hold equity interests. The policy should also spell out whether and under what circumstances transfers can be made to a spouse, including a surviving spouse, and whether such transfers must be made in trust—and if so, what rights the spouse has, such as only to income, and whether the spouse can have a power of appointment.

Investment opportunities. Should there be a policy for sharing investment opportunities and individual estate plans? If a particular family member obtains information about an investment as a result of his or her position with the company, and fails to disclose it to the other family members, and the investment turns out to be highly successful, the other family members may resent the fact that they were not made aware of the investment opportunity.

Other issues. If individual estate plans are not shared among the family members, there will be a potential for inconsistent positions with respect to how voting or management rights are being passed down to the next generation and on the value of equity interests. Restrictions on who can serve as trustee of any trust holding equity interests may be included in the policy statement. Note that these terms would be included in a shareholders agreement or other operative agreement.

Specific goals/timetable.

Specific goals with regard to the development of policies and a business succession plan should be established early in the process, with specific dates for accomplishing the goals. Likewise, specific goals for the business should be established and a periodic review should be scheduled to determine if the goals are being met in a timely manner.

Communication guidelines.

There should be regularly scheduled meetings of the family. Rules of order for conducting the meetings should be established. These should not be too formal in nature but should assist in ensuring that the meetings are conducted in a civilized atmosphere that is conducive to a meaningful exchange of ideas and opinions. In addition, regular meetings for the conduct of the business should be established, if not already in place. These could be combined with the family meetings, but if non-family members are added to the board of directors or other governing body, combining the two meetings may not be appropriate.

The makeup of the persons attending the meetings may vary, perhaps as follows: There could be weekly or monthly meetings of key family member employees and key non family employees. There could be annual or semiannual meetings of all family equity owners. There could be annual or semi-annual meetings of the board of directors or other governing body. There could be annual meetings of all family members, perhaps held at a resort.

Transparency will be important to enable the siblings or cousins to work together as an effective team where all have mutual trust and respect for one another. In addition, education about the business and the family values will be important in developing a sense of purpose and commitment to the continuity of the business.

Appoint an advisory board.

This could be a first step in adding non-family members to the board of directors or other governing body. The number and makeup of the advisory board would depend upon the perceived need of the company for outside expertise. The members of the advisory board would receive compensation. The board would meet regularly, perhaps quarterly or when otherwise needed. Terms should be established, so that members who were not participating in a constructive manner could be removed without having to be prematurely terminated.

Additional considerations.

Consider adding non-family members to the board of directors. This would be a sign of a mature business and that the current owners recognized the importance of objective input. However, having nonfamily members on the governing body could create problems if the outside members joined with recalcitrant family members to oppose sound business decisions. Although the nonfamily members could be removed by the equity owners, such action could lead to more disruptive discord among the family members.

Get the family to commit to the process. Identify the reasons for engaging in, as well as the benefits to be derived from, developing policies and the business succession planning process. Stress the importance of each family member participating in the process or otherwise refraining from Monday-morning quarterbacking once the process has been completed.

Ethical Issues

The advisor will face a number of ethical issues, including conflicts of interest in general. There will be potential conflicts between active and non-active family members, between non-family employees and family members who are employees or just owners, between family members in different generations, and between spouses. Finally, there could be issues where the advisor has represented some, but not all, of the players previously. In this case, full disclosure of the past representation should be given.

Obstacles to Achieving a Workable Business Succession Plan and Other Policies

There are likely to be a number of obstacles to achieving a plan satisfactory to everyone. The spouses of family members may have a different opinion about how the suggested plan affects them. Non-active family members may have a different objective in how the business will be disposed of at the death of the older generation owners. There is apt to be reluctance of the founding owner or senior generation to give up control. There will be concerns for providing for the liquidity needs of the business and the family, and the payment of estate taxes and administration expenses. Replacing key employees who are dissatisfied with the succession plan may require either key-person insurance or other funding. Other liquidity needs may include funding buy-sell agreements, providing retirement income to the founding owner and spouse, and providing other assets to non-active family members. Other circumstances may impede the process, such as a divorce involving the founding owners, non-family key employees who want to obtain an equity interest in the company, and substance abuse by one or more of the family members.

SPECIAL CONSIDERATIONS APPLICABLE TO FAMILY-OWNED BUSINESSES

Avoiding Disputes

Voting stock should not be given to younger family members, nor should younger family members be made the managers of an LLC or general partners of a limited partnership, at least until the entrepreneur is ready to give up control. If voting stock is to be transferred to children who are active in the business, voting stock should not be transferred to children who are not active in the business. Also, children who are not active in the business should not be managers of an LLC or general partners of a limited partnership.

A general partnership should not be used for family business planning. Not only is there risk of exposure to liabilities, but also each member of the partnership has an equal say in the management of the partnership under state law. Consequently, the IRS could argue that depriving a general partner of the right to participate in the management of the company, which might depress the value of that partner's general partnership interest, should be disregarded for valuation purposes.

Preferred or fixed value interests may be given to those younger family members who are not active in the business. These should be non-voting interests. Because they would be given to younger generation members, I.R.C. § 2701 should not apply.

Downside protection may be provided to those younger family members who are not active in the business and have received an equity interest in the business, including a preferred or fixed value interest, by giving them a put right (the right to require the entity to redeem their equity interests) and by placing restrictions on the active younger family members' ability to receive excessive compensation and other financial benefits. The put right would give the non-active family members the right to have the entity buy their interests, usually at a price somewhat below fair market value, payable pursuant to an installment note providing for the payment of interest at the applicable federal rate (AFR) and a term of considerable length, such as ten years. This would allow the business entity to buy the equity interests of the disgruntled owners on favorable terms.

Similarly, it may be appropriate to give the active family members a call right so that they can buy out the inactive family members if irreconcilable differences develop over running the business. In this case, the price would be fair market value and the interest rate at fair market rate, and the term of the installment note considerably shorter than the term of the installment note in the case of the exercise of the put right described above (perhaps five years instead of ten years).

Breakup provisions may be provided for in the organizational documents that allow one or more of the younger family members to dissolve the entity after the death of the last to die of the older family members. This technique is appropriate for entities holding passive investments, such as real estate and marketable securities but would not be appropriate for a going concern where a breakup followed by a liquidation of the business could result in a severe loss in value. In addition, such a provision may reduce the lack of control discount when the assets consist mainly of passive investments. For example, in a client matter I had a number of years ago, the family—father, mother, and two daughters—wanted to set up an LLC to hold marketable securities and real estate investments, but the two daughters did not get along very well. So, after advising them of the potential impact on valuation, I suggested that once the father and mother died, either daughter could unilaterally cause a dissolution and liquidation of the LLC.

Providing for mediation or arbitration in the event that there is a dispute among the family members may avoid unwanted publicity and expenses. Of course, even though mediation may be required before a resort to arbitration or litigation, if one or both of the parties are unwilling to participate in a meaningful way, mediation will be fruitless. A party who brings an action and is unsuccessful should be required to pay attorneys' fees.

Assets other than interests in the family business may be left to inactive family members. Life insurance could provide the funds to equalize the amounts going to active and non-active children. In my experience, sometimes the active family members might have preferred to have received liquid assets, such as life insurance proceeds, rather than the usually illiquid interest in the family business.

A sale of the business to the active family members, rather than gifts, would provide assets (including any down payment and installment notes) that could be used to equalize the amounts going to active and non active family members. Because the purchase price for a minority interest sold to one or more active family members will usually be discounted, the other family members may feel they are being disadvantaged because of the discounted purchase price paid by the active family members, particularly if the remaining assets are going to be distributed equally to all the children—including the active children who also got the business at a discounted price. A sale during the entrepreneur's lifetime may avoid fiduciary problems after the entrepreneur dies.

Parents should distinguish between treating children equally (each child receiving an amount equal in value) and treating them fairly, where the amount each child receives may vary depending upon the child's participation in the business and other factors. This takes into account that fact that the value of the business may be attributable in part to the services of those younger family members who are active in the business.

Planning for Possible Divorce

The best solution may be to provide for the disposition of the family business in a premarital agreement. A premarital agreement is usually more appropriate in the context of a second marriage, and it may be difficult to convince a client or a child of a client to enter into one when he or she is marrying for the first time. A post-marital agreement, which is legally enforceable in some states, may be a way of dealing with a business in the event of a divorce.

Consider whether the purchase price under a buy-sell agreement will be treated as the value of the interest in connection with a property settlement pursuant to a divorce. It is doubtful that the purchase price will be considered the value of the interest if the agreement was entered into in contemplation of the divorce, it is among related parties, and the purchase price is unreasonably low. On the other hand, if the agreement was entered into well before the divorce appeared on the horizon, it is among unrelated parties, and the purchase price is commercially reasonable, the purchase price may be considered the value of the interest. Note that in most states, the court cannot require the transfer of specific assets, although the value of the assets is considered in determining what each spouse is entitled to receive under a property settlement.

In connection with gifts, advise donees to keep the gifted property separate, so that it will not be considered either community property in community property states or marital property in states that have adopted equitable distribution. Again, a good solution would be to have the donee enter into a premarital or post-marital agreement, but this is often not acceptable to the donee. However, if enough is involved, the donee may be willing to enter into the premarital agreement, even in the case of a first marriage. It may be more palatable to the potential donee if the premarital agreement only dealt with the family business interest.

Also, if the donee works in the business, some of the future increase in value may be considered community property (or entitle the other spouse to reimbursement) or marital property, depending upon state law. A marital agreement should make it clear that post-marriage appreciation in the value of the company in which the donee spouse works will be separate property. Another alternative would be to make gifts to trusts rather than outright in order to prevent the gifted assets from becoming community or marital property.

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