SUCCESSION PLANNING FOR FAMILY-OWNED AND CLOSELY HELD BUSINESSES

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I. **Introduction**

Most experienced construction lawyers have heard cautionary tales of construction companies that go under when the founder unexpectedly passes away, leaving the family business in the hands of grieving family members or unprepared managers. Projects are stalled in various stages of completion, owners look to the performance bond surety to step in, and subcontractors and suppliers wonder if they will get paid. While these cautionary tales usually end in bankruptcy court or on the front page of the newspaper, a more common succession problem goes unnoticed: closely held and family-owned businesses that survive the inevitable change in ownership often devolve into protracted disagreements among co-owners or family members about how to continue the business, causing operations to struggle and ultimately fail.

The importance of family businesses in today’s economy cannot be understated. Indeed, according to the U.S. Census Bureau, 90 percent of all businesses in the United States are family controlled), and family-owned companies account for two-thirds of all businesses worldwide, generating more than 70% of global GDP annually. Family businesses also account for more than 60 percent of the U.S. GDP, and between 50 and 80 percent of all private sector jobs in most countries around the world. Family businesses make up about 35 percent of Fortune 500 companies, and family-controlled firms make up 19% of the companies in the Fortune Global 500. Such businesses include Wal-Mart, Ford Motor Company, Berkshire Hathaway, Nike, Volkswagen, Samsung, Comcast, Tyson Foods, Gap Inc., Estee Lauder, and Campbell Soup Company. Studies show that the top 500 family-owned businesses in the world account for a combined $6.5 trillion in annual sales, enough to be the third-largest economy in the world, trailing only the U.S. and China.

Despite its prevalence and salience, family businesses face behavioral issues related to
continuity and survival. For instance, only 30 percent of family businesses around the world make it from first to second generation, 10 percent from second to third, and only 3 percent from third to fourth.\(^8\) Reasons for unsuccessful succession include lack of planning, lack of viable successors, business owners’ unwillingness to pass down control of the company, and the nature and viability of the company itself.\(^9\) In a 2007 survey by MassMutual, 40% of family business owners said they expected to retire within 10 years.\(^10\) Of this number, fewer than half (45.5%) of those expecting to retire in 5 years and fewer than a third (29%) of those expecting to retire between 6 and 11 years had selected a successor. Almost a third (30.5%) had no plans to retire ever, and nearly another third (29.2%) reported that retirement was more than 11 years away. Importantly, nearly a third (31.4%) had no estate plan beyond a will. According to a 2014 survey by PricewaterhouseCoopers, only 16 percent of family firms have a discussed and documented succession plan in place.\(^11\)

This paper examines the underlying issues that make succession planning for closely held businesses, including family-owned business, so complex and challenging. We will cover the different types of governance structures that may be implemented to ensure survival of the company beyond the first-generation owner(s). We will conclude with a discussion of an attractive alternative called an Employee Stock Ownership Plan (ESOP), as a succession planning vehicle, as well as the effect of the 2017 Tax Act.

II. What Is Succession Planning?

Business succession planning is the planning for the transfer of both ownership and management to the next level of owners and managers. These are two separate and distinct categories. Many times, within a family business the original founder both owns and manages the entire business and there is an assumption that the owner's family members will succeed both to
the ownership and the management of the business. Likewise, in a closely held company the unrelated first level of owners and partners generally manage and own the business and often times it is assumed their descendants will likewise succeed both to their ownership and management positions. In reality, however, the assets and resources of family owned or closely held businesses are often used to deal with family situations while independent management would make business decisions benefitting the company with less of an eye towards family economic needs.

III. Why Is Succession Planning Hard?

More often than not, the process of succession planning in a business is just something that is easier to cast aside while owners and managers continue to devote their time growing the successful business. The common presumptions that the next generation of owners will likewise be capable managers also makes it difficult to truly evaluate those assumptions, particularly with first generation owners having a less than objective view of the business ability of their descendants. Independent non-owner managers will often have a different view of the next generation’s abilities. Also, in a closely held business with unrelated owners, each owner’s view of the other owner’s descendants’ abilities to operate the business is often at odds. Addressing these issues in an open and honest basis is difficult.

IV. What Is the Process?

The business succession planning process begins with an open discussion with current owners to allow the advisor to get a full picture of the business and how it operates, along with the owner's goals and objectives. This beginning discussion should lead into more detail about where the owner sees the business in the coming years, both from an external business standpoint and an
internal management standpoint. The answers to this type of in depth interview will set the direction for the planning process.

For example, if an owner states they wish to sell in a relatively short period of time and retire with the proceeds of the sale, much more emphasis will be paid on the appropriate market for the company (including competitors) and the follow up work to put the company in a condition to be attractive to an outside buyer. On the other hand, if the interview indicates the owner's desire to expand the business, then a discussion of management of those new areas leads to a broader discussion on succession planning. Finally, if the owner does specifically state that they wish to have the company continue in their family for generations, a broad discussion of the challenges, benefits and risks of how ownership and management will be structured in the future must occur.

Beyond the owners, if authorized by the owner there should be interviews with other family members to learn their interest, goals and how they see their relationship with the business now and in the future. There should also be interviews with management covering the same area. A set of priorities should result from the initial interview where the advisor should come away understanding the company's needs for cash flow, the company's taxes and the future of the company. The advisor should next review all of the current and personal business planning documents to determine the steps necessary to convert the current plan, or lack thereof, to the new plan. After all of the above are complete, an initial business succession plan should be drafted and that plan should be discussed in great detail with the current owners. Once the general provisions of the initial plan are acceptable the advisor should implement the plan, including a broad discussion of how the plan operates. All documents to put the plan in place should be prepared, discussed and executed. Finally, once an initial plan is put in to place it should be continually reviewed and modified over time.
V. Alternatives for the Sale of a Business

A. Do Nothing

Owners always retain the option to simply hold onto their equity rather than formulating a succession plan to transition equity. The risks and benefits attendant to holding the equity are as follows:

- **Owner’s Age:** The business suffers as the primary shareholder ages and is no longer either interested or capable of devoting the same level of effort to the enterprise that made him/her successful.

- **Economy:** Overall economic conditions may slow down materially, as they did in 2007. Given the cyclical nature of the construction industry, it is best to sell during an “up” cycle rather than a “down cycle.”
  - Not only are earnings presently at or near historic highs for many contractors, but the “multiple of EBITDA” used in sales of contractors is currently at historical highs.
    - The combination of peak earnings and peak multiples serves to drive maximum sales values.

- **Diversification:** Most privately held business owners retain the great majority of their wealth in the enterprise value of their company. Typically, in excess of 80% of their net worth is tied up in the company. A sale enables them to spread their risk among a more diverse portfolio of stocks, bonds and real estate, which should translate into a far safer financial plan.

B. Sale to a Third Party (private equity, strategic buyer, management team)

Contractors very rarely sell their companies in “all cash” transactions. Instead, they
typically sell for a combination of cash and a contingent earnout.

- Contractors typically sell to third parties for valuations of 3-5 x EBITDA. Typically, approximately 40% to 60% of this purchase price is in cash.
- The remaining purchase price is contingent in nature and is referred to as an “Earnout”
- The Earnout is typically predicated upon future EBITDA
- The control of the business will shift to the Buyer at closing
- This leaves the Seller with a Contingent Purchase price coupled with a lack of control. For this reason, many Earnout targets are not achieved, the contingent purchase price is not paid, and the parties are frequently engaged in litigation.

C. Sale to an Employee Stock Ownership Plan (ESOP)

An ESOP is a defined contribution plan that invests primarily in employer stock and is governed by the Employer Retirement Income Security Act (“ERISA”) of 1974. The intent was to create ownership and retirement assets for working-class Americans. ESOPs are subject to Department of Labor and IRS regulation and compliance. As of 2014, the most recent year U.S. Department of Labor data was available, there were 6,717 ESOPs in the United States, holding total assets in excess of $1.3 trillion. These plans include over 14 million participants, of whom 10.6 million are active participants.

Eleven percent of U.S. companies in the construction industry have ESOPs. In addition, numerous architectural and engineering firms are employee owned. Some of the benefits of an ESOP to companies in the construction industry are its use as an ownership transfer method that is part of a succession plan, its use as an incentive plan for retention of key employees and crews, and its potential to enhance the financial stability of the company.
Many contractors have no plans for business succession after the retirement of the majority shareholder. An ESOP can provide a solution by creating a readily available market for the purchase of shares from the controlling shareholders(s) as part of a succession plan.

ESOPs can also provide employees with the incentive of sharing in the growth of the company. Likewise, employee ownership also benefits the company because the employees’ interests are aligned with management’s interests. Studies have shown that employee owned companies have increased productivity, better retention of employees, and increased ability to withstand economic downturns.

ESOPs also serve to enhance the financial stability of construction companies. A contractor can reduce or eliminate its corporate income taxes and increase its cash flow, which can, in turn, create additional capital to finance projects.

VI. What Is an ESOP?

An ESOP is a type of employee benefit plan. A company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. The ESOP can also borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Shares in the trust are allocated to individual employee accounts. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. When employees leave the company they receive their stock, which the company must buy back from them at its fair market value.

VII. Use of an ESOP as a Succession Plan

There are a multitude of benefits in using an ESOP as a succession plan for a closely held or family-owned business. The following elements of an ESOP should be carefully considered when the owner(s) evaluates the different mechanisms available for passing the company to the
next generation:

- An ESOP provides a Buyer to purchase up to 100% of a Company’s stock
- The Valuation is required to be Fair Market Value, as defined by Rev. Rul. 59-60, which defines Fair Market Value as the price that an arm’s length willing buyer and willing seller would agree upon, if neither was compelled to enter into a transaction.
- The ESOP sale is a negotiated transaction with the ESOP Trustee, who hires an independent valuation firm to determine the Fair Market Value of the company. The valuation takes into consideration many issues, including:
  - Projected growth compared to historical trends and industry forecast
  - Soundness of EBITDA Adjustments
  - Concentration Risk (customers, suppliers, product lines, geography, employee)
  - Predictability of revenues and margins
  - Size (risk premium for smaller companies)
  - Capital expenditures going forward

VIII. Tax Advantages that Drive ESOP Transactions

In addition to the benefits discussed supra, an ESOP affords several tax advantages that other succession vehicles may not. The following factors should be weighed by any professional who is advising a client about the pro’s and con’s of different succession options:

- 100% S-Corp ESOPs do not pay Federal income taxes and do not pay State income taxes in almost all states.
• The tax-free status allows S-Corp ESOPs to expedite repayment of acquisition debt.
  o For example, in Ohio, the highest marginal tax bracket for both Ohio and Federal purposes after the new tax act, is approximately 35%.
  o For example, on $5 million of taxable income, the client will pay $1,750,000 of income tax, leaving them with $3,250,000 after tax.
  o If an ESOP owned the same company, then there would be NO taxation and the after-tax cash flow would equal $5 million.
    ▪ The $1,750,000 of annual tax savings in this example is what fuels the ability of the ESOP to quickly pay off the Seller.

• The increased cash flow would enable the company to pay off the Sellers in approximately one-half of the time that it would take to pay off the Sellers in a non-ESOP transaction.

• An ESOP is especially effective where an owner wants to sell the company to his or her management team and they lack the equity to purchase the owner’s shares.

• In an ESOP, the individual employees do not need to come up with any equity or guarantee any debt. Typically, the company’s bank will provide non-personally guaranteed cash at closing and the Seller will provide the remainder of the financing on a Seller Note, which is subordinate to the bank. A typical interest rate on the Seller Note is 12%.

• Sellers in a C corporation can obtain a tax deferral. Pursuant to I.R.C. Section 1042, so long as the Seller reinvests the proceeds of the sale in other qualifying securities, they may defer any tax on the gain. Section 1042 is very similar to a like kind exchange pursuant to I.R.C. Section 1031. When the 1042 treatment is married with the Seller’s
estate planning, it is possible that the income tax on the sale may be eliminated.

- Employees will eventually have their shares purchased by the company upon separation of service. They may roll their proceeds into an IRA.

IX. Financing of an ESOP Transaction

Another important consideration is how to finance an ESOP transaction, which if done correctly can result in crucial tax savings that may increase the likelihood that the company survives to the next generation. The basic tenets of an ESOP transaction:

- ESOP Transactions are financed through a combination of Bank Debt and a promissory note made by the Company to the Seller, known as the “Seller Note.”
  
  o Bank Debt is typically **nonrecourse** to the Selling Shareholders and is secured by a first lien on all of the Company’s Assets
    - Typical pricing on the Bank Debt is LIBOR + 300 basis points
  
  o The Seller Note is subordinated to the Bank Debt
    - Since the Seller Notes is truly Mezzanine Debt, the typical interest rate is 12%
    - Seller Note interest is significant and typically is approximately 20% of the Purchase Price
  
  o Since the shareholder is an ERISA Plan, the Company’s earnings are no longer taxable
    - The greatly enhanced cash flow typically pays off Selling Shareholders in 4-5 years

X. Seller’s Objectives

Obviously, every seller wants to get the most bang for her buck. But there’s more to the
sale of a company than profit. The following are some of the primary seller’s objectives that can be achieved through use of an ESOP:

A. Maximize Value

- In an ESOP transaction, the Seller’s investment banking firm’s job is to obtain a “full and fair value” for the Sellers
  - The role is very similar to an investment banker’s role in a more typical M&A Transaction

B. Taxation of Gain

- If the Selling Shareholder in an ESOP transaction elects to take advantage of I.R.C. Section 1042, the gain will be tax deferred/tax free
- Otherwise, the typical long-term capital gain rules will apply

C. Liquidity and Payout

- In an ESOP transaction, the Sellers typically receive approximately 30% of the Purchase Price in cash at closing, with the remainder payable by way of a 12% interest Seller Note

D. Likelihood of lose

- Unlike a typical M&A Transaction, the probability of closing at fair market value is 100%
  - The ESOP Trustee is a guaranteed Buyer so long as the parties agree upon fair market value
  - There are very few buyers for Contractors, so having deal certainty is a material consideration

E. Potential Disruption of Operation
• Unlike a typical M&A Transaction, the ESOP Trustee’s due diligence is not disruptive to business operations

F. Employee Benefits

• Over time, the value of the Employees’ ESOP Shares will be very material
  o Individual retirement account balances in excess of $300,000 are very common

• When Employees retire, their account balances are purchased by the Company and their proceeds may be rolled into an IRA

G. Maintain Legacy of the Business

• Many strategic Buyers look for layoffs since cost eliminations are an important element of maximizing profits
  o In an ESOP setting, there is no reason for layoffs

• The sale to the employees enables the Company to continue in business
  o There are few purchasers for Contractors, so it is not uncommon to see Companies liquidated so that the owners can get their capital out of the business

• Many ESOP Sellers are motivated to enrich the employees whose efforts have contributed to the success of the business.

XI. ESOP vs. Sale to Third Party – 9 Reasons Why an ESOP May Be the Right Solution

The potential advantages an ESOP could dramatically increase the odds that the closely held or family-owned business will avoid the common pitfalls of inadequate succession planning and make it easier for the next ownership group to continue the company’s success. To summarize, there are at least 9 reasons why an ESOP might be the right solution for your client:
1. Total sale proceeds, including interest on the Seller Note, typically exceed other exit options
2. Company can become federal and state tax free
3. Seller can potentially sell tax-deferred/tax-free
4. Operations continue in the same manner
5. As owners, employees benefit from the success of the company
6. Key employees have the ability to receive additional incentives
7. If you own real estate, you can maintain a tenant or sell the real estate to ESOP
8. Due diligence is less intrusive and confidential company information is not provided to competitors
9. Third-party studies show ESOP companies outperform non-ESOP companies and have better employee retention.

XII. Different Ownership Scenarios

A. Non-Family Co-owners (when the business is owned by multiple non-related partners, members or shareholders)

The succession plan should deal with the voluntary withdrawal, retirement or death of an owner, including the following factors:

- **Divorce** - the plan may generally encourage purchase by the divorcing owner from the spouse with an option to the company perhaps followed by an option to the other shareholders or members to buy those shares in the event of a divorce, including a price, perhaps payable in installments. Having spouses of shareholders, members or owners sign the plan documents is extremely important, particularly in community property states.
• **Disability** - the plan may well look at some short-term disability prior to any consequences, but also focus on the ability for the company or other shareholders, members or owners buying out the disabled individual for a formula price, generally in installment payments.

• **Death** - Great care should be taken in designing the plan to determine whether or not the original shareholders, members or owners have the ability to transfer their ownership interest to their descendants, or such ability is limited. In the event transfers to descendants are limited or prohibited, there should be buyout provisions allowing the company or other owners to buy their shares from the estate or eventual heirs or legatees, once again with a price determined in the agreement and perhaps installment payments.

• **Insurance** - In a business with unrelated owners one way to consider funding the buyout is cross-purchase life insurance where each owner owns policies on the other owners and the buyout formula should require the use of such proceeds as the cash payment.

**B. Family Members as Successor Owners**

To properly plan for family members as successor owners much attention should be paid to the willingness of the family members to continue in the business that their parents may have started. The advisor should also do what they can to determine what, if any, issues of family disunity may exist in the next generation. The income needs of each family member should be considered to determine whether or not continuing family ownership is the best way to meet those needs. Some attention should be paid to whether or not the children will continue the same feelings and desires to benefit employees of the company, the community and perhaps charitable goals as
previously established by the original owners. The ability of descendants as appropriate individuals to take over the business must be seriously considered. Issues with siblings with different interests and abilities must also be considered and finally appropriate provision for key employees essential to the continuing success of the business should be met.

Often times the best succession plan is to continue the company through valued managers or key employees that may not be related to the original family owners. To determine whether that type of plan is appropriate, key employees should be evaluated for their leadership abilities, capabilities and perhaps a trial run by placing them in to management positions with substantial authority during the life of the original owners. While transferring ownership to non-family members during the life of the original owners may not be preferred, entering into an appropriate employment agreement with such key employees including ownership type benefits such as performance-based bonuses, stock appreciation rights or phantom stock plans combined with employment agreements including covenants not to compete may well be appropriate.

C. Non-Family Members as Successors

In some situations, the best successors are found within the company in the form of managers or key employees who may not be related to the current owners.

D. Family Owners and Non-Family Managers

Family owners and non-family managers – the fun combination! In many cases it makes sense to continue the ownership of the business within the family while retaining non-family members as managers and key employees. Obviously, this can include great opportunities for success and some chances for failure! As far as the key employees are concerned, all of the compensation arrangements mentioned above should be considered, particularly while parents are
still owners, to encourage non-family managers and key employees to stay on with the Company following the transfer of ownership.

Family owners remaining in the business should be fairly and objectively compensated and evaluated, another example of when outside directors may be advisable. Options to non-family managers might be considered.

A plan which allows family members to succeed in the ownership combined with non-family managers while challenging may often produce the best results. This certainly includes great opportunities for success and some chances for failure. To consider such a plan, key management and employees should be identified, compensation agreements with performance type benefits and covenants not to compete should be entered into with such individuals particularly while the first generation is still on board. In the event some family members are involved in the business they should be fairly, but not overly compensated with compensation sometimes determined by independent or outside directors. Options to non-family managers to purchase ownership interest might also be considered.

**E. No Successors Available in the Family or in the Business**

Sale of the business to an outsider. In the right circumstances planning for the sale of a business to an outsider, either at death or preferably during the life of the owners may be the best solution. If there are no apparently family members who should succeed to the ownership of the business and no non-family managers who are capable of taking over, this may be the best result. A sale during life can have advantages including the ability of the current owner to know and relate to the new buyer, their business, or their customers and assure a smooth transition. The proceeds of the sale may provide the appropriate retirement to the current owner who may have not funded a large retirement account while building the business. Even after the owner’s death, passing on
cash resources or an investment portfolio to the family may meet the owner’s and family’s goals better than passing on a business to successors unwilling or incapable of continuing its success. Some activity in the acquisition market recently might indicate an opportune time to consider a sale to an outsider.

XIII. **Tax Issues and Opportunities Under the 2017 Tax Act**

On December 22, 2017, President Donald Trump signed legislation referred to herein as the "2017 Tax Act." This legislation provided multiple changes and opportunities for business succession planning both on the income tax side and estate tax side.

**A. Estate Tax Changes**

The Federal estate tax and gift tax remains in effect and greatly affects business succession planning. The 2017 Tax Act doubled the exemptions against the Federal estate tax and gift tax which, at the time of this writing, is estimated to be $11.2 million dollars per person, generally allowing a couple to transfer $22.4 million dollars at their death, or during life, without incurring a federal gift tax or federal estate tax. This expands the opportunity to transfer businesses to family members. From a planning standpoint, however, the step-up in basis that occurs upon a transfer at death, allowing the income tax adjusted basis of the assets passing at death to change to their higher value, potentially reducing income tax if and when the company or company’s assets are sold, must be considered.

**B. Changes in The Income Taxation of Business Entities**

The 2017 Tax Act also greatly changed the income taxation of business entities, including sole proprietorships, partnerships, LLCs and corporations. In general, the highest income tax rate for C Corporations was reduced from 35% to 21%. The top income tax rate for individuals, trusts and estates, including owners of pass-through businesses, has been reduced from 39.6% to 37%. 
A new deduction is available to taxpayers other than a C Corporation, of 20% of the qualifying business income of pass-through businesses (sole proprietorships, partnerships, S corporations and LLCs which are disregarded, or taxed as partnerships or S corporations), which provides new opportunities for the structure of a business or, even consideration of modifying the current structure of a business. Generally, the deduction is equal to 20% of certain income of those businesses. While the deduction phases out for tax payers with income above certain levels, (generally $315,000 in the case of a joint return and $157,500 in the case of other returns), with tax payers having income in excess of those amounts, the deduction may be larger based on W-2 wages paid to employees of the business and the unadjusted basis of qualified property, either of which may allow tax payers with income far in excess of those limits to qualify.

C. Tax Changes Affecting Business Succession Planning

In addition to the income tax rates mentioned above, changes in asset expensing, deductibility of interest, taxation of foreign earnings and in the taxation of net operating losses, all affect business succession planning.

XIV. Case Studies – Death, Disease, Distress and Divorce

Proper succession planning is critical to the continued success of any closely held or family-owned business. The failure of ownership to plan ahead can lead to troublesome consequences for the unwary and unprepared. Clients who wait to sell their companies can end up in bankruptcy court or liquidation instead of the closing table if there is a recession or distress in a certain industry. Or an officer of the company may make a deathbed offer to the sole shareholder of the company that results in an unfair sale. Or a company is passed on to family members who have no idea how to run the business. An ESOP transaction can be extremely useful in avoiding these nightmare scenarios.
Calamities of this nature happen more frequently than you may think. In a 2014 study of 1,600 family-run businesses conducted by PricewaterhouseCoopers, only 36 percent of family businesses surveyed survived passage into the second generation. Only 19 percent survived into the third generation and a mere 7 percent continued into the fourth. The stories behind failed successions can be found in any industry, but they are particularly prevalent in the construction world.

Take for example the successful cement company started by Cloyce Box, a Texas businessman who was the inspiration behind the creation of J.R. Ewing on the TV series “Dallas” in the 1980s. Cloyce had four sons, but the family business didn’t make it very far into the second generation. Cloyce got his start in the construction industry at the George A. Fuller Construction Co. in New York City. He later founded the Oklahoma Cement Co. and, eventually, the Box Energy Company. At 70 years old, Cloyce was still the CEO of the family business when he died in his sleep from a heart attack in 1993 without a succession plan in place. His sons fought over control of the company, including suits against each other, until they decided to sell the company to Simplot for $220 million only a few years after Cloyce had passed away. Less than 10 years later, Simplot sold the company for $1.36 billion. The oldest son, Doug Cloyce, later remarked, “A family business always dies from within. It’s never due to external reasons.”