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TITLE: Practical Problems in Succession Planning for Small, Family Owned Businesses

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PANEL: Dispute Resolution Before and/or After Death of the Entrepreneur for Unrelated Families and/or Dysfunctional Families

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COMMITTEE: Closely Held Businesses; Business Planning Group; Litigation and Controversy Group

I. PRACTICAL PROBLEMS IN SUCCESSION PLANNING FOR SMALL, FAMILY OWNED BUSINESSES.

A. INTRODUCTION: Business continuation planning for closely held businesses is an area where the tax tail often wags the planning dog. Though a number of planning devices may produce significant tax and technical benefits, the creation of a technical structure for the transaction without taking relationship and emotional issues into account is a blueprint for disaster.

B. BUSINESS SUCCESSION ISSUES.

1. Transition from Individual Control To Family Control. Many business owners have not seriously considered succession planning. Even when it is raised, many clients tend to avoid addressing the issue. Succession planning is difficult enough from a strictly business perspective, especially when it involves going from a fairly simple ownership structure to a more complex structure involving more owners. In many cases the client has a majority ownership interest, manages the business and receives or at least controls the economic benefits flowing from the business. With respect to accountability and potential conflict considerations the one person owner/manager scenario is fairly simple: the client is accountable to him or herself for the management of the business and the existence and allocation of economic benefits. Because a succession plan almost always involves transfer of the business to more than one person the level of complication goes up dramatically. When emotional family issues are thrown into the mix its no wonder that many clients simply avoid the issue. However, failure to put a succession plan into place often has adverse tax and legal consequences that can destroy family relationships. It's the attorney's job to create a succession plan that addresses both the business and family issues as far as possible.

2. Management/Control Issues.

a. General. When a parent or parents consider transfer of ownership in a closely held business to the children (and/or other family members or employees) one of the most difficult issues is distribution of management and control authority. This issue can be very difficult when it doesn't involve family. When emotional family relationship issues are brought into the picture it can be virtually impossible. Experience makes it clear there are times when sharing control among family members is not a viable option. Options for addressing this issue are discussed in more detail below.

b. <u>Specific Management/Control Problems.</u> Management and control problems generally come in one of three forms.

(1) The new owners (usually the kids) share management authority and cannot agree as to how to operate the business. This can result in a stalemate that literally causes the business to cease operations, or at least hamstrings operations to the extent that the continuing viability of the business is in question.

(2) One or more of the children has management authority while others retain an economic interest in the business. Those without management authority are convinced the managing siblings are taking advantage of their position to unfairly deprive them of their reasonable economic interest.

(3) Disputes over retention of the entire business or the individual interests of the new owners. That is, some of the kids want to keep the business going and others want to sell the business, or at least their interest in it.

3. <u>Family Relationship Issues.</u> Family relationship issues have the potential to make every aspect of business succession planning more difficult. Even where family relationship issues are fully taken into account in creating a succession plan, shifting family dynamics may wreck the plan when it is time to use it. Family members who have gotten along with each other for years sometimes find that they cannot agree on anything when it comes to running a business.

4. <u>Throwing Non-Family Members Into the Mix.</u> These issues are sometimes made even more difficult if ownership of the business is shared by non-family members. In some cases, there are non-family members who are critical to the operation of the business or who have been promised an ownership interest in the business. Depending on the circumstances, the inclusion of non-family members in the ownership or management of the business can make things easier or more difficult. On one hand, allocation of some management/control authority to non-family members may eliminate deadlock that would result from allocation solely among family members. On the other hand, non-family members may not have the patience required to address the family relationship issues.

II.

REASONS TO PLAN ANYWAY. In spite of the difficulties, there are number of very important reasons for addressing business succession issues with the business or estate planning client.

A. PRESERVING THE VALUE OF THE BUSINESS. In the case of smaller businesses the failure to plan for succession can result in a loss of substantially all of the value of the business.

1. For example, where the client owns a business with few capital assets and a value based in large part on the client's knowledge and personal contacts, the business may become virtually worthless on the clients death if there's no succession plan in place. It's certainly possible for a business of this type with a pre-death value of the few hundred thousand dollars or more to end up as a burden to the estate where appropriate planning has not been put in place.

B. PRESERVING CLIENT'S LIFEWORK. In addition to the monetary consideration, many business owners have a strong desire to see the business continue after their death because the business represents their life's work. However, the client may not be aware of the work required to arrange for the continuation of the business. Many clients innocently assume that the business will go on without them with little or no prior planning.

C. PRESERVING AN INCOME STREAM. The client's business may also provide a source of income for his or her family which can be difficult to replace, even if the business can be sold at "fair market value". The market value of a small business is often far less than the amount needed to generate the same income by way of investment.

III. SUCCESSION METHODS AND ASSOCIATED PROBLEMS.

A. SUCCESSION BY SALE.

1. One of the primary goals in business succession planning is often preservation of the value of the business. In some situations, for example, where there are no family members interested in managing the business, it may be appropriate or necessary to plan for a sale of the business if its value is to be preserved.

2. Succession by sale can be accomplished in two ways: a pre-retirement lifetime sale of the business; or lifetime arrangements for the sale of the business to a third party at death or retirement. Where the client might be

interested in getting out of the business in any event, a lifetime sale may very well be appropriate. The lifetime sale allows the client to convert the value of the business to something more liquid and pursue other endeavors. If the client wants to continue the business until death or retirement, it may be possible to prearrange a sale to a third party, with the sale to occur at the appropriate time. Because the sale will not occur until the client is getting out of the business anyway, an existing competitor may be an appropriate purchaser.

B. PLANNING FOR SUCCESSOR MANAGEMENT IN THE CONTEXT OF NON-SALE TRANSFERS.

1. While the general concept of protecting the value of the business by succession planning is usually fairly easy for clients to accept, the details of planning for succession can be problematic. Often one of the most difficult issues is the allocation of management control.

   a. While many clients are comfortable with the general proposition that "the business should go to the kids", they often have tremendous difficulty deciding which of the kids will manage the business or how management will be shared among the children.

2. The estate planning adviser should also remember that management of a business is a different issue than ownership of the business. When a client says he or she wants the business to go to the children in equal shares, it may not be necessary or even intended by the client that management authority go in equal shares as well. This fact actually gives the estate planner additional flexibility, in that ownership of the business can pass to individuals who may not have the ability or desire to manage the business.

3. In any event, planning for management of the business is critical to succession planning. Any succession plan must provide for competent management and address the often difficult family relationship issues associated with the allocation of management authority to family members. If, or maybe it should be when, surviving family members cannot agree on how to operate the business, everything goes downhill quickly without a good management and control structure. In addressing

   management and control issues, a planner may want to consider the following:

a. A mechanism for dealing with deadlock. This could include designation of an outside party as a tie-breaker, a mediation provision, a forced buy-out provision, or some other prearranged plan.

b. A mechanism for getting out of the company at fair market value. Sometimes family members simply cannot get along in spite of a well drafted management and control structure. In that case, it is important that some method exists for "getting out of the company" at what the parties perceive as fair market value. For example, the owners could be authorized to require that the company purchase their ownership interest at fair market value determined by an independent appraiser. Payment might be spread over a number of years to avoid liquidity problems, and the total amount to be paid could be tied to income to avoid the manipulation of value by the individuals with a controlling interest in the company.

C. SUCCESSOR MANAGEMENT STRATEGIES

1. The first step in planning for successor management is to determine whether any of the intended recipients of an ownership interest have the required management skills. If so, the question becomes how management authority should be allocated among the new owners. If not, the question is whether hiring outside management will work. This in turn, depends largely on whether income from the business is sufficient.

2. Another option is to begin grooming someone for management prior to the clients death or retirement. The individual selected may be one of the intended beneficiaries, a current employee, or an outsider, depending on the circumstances.

3. If the intended new owners are not capable of managing the business whether because of lack of skills or lack of ability to cooperate, and employment or grooming of new management is not feasible, it may be necessary to plan for the sale of the business. A sale can be planned either during life or at death.

a. The first step in arranging for a sale of the business is to locate a potential purchaser. Note that the situation being addressed here is a proposed sale to someone other than an intended beneficiary or an employee or group of employees.

b. Depending on the circumstances, one candidate as a potential purchaser may be a current competitor. A competing business owner is likely to have the required management skills or the ability to obtain them, may have a strong interest in acquiring the business, and may be in a similar situation with respect to business succession him/herself. Under the right circumstances, competing business owners may enter into an agreement to purchase each other's business at a set or formula price.

c. It is not difficult to imagine a number situations under which a sale to a competitor would not be appropriate. In those instances, it may be appropriate to contact a business broker to assist with locating an appropriate purchaser.

d. If a sale of the business is necessary because appropriate successor management is not available among the intended beneficiaries or current employees, it may be necessary to arrange a sale of the business during the owner's life if possible. Following the owner's death, the lack of adequate successor management may make it difficult to sell the business at a reasonable price.

4. Whether post death management will reside with an outsider or one of the beneficiaries it may be appropriate to provide an equity interest (or an additional equity interest) to the post death management team. There are a number of ways of doing this including: a non-voting equity interest; a minority equity interest; a " phantom stock" or similar arrangement; or, a stock option type arrangement.

5. It may be appropriate to provide the new manager with a majority voting interest. For example, when the client wants to divide economic benefits equally among 3 children, but wants one child to have management control; however, this should usually be done in conjunction with a buy-sell agreement to protect any minority owners.

6. The estate planner and the client should also discuss ways to provide for successor management in the event the first choice is not available, or does not work out.

D. DISABILITY SUCCESSION.

1. To this point the outline has concerned itself almost exclusively with succession issues associated with death or sale. However, the client and estate planner should also address succession in the event of disability.

2. Disability insurance addresses the replacement of income, but not necessarily the continuation of the business.

3. The issues associated with succession planning resulting from disability are substantially the same as the issues which arise in connection with death except that in the case of disability transfer of ownership may not be a consideration and transfer of management control may not be permanent.

4. In addition, because of disability is usually unexpected it may be more difficult to provide for the transition of management.

   a. For example, in a small business it may not make sense to groom someone to step in as manager until the owner begins considering retirement. A smaller business may not generate sufficient income to support the salaries of two individuals qualified to manage the operation.

5. However, if permanent or temporary successor management is available from the business owner's family, an employee or employees, or from some other source, appropriate arrangements should be made. If the business can support it, it may make sense to bring a potential successor manager in as an employee with the possibility of a subsequent equity interest in case of permanent disability.

IV. DISCUSSION SCENARIO.

A. Facts: Your clients, the Smiths, own a small consulting business. They advise clients regarding HVAC issues in buildings where hazardous waste gasses exist. It's a specialized field with only one or two competitors in the region. They get their work through referrals from people who know your clients and their expertise in this area. The business has consistently generated substantial income for a number of years, and in spite of having very few fixed assets is worth approximately $600,000. There are no employees other than a part time bookkeeper. The Smiths have 3 children, none of whom is qualified to or interested in taking over the business.

B. Question 1: If the Smiths pass away, or cannot continue running the business for any other reason, and do not have a succession plan in place, how much is the business worth?

C. Question 2: What options are available to the Smiths if they want to protect the value of the business at death?

V. SCENARIO 2.

A. Facts: Same as above, but one of the three children has been helping with the business for a few years and is interested in continuing. The value of the business is the only substantial asset of the Smith's estate except for their residence worth $200,000. The Smiths feel very strongly that their estate, including the business, must be left equally to the kids, who really don't like each other and are already bickering about what to do with the house and how to run the business.

B. Question 1: What happens to the business if its left to the kids in equal shares?

C. How can you deal with the problems that are likely to arise as a result of the above succession plan?

D. What alternatives might the Smiths consider?