MURTHA MEANS MORE
INDUSTRY INSIGHT

PRIVATELY OWNED BUSINESSES NEWS

OCTOBER 2015

BUSINESS SUCCESSION PLANNING: AN OUNCE OF PREVENTION TODAY

If you told a family business owner that he or she had a one in three chance of survival as a result of a current condition, you would likely get their attention. However, when you tell that same owner that their business, as it currently exists, has a one in three chance of survival in the event of their death the response is often "I will worry about that tomorrow." The failure to plan may put the family's financial well-being at risk. This article will address the conflicts that cause family businesses to fail to survive into successive generations and the potential solutions which should be implemented to alleviate such conflicts.

Why Do Family Businesses Fail?

Family businesses fail twice as often because of relationship issues within the family as due to management issues. Which child or children will work in the business and which will not? Which child will be in charge? Will all family members be supported by the business and what internal and external resentments will be heightened by that decision? If the head of the family does not effectively balance the goals of securing the future success of the business with family unity, survival is unlikely. Recognizing the disparate characteristics between family operations and business operations is a start. Families are fueled by emotion and businesses are fueled by logic. Families rely on history and are resistant to change whereas businesses need to adapt and grow. Families accept shortcomings and rationalize poor performance while businesses fire those who are unproductive. Families seek equality while businesses reward achievement. Acknowledging and addressing these conflicts is essential to a successful business succession plan.

Developing the Plan.

1. Identifying Objectives. The first decision to be made by the business owner is the identification of goals and objectives. What does the owner want to happen; i.e., sale versus transfer by gift. When should it happen, today, five years from now or only on death? How should it happen, gifts, sale, inheritance? Who should be involved, children employed by the business only, all children, descendants, in-laws?

2. Identifying Financial Needs. The financial needs of the business owner and spouse will often be determinative with respect to the previously-mentioned objectives. If the business is the owner's primary asset and therefore the primary method for funding retirement, then value realization is key. The threshold question is what is the business worth? Owners often have an elevated opinion as to the business's value given it is the culmination of their life's work. A professional business appraiser will value the business more objectively. The next question

Members of Murtha Cullina's Privately Owned Businesses Group:

Marcel J. Bernier
Emily G. Brown
Frank M. Cappezzera
Alfred R. Casella
Michael P. Connolly
Bridget M. D'Angelo
Thomas M. Daniells
Scott M. Gerard
H. Kennedy Hudner
Nisha Kapur
Kenneth L. Levine
Richard A. Marone
David A. Menard
Natale A. Messina
Willard F. Pinney, Jr.
Irving S. Schloss
Rachel Faye Smith
David R. Sullivan
Joseph R. Tarby, III
Edward B. Whittemore

Copyright © 2015 Murtha Cullina LLP. This alert is one of a series of publications by Murtha Cullina LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances.The contents are intended for general information purposes only, and you are urged to consult your own lawyer concerning your own situation and any specific legal questions you may have.

is will the realization of that value adequately fund the owners' expected level of retirement? Finally, on what basis will those funds need to be paid, how does the owner insure future security, and will the business survive under the weight of those payments?

3. Developing Successor Management. It is often difficult for an owner to relinquish day-to-day control. However, the development of successor management is essential for emergency as well as long-term planning. An emergency plan should be established utilizing existing personnel and outside professional advisors such as accountants, attorneys and financial advisors. A long-term plan may include the next generation of family members, key employees or some combination of the two. The formulation of this plan should commence five to ten years in advance of the date of the owner's retirement. If the future leader is a family member, it is important that he or she be qualified for the position and have the support of employees and other family members. A gradual transition will allow for the development of the successor's capabilities. Further, as the successor becomes more accustomed to increased responsibility the existing owner can adapt to the loss of responsibility. Such advance planning will more likely result in a smooth transition.

4. Retaining Key Employees. Family businesses often have a few key employees who are critical not only to the eventual succession of the leadership of the business but also to the emergency plan that should be in place in the event of the death or disability of the leader. The following four techniques can be utilized to retain key employees.

a. Employment Agreements. An Employment Agreement will summarize the duties and responsibilities of the employee. However, to encourage retention, the Agreement can also incorporate legal restrictions such as a covenant not to compete and financial incentives such as profit sharing or incentive compensation arrangements. These financial incentives can also utilize vesting periods to encourage continued employment and productivity.

b. Non-qualified Deferred Compensation Plan. A Deferred Compensation Plan is an agreement where the company promises to pay a benefit to the employee at his or her retirement, death or disability as long as the employee continues to be employed for a stated period of time or if the employee is employed upon the sale of the business. If the employee does not continue to be employed, the benefit is forfeited. If properly structured, the payments are taxed to the employee and deducted by the company at the time of payment.

c. Phantom Stock Plan. A Phantom Stock Plan or Stock Appreciation Rights Plan will provide an employee with a benefit that will simulate the appreciation in value of a common stock ownership in the company during the period the employee is employed. This arrangement will compensate the employee for his or her contribution to the success and increasing the value of the company. Vesting provisions can also be utilized to retain the services of the employee. Finally, such a plan avoids the entanglements that can come with true stock ownership by an employee such as voting rights, possible breach of fiduciary duty claims and the obligation to repurchase the stock upon termination of employment.

d. Change of Control Agreement. A Change of Control Agreement can be utilized with the previously-mentioned arrangements to provide comfort to an employee that his or her terms of employment such as compensation and benefits will not be changed for a set period (one to three years) following the transfer of the business. Even if the employee is terminated, the Agreement will guarantee continued payment or a bonus for continuing to be employed with the business until the sale.

Executing the Plan.

The key to effectively executing the plan is balancing the owner's financial security with fairness and family harmony. The following are alternatives and considerations:

1. Sell the Business to Active Children. If the business is sold to active children for its fair market value as determined by an independent appraiser, then all family members are effectively treated equally. The purchasing children get the business, the financial future of the owner and the owner's spouse is secured and upon the death of the survivor of them, both active and non-active children can inherit equally. The

issues of conflicting opinions and the disparate needs of active and non-active children are eliminated. The downside of this approach is its tax inefficiency. The owner will recognize capital gains and the active children will purchase with after-tax dollars.

2. Business Real Estate. If the owner owns the real estate on which the business is operated, the owner could consider retention of the business real estate subject to a long-term lease. The lease would provide the owner and the owner's spouse with a continuing source of income. Retention of the business real estate could also provide an asset for the equalization of the inheritance of non-active children. Finally retention of this asset would reduce the lifetime transfer cost of the business interest to the active children.

3. Voting and Non-Voting Stock. Whether the owner of the business wants to transfer ownership currently or needs to use the business to equalize the inheritance of active and non-active children at death, consideration should be given to recapitalizing the company with voting and non-voting stock. Active children can receive the voting stock to allow for the effective management of the company and non-active children can receive the non-voting stock to allow for the continued participation in the growth of the value of the company. Active children should have Employment Agreements to ensure them fair compensation and protect non-active children from the misdirection of company assets. The non-voting stock could be subject to "call" options by the active children and could be subject to a "put" option by the non-active children to allow for a fair separation of interests should one be necessary. A "buy-sell" agreement between the shareholder children can incorporate the "put" and "call" as well as the transfer on death or disability of a shareholder child.

4. Equalize with Non-Business Assets. If there are sufficient non-business assets in the estate of the owner, then equalization of inheritances is more easily accomplished. Ownership interests in the business can be transferred during life or at death to active children and the non-business assets can be transferred to the non-active children. Since all assets are valued at fair market value at death, equality can be made more apparent.

5. Tax Minimization. Although financial security and family fairness are often the primary goals of succession planning, tax minimization is normally also a high priority. Various planning techniques can be incorporated in the context of succession planning discussed above.

Conclusion.

Succession planning does not happen by accident. Successful planning for the termination of ownership of a business interest should be started well in advance of when the ownership will be terminated.

If you need additional information or have any questions on this topic, please contact the following members of the Murtha Cullina LLP Privately Owned Businesses Group:

Nat Messina at 860-240-6027 / nmessina@murthalaw.com
Marcel Bernier at 860-240-6087 / mbernier@murthalaw.com