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Planning for the Generational Succession of a Family Business

by Stephen R. Urbinato

Nearly half of all family businesses are sold or liquidated after the retirement or death of their founders. Less than one-third of family businesses are successfully operated by a second generation and less than 13 percent by a third generation. The average life span of a family business is approximately 24 years—a time period roughly equivalent to the working life of the business founders.¹

These statistics demonstrate that planning for and successfully completing the transfer of a family business from one generation to the next can be a difficult challenge. Compounding the problem is the fact that many founders of family businesses do not recognize the succession challenge, and many of those that do often postpone facing the issue due to various personal or psychological impediments. This can often lead to a scenario where the founders unexpectedly die or become incapacitated, leaving the business in crisis without any plan for the future.

A business lawyer can do a great service to his or her family business clients by taking a proactive approach to succession.² A family business often represents one of the primary assets of the founding generation, and a way of life for family members who work in the business. In helping a client successfully plan for and implement a succession strategy, the business lawyer can have a positive impact not only on the

business, but on the lives of the family members who work there.

A Proactive, Multi-Disciplinary Approach

The process of achieving a successful business succession can be divided into the following four stages:

1. Start the process;
2. Identify the goals of the founding generation;
3. Plan and formulate the legal and business strategies to achieve the goals; and
4. Implement the plan.

Although the business lawyer can play an active role in all four stages, the founders will need to consider a variety of factors along the way, including many of a non-legal nature. Accounting, financial/estate planning and psychological factors can be as important to the success of a succession plan as the legal tools utilized. It is therefore imperative that the

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business lawyer encourage and seek out the input of the client's other professionals, or in the absence of existing relationships, assist the client in assembling a team of qualified professionals.

At a minimum, the client's regular accountant should be consulted. There are a variety of ways a succession plan can be implemented, and each has its own accounting and tax ramifications. The accountant can provide valuable insight into the financial structure and prior accounting practices of the company. The financial condition and other investments of the various family members can also play a role in defining the objectives of the founding and succeeding family members. Consulting with their respective financial, insurance and investment advisors can therefore be of value. Lastly, the psychology and relationships of the various family members can greatly impact both the planning and the implementation stages. The business lawyer will often be in a position where personal or psychological factors impede a client's ability to establish goals and make decisions regarding how best to achieve them. In appropriate situations, the intervention of a psychologist experienced in the interpersonal relationships and issues present in a family business can bring a fresh perspective that can identify and resolve psychological impediments.

Conflicts of Interests

Before turning to the four stages of a successful succession, the business lawyer must consider the issue of conflicts of interest. In most instances, the interests of the founding generation will differ from the successor generation. The interests of different members of a given generation will also often differ from other members of that generation. It is thus important for the business lawyer to identify exactly who the

lawyer represents, and to communicate that fact to the other individuals involved. This can be a difficult task for the business lawyer because there may be more than one family member who considers the lawyer to be his or her personal lawyer. The conflict issue will usually result in a situation where the lawyer must either disclose the actual or potential conflict and obtain written waivers or decline to represent multiple parties.³

Even in cases where the conflict can and is waived by the various parties, the goal of a successful succession plan may be best served by insisting that the various individuals (or similarly situated groups of individuals) have independent counsel. Another approach may be for the lawyer to plan and formulate the succession plan as counsel to the corporation, and then insist or recommend that all family members or similarly situated groups seek the advice of independent counsel prior to implementing the plan. Regardless of how the lawyer resolves the conflicts issue, it is important to do so in writing—both to ensure that the parties involved understand the issue and to protect the lawyer from potential malpractice and ethics claims.

Stage One: Start the Process

The first stage can be both the easiest and the most difficult. This stage usually will involve raising the subject with one or more members of the founding generation but also can start with the successor generation or a combination of the two. The method of proceeding largely will depend on the interpersonal relationship between the lawyer and the client, and who the lawyer most often interacts with in the business. This stage can be difficult, because it requires the business lawyer to speak up on an issue the client (particularly the founding generation) may not be ready to consid-

er on a personal or psychological level. It can also be the easiest stage, since the only thing required is to raise the client's awareness. As discussed above, the involvement of the client's other professionals can be very valuable here.

Stage Two: Identify Goals

Identifying the goals of the founding generation is often a complicated process involving the balancing of many factors. While identifying generalized goals is usually not difficult, fitting those general goals into the context of a specific business is frequently more difficult. For example, a common general goal is to ensure the orderly transition of ownership of the business to the succeeding generation. Another common general goal is to ensure the maximum probability of continued business success in the next generation. What these goals mean within the context of a particular family business will depend on the individual circumstances of each family and each family business. The founders will thus need to assess and resolve numerous factors prior to establishing their succession goals, including the following:

1. Their individual financial condition and future income needs;
2. Whether all of their children are involved in the business and, if not, whether and how to provide for children that are not active in the business;
3. The individual strengths and weaknesses of their successors; and
4. What future role they desire to have in the business, if any.

As the founders consider these factors, input from outside professionals can again be invaluable. For example, a parent may find it very difficult to assess

a child's strengths and weaknesses, or to select one child over the other to assume management control. Failure to select the most qualified individual child to lead the business in the successive generation (or in some cases, the failure to select any child and instead opt for a committee approach) can often lead to sibling infighting that can paralyze and threaten the continued viability of the business. A psychologist experienced with family business issues can be more objective and provide insight that enables a founder to make sound decisions.

Also, an outside financial advisor may be better able to evaluate a founder's financial holdings and provide more accurate estimates of the amount of income the assets can be expected to generate. These financial projections can then be used in determining the founder's future income requirements, and what non-business assets might be available to provide for children who are not actively involved in the business.

There is no right or wrong answer regarding the founding generation's goals. In one instance, the founders may have sufficient outside financial resources to provide for their needs and sufficient confidence in the management of the succeeding generation so that there is no need or desire for their future involvement in the business. In other instances, the business enterprise may represent the founder's only substantial asset, thus necessitating a continuing future income flow from the business following the succession. In yet other instances, the founding generation may not have sufficient confidence in the succeeding generation to manage the business, and will thus desire to remain involved in the business during an extended transition period.

Stage Three: Plan to Achieve the Goals

Once the founder's goals have been determined, the business lawyer must formulate a plan to achieve them by utilizing a variety of legal tools and techniques. The business lawyer's challenge is to determine which tools are most appropriate, and then tailor them to meet the specific needs of a situation. Five commonly used tools and techniques will be reviewed.

Gifts of Ownership Interest to Successors

Gifts of ownership interest are a simple way of transferring ownership to the successor generation. As part of a long-term succession plan, gifts can often be accomplished in a manner that avoids any adverse estate or gift tax implications. For calendar year 2006, an individual's lifetime gift tax exemption amount is \$1,000,000, and the annual gift tax exclusion is \$12,000.⁴ Thus, if a founder and his or her spouse join in the gift, the annual exclusion gift amount to each individual is \$24,000. Larger tax-free gifts can be made by utilizing all or a portion of the lifetime gift tax exemption.⁵

The value of the gift can also be enhanced by the use of valuation discounts. A minority ownership interest in a closely held or family business is frequently not readily saleable, and often does not allow its owner to exercise any real control over the business. As a result, the value of the minority ownership interest does not necessarily correspond to its *pro rata* share of the overall enterprise value of the company. For example, if a given business has an overall enterprise value of \$100,000, a one percent ownership share would have a *pro rata* value of \$1,000. Since that one percent share, however, is not likely to be readily saleable, and does not by itself allow its owner to exercise control over the busi-

ness, its real value is typically less than its \$1,000 *pro rata* value. Valuation discounts in the range of 10 to 20 percent are often employed with respect to each of the non-marketable and lack of control factors, which result in an overall discount in the range of 30 percent. Thus, the one percent ownership interest would not be valued at \$1,000 but rather at \$700 (*i.e.*, \$1,000, less 30 percent).

If a founder's succession plan involved making gifts in the maximum annual exclusion amount to a given successor, the gift would not have to be limited to 12 percent of the company (*i.e.*, \$12,000 annual exclusion amount divided by \$1,000 *pro rata* value), but could instead be a gift of 17.14 percent of the company (*i.e.*, \$12,000 annual exclusion amount divided by \$700 discounted value). Thus, by making gifts over a period of time, the transfer of ownership of an entire business can be made free of gift tax, while at the same time removing assets from the founder's estate for estate tax purposes.

Sale or Redemption of Ownership Interests

It is fairly common for a founder's ownership interest in the company to be his or her primary asset. In such event, it will not be possible for the founder to gift his or her interest away to successors without receiving some form of financial compensation to be used to fund his or her retirement. One way to provide the compensation is for the founder to either sell his or her interests to the successors or have the company redeem the ownership interests. An advantage to this approach is that the founder can often realize the value of his or her interest and be taxed at capital gains rates (or the sale or redemption may be tax-free to the extent of the founder's tax basis in the interest being sold or redeemed). In both instances, the funding for the purchase or the redemp-

tion can often be provided in installment payments from the current and future operation of the business.⁶

Stockholder, Operating or Partnership Agreements

The governing agreement for the given business entity can be a useful tool in a succession plan. Although the form of the governing agreement will vary depending on the type of business entity involved (*e.g.*, stockholders agreement for a corporation, operating agreement for a limited liability company, etc.), the role the agreement can play in achieving the succession goals is essentially the same in all types of entities. The founders can insist that as a condition of a gift, sale or other transfer of ownership interests or control to the successors that the successors enter into a governing agreement that contains provisions the founder believes will further the goals of the succession.

For example, in order to further the goal of maximizing the company's chances for continued success, the agreement could require that all owners elect a given individual (often pre-selected by the founder) to serve as the chief executive officer, or that a certain group of individuals be elected to serve as directors or managers. As another example, in order to further the goal of eliminating or minimizing rivalries or infighting among the successors, the agreement could provide limits on how the company (or the selected officer or board) will determine how and when profits and distributions will be made and how salaries or guaranteed payments to owners will be determined. The founder may or may not be a party to this agreement, depending on whether he or she continues to hold any ownership interest at the applicable time. Nonetheless, the agreement can allow the founder to keep his or her imprint on the company after he or she no longer

owns a controlling interest.

Employment or Consulting Agreements

Employment and consulting agreements can be utilized for both founders and successors. For founders, a consulting agreement can be utilized to achieve the goal of providing founders with a continuing source of income following the succession. The same agreement could be utilized for the purpose of keeping the founder involved in the company during a transition period in order to maximize the chances for the company's continued success. For successors, an employment agreement can be useful for ensuring that given individuals (often pre-selected by the founders) are utilized to perform given functions following the succession. The same agreement can be used for the purpose of protecting a given individual from sibling infighting by providing a guarantee of continued employment.

Leases

It is common for founders to own the physical facilities within which a company operates through a separate ownership entity. This situation can often facilitate achieving both the goal of continued income to the founder following succession and the goal of providing fairly for other family members who are not directly involved in the business. By entering into a long-term lease with the company prior to the succession (or requiring that the successors agree to enter in the lease as a condition of the succession), the founder can ensure continued income while at the same time preserving an asset that can be used to provide for other family members as part of the founder's overall estate plan.

Stage Four: Implement

The fourth stage, like the first stage, can be both the easiest and the most difficult. Once the founder's goals have

been determined and a plan has been formulated to achieve them, all that remains to be done is to draft and finalize the documents and implement them. Depending on how the conflicts of interest issue has been resolved, this is the time that unrepresented participants should be most encouraged to seek independent counsel. This stage can be difficult because the same personal and psychological factors that can cause a client to avoid stage one can often resurface to prevent the client from finalizing and implementing the plan. In the event of inaction, the business lawyer will serve his or her client well by keeping the client focused on the reasons they began the succession planning process and the potential ramifications of failing to implement the plan.

Conclusion

Business succession can be a challenging area for the business lawyer. To meet this challenge, the business lawyer must take an organized and proactive approach to the issue and work closely with his or her client to define the succession goals and to then formulate the succession plan. The business lawyer's role in facilitating a successful transition can have a lasting impact on the future success of the business and the lives of family members. ◊

Endnotes

1. Nancy Bowman-Upton, U.S. Small Business Administration, *Transferring Management in the Family-Owned Business*, (Emerging Business Series 1991); Ronald Drucker and Richard Landman, "Nurturing a Family Business," *The Financial Manager*, March-April 1990.
2. Although there can be a variety of generational succession scenarios, the most common is one where the founding generation nears retire-

ment age and seeks to transition the business to their children. For ease of discussion, this article will therefore speak in terms of parent founders and children successors, and will focus on the succession process primarily from the founding generation's perspective. This article will not address non-succession exit strategies available to the founders, such as an outright sale of the business to a non-family third party.

3. See New Jersey Rules of Professional Conduct 1.7 and 1.8.
4. Internal Revenue Code, 26 U.S.C.A. 2503 and 26 U.S.C.A. 2505.
5. Prior to utilizing the lifetime exemption for a gift of an ownership interest, a thorough analysis of the founder's other assets and the estate tax implications of the gift should be conducted.
6. The decision whether the company should directly redeem the founder's ownership interest, whether the successors should purchase the interest, and in the case of the latter, how the company should distribute cash to the successors (*e.g.*, as salary, guaranteed payments, loans, capital distributions, etc.) to enable them to fund an installment purchase can be complicated. This is an area where the company's regular accountant or tax advisor should have some input.

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