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Take a multidisciplinary approach to exit and succession planning

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Effective succession planning is a multidisciplinary process that combines an understanding of the psychological dimensions of the business-owning family with the legal structures necessary to realize the business leader's desires and objectives. What does the exiting leader wish to accomplish, and how can he or she achieve those goals while keeping the estate, the family and—if desired—the business intact?

The failure of many family businesses to transition successfully to the next generation is legendary. What is often unappreciated, however, is that barriers to exit and effective exit planning frequently have emotional underpinnings. An owner's powerful emotions often play a significant role in the decision to sell, not to sell, or to transition a business. While family members may humorously refer to the business as the owner's "child" or "favorite child," the emotional force behind these comments may come to dominate succession planning in counterproductive, if not destructive, ways. Failure to discern and address these factors may result in significant reduction in value.

Emotional factors may override sensible decision making in many areas, including overvaluation of the business, the decision to sell at a time of low value, and the wrong successor being chosen for the wrong reason.

Conflict commonly arises between a group of second- or third-generation owners who are employed in the business and a group of their siblings or cousins who are not. Without planning, the employee and non-employee owners will be on course for a disagreement after the senior generation passes away.

Many times, expensive and devastating litigation results. Trial judges, often ill equipped to handle business ownership and family disputes, tend to issue court orders for the dissolution of the business or unaffordable buyouts of the non-employee owners. It is much better for the senior business leaders to handle transition planning during their lifetime, as opposed to leaving the matter to the courts to resolve.

Business owners would be wise to think about their succession plans early and often, which means realistically considering the value of their business and the possibility of a sale. If selling the family business is not an option, the senior generation must properly address estate planning—e.g., what would happen if the founder died owning 100% of the company, or a controlling interest—because to do nothing can ruin the company.

Yet it is no simple feat to plan for transition of an estate that consists primarily of a family-owned business. Consider the allocation of assets. The most common question raised at an estate planning meeting is how to divide an estate among children who have different levels of wealth. For example: Do you give your son the schoolteacher more of your estate than you give to your daughter, who is a successful and wealthy doctor, or do you give each a 50% share?

If your estate is passing to your grandchildren, do you give each grandchild an equal share of your estate? What if one of your children has just one child, while another has four children? Will the grandchild without siblings receive the parent's 50% share, while the four grandchildren in the other branch receive 12.5% each?

As a parent and grandparent you have many decisions to make. Treating everyone equitably does not mean treating them all equally.

In addition, it is difficult to accurately value your business. Value depends at least somewhat on the quality of management after the company is in the next generation's hands. The following scenario is just one illustration of how complex these issues can be.

Different heirs, different perspectives

Consider a family with two children: Steve, who manages the family business, and Dave, a teacher. After their parents pass away, Dave and Steve will each receive 50% ownership in the business.

Steve, the CEO, wonders if this ownership structure is fair. He works long hours, while Dave contributes nothing to the business. Wouldn't it make more sense, he thinks, for him to own the entire business? He also notes that the more he builds the business, the more it will cost him to eventually buy out his brother's 50% interest.

Dave is proud of the family business but sees that his brother lives a lavish lifestyle with many perks from the business their parents built. The family business does not pay any dividends to Dave; all extra cash flow is invested back into the business. Dave, understandably, feels that under the circumstances his equity in the business has little current value to him.

Restructuring the business for the inactive owner

Because the parents do not have material wealth outside of their business, they find it difficult to be equitable. If they give Steve 100% ownership of the business, the assets available for Dave, such as their relatively small brokerage account investments, will be of lesser value.

One option is for the parents to divide the business into two parts: the operating company (to be inherited by Steve) and the real estate (to be inherited by Dave). The real estate will provide Dave with rental income as well as an appreciating asset.

Another option to provide some liquidity to Dave is to recapitalize the business when ownership passes from the parents to the children. For example, the parents can give Dave either a preferred stock interest in the business or a promissory note issued by the business. Tax rules limit their options. In a limited liability company, they can use "preferred" interests for Dave, but they cannot do so in an S corporation. If the business is an S corporation, a promissory note or other non-voting stock redemption arrangement is the best option for Dave.

If the business is worth $10 million, Steve would receive 100% of the common stock interest in the business, while Dave would receive either preferred stock interests worth $5 million or a $5 million promissory note. In both situations, Steve would end up with stock worth $5 million and Dave would receive an asset worth $5 million. However, as a common stock owner, Steve would be entitled to all of the business appreciation for his hard work. Similarly, he would lose his equity value if the company does not do well under his leadership. Dave's risk is minimized, since he would always be entitled to $5 million before Steve could get his equity.

Parents set the valuation and pay out to inactive heir

If the parents set Dave's value at $5 million, there is no dispute between Dave and Steve over the value of the company or the value of Dave's interest. This kind of valuation is a complex matter, since generally accepted methodologies include discounts for Dave's lack of control and the stock's lack of marketability, not to mention the inexact science of business valuations. In their estate plan, the parents should handle the potential for further conflict between Steve and Dave.

For financial reporting purposes, Dave's $5 million promissory note would be considered debt on the balance sheet, while a $5 million preferred interest would be considered equity. Either would result in Steve's equity interest in the $10 million business being $5 million.

Further, Dave's $5 million preferred interests would typically receive dividend income on the face amount of the $5 million of equity. In the second case, Dave's $5 million promissory note would receive interest income on its principal debt. The dividend or interest payments provide Dave with some income he would not have had otherwise. The parents set the dividend or interest rate, which can be a fixed or variable rate based upon an index such as the WSJ Prime plus or minus certain basis points. Keep in mind that interest payments are tax-deductible to the company, and the dividends and interest are subject to different income tax rates for Dave.

The parents could also establish a reasonable payment schedule to pay down the $5 million principal on the debt or to redeem the preferred stock interests over several years. (Payment periods of five to 10 years are common.) The extended payment schedule will minimize the financial drain on the company (and thus the burden on Steve) but will allow Dave to otherwise enjoy his inheritance. Steve may also be able to borrow money to pay off Dave sooner, as a prepayment option without penalty. This would be beneficial to Steve if the borrowing rate is lower than the interest or dividend rates established by his parents.

Other issues

There are many more collateral issues to address, such as voting rights. Dave's consent on certain material business matters may be required while his interest in the company or promissory note balance remains significant. These rights are typically outlined in shareholder agreements and commercial loan agreements (for example, limitations on the company's right to make certain large capital expenditures or restrictions on Steve's compensation while the company still owes Dave money).

Proper estate planning is more than having a lawyer prepare a last will and testament. Careful estate planning that ensures business owners will leave a valuable legacy to all their children is a complex process.

Parents who leave all their assets in equal shares to their children may not realize they could be setting the heirs up for litigation or the breakdown of sibling relationships. As we saw with Dave and Steve, failure to plan results in an inequitable solution.

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