

The EXIT Planner

July, 1999

A Publication of
Business Enterprise Institute, Inc.

WHAT'S INSIDE

by John H. Brown
President, Business Enterprise Institute, Inc.



→ JOHN H. BROWN

INGREDIENTS FOR A SUCCESSFUL TRANSFER OF A FAMILY-OWNED BUSINESS

What could be easier than transferring your family business to its natural successor, your heirs apparent, your offspring? If some of your first guesses were peace in Yugoslavia, bi-partisanship in Congress, or the Chicago Cubs winning the next World Series, like me, you have probably witnessed your share of family business transfer disasters.

Statistics, widely quoted by estate planning writers, indicate that “only” one-third of all family-owned business are passed on to the second generation, and “only” ten percent of family-owned businesses are transferred to a third generation. My own experience dealing with hundreds of family-run businesses indicates that those statistics are wildly optimistic and overstated. My pessimism notwithstanding, some family businesses are indeed *successfully* transferred to younger generations. For the transfer of business ownership and control from parent to child to be deemed “successful” the parents must achieve all their exit objectives, including:

- Financial independence and security, completely divorced from reliance on cash flow from the business;
- Intra-family fairness regarding distribution of family wealth; and
- Complete transfer of business operation and ownership control to the younger generation. This usually means the parent is out of the business and is not needed in the business for any reason.

This article asks the question, if it is so difficult to *successfully* transfer a business from one generation to the next, is there a way to improve the likelihood of success? Better yet, is there a no-fail “recipe?” In the checkered, but always interesting, history of nepotism (as it relates to business transfer) we find that parents hope a child will take over a business for several reasons:

1. The joy of working together. (At least that’s what some owners claim.)

2. Greater employment and financial security for family members than that available elsewhere.
3. Maintenance of the family’s focal point — the business. Parents see the business as the “glue” that helps the family stick together.
4. Fulfillment of a childhood dream. The child(ren) has grown up in the business, knows it, and wants to stay in it by acquiring ownership.
5. Gradual retirement. The owner can stay semi-active in the business by gradually turning over operations and ownership to the new generation.
6. Family pride. The owner takes considerable (and often justifiable) pride in continuing a family business and tradition.

Doesn’t this all sound great? It is great, but all too often your hopes and aspirations crash headlong into the brick wall of reality.

- The children, for lack of a more elegant phrase, don’t get along with each other.
- The children have substantially different career goals.
- The parents need to achieve financial security before feeling comfortable transferring a business to children. The children, on the other hand, desire significant ownership sooner, rather than later.
- The children simply don’t have the same desire, ambition, or aptitude for running the business as the parents.

Yet, despite all the obstacles, it is quite possible, given the right circumstances, to successfully exit the business by transferring it to your children.



PASSING THE TORCH OR THROWING IN THE TOWEL?

by John H. Brown

There is indeed a “recipe” for creating successful intergenerational transfer. It isn’t the only recipe that works, but because it depends on five carefully chosen ingredients, its chances for successful completion are greater than others. If any of the following five ingredients is compromised, or worse still, missing, the result will change.

1. The one child active in the business becomes the sole successor owner.
2. The business transition plan is fair to all children.
3. Parents have achieved financial security (independent of the future cash flow of the business) before business ownership and control is transferred to the business-active child.
4. The business-active child has demonstrated the capacity, ability, and willingness to run the business for a significant time period (at least three years) before the parents transfer control and ownership.
5. There is a back-up plan.

Just as baking bread at sea level is not the same as baking at high altitude, this is not a “one size fits all” recipe. Regardless of altitude, bakers use flour, yeast and water but quantities, temperature and cooking time vary. So too, the recipe here may need to be adjusted to your specific circumstances. For example, you may be able to include several children in business ownership. Also intrinsic to this recipe is a contingency plan. Every chef knows that unanticipated events can throw the best plans awry. If the power goes out, the prepared chef has a contingency plan.

These five “ingredients” are nothing more than a pattern of facts that, when present, enhance the chance of a successful family business transition and, in my experience, constitute the recipe that provides the most significant opportunity for success.

EP FIRST INGREDIENT: One child shall succeed in business ownership.

In one of my first books, I observed that it is easy to recognize those business owners who have dedicated their lives to ensuring a successful transfer of a family-run business — they have but one child. However, for most of us, it is a bit late to reverse our course. Why just one child? Let me explain.

There are two possible ownership scenarios for families having more than one child. The first is that more than one child is active in the business. In that case, the predominant issue is to determine how multiple children are to *share* the

control and ownership of the company. The second is having one business-active child and one or more children inactive. The primary concern in that case is to give the business to the active child while being fair to everyone else (ingredient two).

Owners in the first situation must ask themselves, “How can children who couldn’t share a ninety-eight cent toy when they were younger now share the ownership, management, and control of a successful, multi-million dollar business enterprise?” Forcing the children to work together ordinarily creates an unnatural coalition of differing talents and desires, united only by bloodline. Contrast that situation with business partnerships that do work — two or more individuals enter voluntarily into a business arrangement for their mutual benefit, each contributing experience, talent, and perhaps money. In return they each receive an agreed upon, negotiated, ownership interest in the business — a proportion *they* agree upon, not a proportion given to them by someone else. Further, they are likely to have similar goals, aspirations, drive and ability. Hoping to enhance the likelihood of business success brings them together, not family ties.

Family ties of a different sort can also create dissension and discord. Adult children who, years before, found sharing a toy difficult (if not impossible) because of sibling rivalry now find another relative introduced into the mix: their spouses. The influence of a spouse on a child’s business decisions reminds me of the influence gasoline has on fire. Whether the son- or daughter-in-law becomes active in the business or simply offers observations, an already warm brew can begin to boil. For this reason, co-ownership among siblings is rarely permanent, especially once the parents are out of the picture.

Look at the difficulties of multiple children owning the business from another perspective. As a business owner, you know many other owners. How many of them share ownership equally with a brother or sister? My guess is that you know none. In fact, I venture that almost all owners you know are the sole owners of their businesses, unless they have sold or transferred a small, minority interest to one or more key employees. Equal ownership of a business with even an unrelated person is an odd bird in the business world for good reason. Successful entrepreneurs are notable for above-average amounts of desire, drive, ambition, dedication and commitment to their businesses. These are not personality traits that work well in a cooperative environment. They are attributes born of the simple fact that they own and are responsible for those businesses. Sharing that burden, although tempting at

times, is not a route most owners voluntarily take.

I do find that in many family-run businesses, the parent did once co-own the business with one or more brothers or sisters. Over the years, however, those siblings dropped out or were bought out of ownership. It would seem that co-ownership just doesn't work for most families. It's unlikely to work for yours.

This first ingredient — transferring the business to one child — must now be blended with the quest for the second: fairness to all children.

EP SECOND INGREDIENT: A business transition that is fair to all children.

Most parents have a natural inclination to distribute every asset equally to all children. The thought of giving one asset, and very likely the most valuable asset, to one child is considered unequal and, therefore, unfair to the other children. Yet, upon closer examination, leaving the business entirely to the business-active child *and* making an equitable distribution of the balance of family assets to the inactive children is the fairest plan of all.

“Fairness” in this context is usually a judgment parents make about *they think* is fair to the children. What it overlooks is *what the children* deem to be fair to each of them. This perspective is all too often missing in family transition planning. To determine what is fair, assume the point of view of the business-active child and then that of the inactive child.

Let's look at why the *business-active child* might well resent having a co-owner sibling who is inactive in the business. Perhaps one of these reasons applies:

- It is the efforts of the business-active child to increase the value of the business that should be rewarded. You probably offered all of your children an *equal opportunity* to participate in the business and become owners. Yet, only one child seized that opportunity. Why force your most ambitious, risk-oriented child — the one who chose to succeed you — to share the rewards with children who chose different career paths?
- You had no co-owners in the business because you wanted to operate the business independently. As an entrepreneurial “chip off the old block,” your child doesn't want to share ownership any more than you did.
- The controlling vote is not enough! When there are co-owners, the child running the business has a fiduciary duty of due care and loyalty to all other shareholders. That means that the business-active child's actions, such as giving herself a bonus, or increasing her own salary, or indulging in other business “perks” (as you do), must all be reasonable and comparable to what a non-shareholder performing the same duties for the company might reasonably expect. I doubt you would subject *your* compensation and perks to the same level of scrutiny.

And what about the *inactive child's* perspective? Inactive children are unlikely to want ownership in the business, if other choices are available.

- As I discussed in my book, *The Completely Revised How to Run Your Business So You Can Leave It In Style*, inactive children generally prefer to own, or receive, assets that are more liquid and less risk-oriented than ownership in the business. This is true even if they have to wait until both parents die to receive their inheritance.
- If the inactive child owns part of the business, have they received anything of real value? Partial business ownership will make the inactive child the proud owner of an illiquid security that generates no immediate income or other benefits. Further, the inactive child has no ability to sell his interest, except to the business-active child. Yet, that's hardly a problem since the active child won't, in all likelihood, have the money to purchase it. And, if he does, the business-active child's idea of fair market value is likely to differ dramatically from that of the inactive child. Congratulations! You've created your own Cain and Abel!
- It would seem from the above point that the inactive child's ownership interest would have little value. The (now friendlier) IRS begs to disagree. While a non-controlling ownership interest can certainly be discounted in value, it will nevertheless rise in value as the overall business value increases (due to the efforts of the business-active child). Because it is difficult for the inactive child to get rid of the ownership, he or she has to deal with the tax consequences.
- And one last thing. Keep in mind that the inactive child will not be able to make any decisions regarding the future course of the business.

At this point, could you still be committed to attempt a transfer to more than one child? Is it possible to create a workable model? Yes, although a successful multiple ownership transfer usually requires a business that is sufficiently sizable and profitable to enable each child to run a separate division. Each child's compensation can then be based upon the success of that particular division.

For those of you who still wish to sail against the wind and transfer the business to multiple children, I offer the following characteristics present in businesses that have been successfully transferred to multiple business-active children:

- Family loyalty and family values are stronger than “business values” or the desire for personal gain. In other words, each child views business success through the eyes of the family, and each of its members, rather than through his or her own eyes.
- One child has effective day-to-day control over the business operation. Usually control is granted to that child,

not because of stock ownership, but because of the child's experience and leadership abilities.

- The business is large enough to support all children and give each child a separate area of responsibility.
- Each child's salary is based upon job description and performance.
- Children have been active (alongside parents) in the business long enough to make each child comfortable with the role each plays within the business.
- Alternatively, the business must be large enough to be considered an investment (mature, solvent, stable, usually run by non-family managers as well as one or more children, and sufficient cash flow to handsomely reward the business-active child while providing an income stream to other children who are simply passive investors).

If I've convinced you that only one child should run the business, how do you find the second ingredient — fairness to all children — when transferring the business to the business-active child and other assets to the inactive children? Obstacles to a *fair* transfer of assets include:

- The business value may be significantly greater than the combined value of the remaining family assets.
- If part of the business value is attributable to the business-active child's efforts, is it not fair to consider that part of the business to be that child's interest now? How do you determine the active child's contribution to existing business value?
- And let's not forget the timing issue. It makes good business as well as estate tax sense to transfer a significant amount of the business *during your lifetime* to the business-active child. The inactive children, however, will not likely receive their "share" of the family wealth until after you and your spouse die. The reason for this is simple: the non-business assets are usually retained by you to provide income and financial security to you and, after your demise, to your spouse. The resulting timing difference is mitigated by the liquidity difference in the assets the children receive. The business-active child may receive assets now but his assets are highly illiquid. The inactive children may have to wait but the assets they receive will be highly liquid.
- In addition to the present difficulty of distributing business and non-business assets equally, there is an added difficulty of measuring the *current value* of the business interest given to the business-active

child against the *future value* of the bequest given to the inactive child. To understand the present vs. future value conundrum consider the following:

1. Is the business-active child, in effect, paying for the business now through "sweaty-equity" (lowered compensation, more working hours, and greater risk)? If so, the current gift is not really a gift, but recognition of that child's efforts.
2. Is the business-active child adding to the business's value through his or her efforts? If so, he should not have to pay for that effort by receiving a reduced share of the ultimate estate.
3. Has the active child, by continuing in the business after your retirement, become a critical element in your retirement plan by ensuring that the business can pay you any deferred compensation and purchase your stock? If so, the means by which you tie her to the business — the golden handcuffs — may be the transfer of stock. Again, acquiring stock because it benefits you should not penalize the business-active child when it comes to sharing in the estate.

How can one possibly find the correct measure of this ingredient?

For most families, the decision ultimately comes down to a discussion of fairness vs. equality. Because the difference in contribution to the business and differences between assets being gifted (business vs. non-business and consequent timing difference) it is imperative to be *equitable* or *fair* in treatment, not necessarily *equal*. Parents must strive to be fair. They must communicate and explain this strategy to all of the children. Often it is best to hold a family meeting using advisors to facilitate the discussion, if necessary.

Finally, be certain to make appropriate adjustments in your will, trusts and buy-sell agreements to apportion assets if your lifetime transfers of the business and other assets are not completed before your demise. As part of those documents, the business-active child should have the right to have her share of your estate consist of business interests while the remaining children have the right to have their portion of the estate satisfied with other interests.

EP THIRD INGREDIENT: Transfer of ownership and control to the business-active child FOLLOWS parental financial security and independence.

The business is the primary source of wealth and income for almost all owners. As an owner, you should have all of the desired cash in the bank *before* you transfer control and ownership.

Financial security comes in three basic varieties: those who have it; those who know how to secure it; and those who have the means to obtain it.

1. Those who have financial security can afford to receive less than full fair market value for their businesses. They have typically attained financial security by accumulating financial wealth outside the business. They have invested excess earnings outside the business during their active years.
2. Those who know how to secure financial security commonly purchase assets outside of the business, and lease those assets back to the business for use. Assets purchased for lease typically consist of office, warehouse/manufacturing facilities, or equipment used by the business. Keeping these types of assets outside the business lowers the value of the business, thus easing its transfer to the active child by incurring less transfer (gift or estate) taxes. Second, keeping assets outside of the business makes those assets (or wealth) available for transfer to the inactive children. Finally, keeping assets outside the business protects them from future creditors of the business after the parent has left.
3. Those who possess the means to achieve financial security are able to sell their businesses *for cash* to the business-active child. The February 1999 issue of **The Exit Planner**, “Selling a Business to Key Employees,” discusses techniques that can be used to allow an employee (or business-active child/employee) to purchase a departing owner’s ownership interest for cash. *A business owner should not consider, even for a moment, transferring control, either operational or ownership, before financial security has been achieved.* If an owner wishes to leave the business before accumulating enough wealth to be provided with sufficient independence, then it is incumbent upon the business-active child to obtain financing in order to pay sufficient cash for the ownership interest.

As a business owner, you must determine which flavor of financial security suits your palate. Keep in mind that even if your financial security does not depend on receiving full market value for your business, you must either insist upon it or accept the fact that by accepting less you are giving away at least a part of the business. Once you start giving things away the fairness issue crops up. If you don’t handle these fairness issues through your estate planning documents, your recipe has become, at best, unpalatable to the children.

Some of you may have noticed that financial security did not include selling a business, over time, for little or no cash to the business-active child. Although this course of action is all too common, it is fraught with peril and usually doomed to failure. At the outset of this article, we established that we would provide only *successful* recipes. Hence, the omission.

Finally, those parents who sell the business for cash to the business-active child must begin the transfer process before they begin retiring. Under the best of circumstances, the “modified cash method” requires that the “pump be primed.” A child must receive significant ownership before acquiring the balance of the company for cash. If the transfer is to occur over an extended period of time, it is vital that parents retain ultimate control as well as a buy-back agreement. In this agreement the parent will want to be obligated to repurchase any interest from a business-active child so that, if he or she chooses not to complete the buy-in process, you can execute your back-up plan.

EP FOURTH INGREDIENT: The chosen child has demonstrated the capability and willingness to run the business for a significant time period (at least three years) before the parents leave.

How does a parent know whether a child is capable and willing to run and own a business? One of the best indicators is the parent’s past willingness to take extended vacations without calling the business to just “check up on things.” Of course, handling day-to-day issues does not tell you if the child is capable of being a long-term owner who can handle larger issues of growth, future competition, and economic down-turns. Your job is to prepare the child for future business risks as you would any key employee: with training, responsibility, education and example. It is at this point that the assistance of advisors can be most valuable.

EP FIFTH INGREDIENT: Having a Plan B.

As one assembles and prepares the ingredients for a recipe, any number of things can go wrong. So too with an intergenerational business transfer. That is why having a back-up plan is crucial. Let’s look at the most common causes for employing your “Plan B.”

- If you die or become incapacitated before the transition is complete, your estate plan (wills and trusts) must effect the transfer of the business to the child(ren) of your choice.
- If the business has increased in value to such a point that a buyout by a child is just too difficult financially, you must be prepared to offer the business for sale to employees or to a third party.

- Even if your child is able to purchase a highly valuable business, you may not be able to provide assets of equal value to your other children. Remember that fairness is a crucial ingredient for a successful transfer.
- Similarly, some businesses become too complex or too sophisticated for any one person to run and control. No child can be expected to shoulder that burden successfully. In this case, a better alternative is to sell to a third party.
- As time passes, you may discover that the business-active child does not possess the drive or interest to carry the business. His or her desire to please you may have blinded you to his lack of ability or willingness to assume the risk. Or, he may not have fully understood the personal and financial sacrifices necessary to continue the success of the business. Again, a sale to a third party may be a better option.
- Finally, as parents and child move through the transfer process, substantial differences in management style and practices emerge. Sometimes these difference can be overcome but often they are so great that the transfer cannot be completed. It is imperative that if the transfer falters, the business-active child's ownership interest be reacquired by the company at the lowest practical price. This is best accomplished through binding buy-back agreements between the company and children.

For all of these reasons, it is important that a back-up plan exist. If the business transfer goes awry at any point, the family must prepare to go to Plan B.

▶ CONCLUSION

Owners do not suddenly and decisively opt for a particular exit strategy involving their offspring. Usually family and business life become entwined when children first begin to work in the business after school and during summer vacation. I know. I worked for many summers at my parents' grocery store during my high school and college years. Many unspoken assumptions are made and promises given, often well before the full consequences of those commitments can be appreciated. In other families, careful consideration, adherence to the recipe and action, including the use of professionals, underlie the transition of the family run business.

To increase your chance of successfully completing an intra-family transfer you must focus on the five ingredients:

- The choice of one child as sole successor
- Fairness to all children
- Financial security for you and your family
- Child who demonstrates ability and willingness to carry the business
- A clearly understood back-up plan

John H. Brown is a founding shareholder of the law firm Minor & Brown, P.C., as well as the President of Business Enterprise Institute. He can be reached at (303) 320-1053.



We at The Exit Planner, are happy to answer any questions you have about articles that appear here We also appreciate suggestions from readers about the Exit Planning topics that they wish to see addressed. We welcome your comments regarding our newsletter. You can address your questions, comments or suggestions to: John H. Brown, President, Business Enterprise Institute, 650 S. Cherry Street, Suite 1100, Denver, Colorado 80246 (303) 321-2242.

The Exit Planner is published five times per year. Because this newsletter is general in nature, please consult your attorney and other advisors before acting on any information contained in The Exit Planner. ISSN # 1094-4583

PRODUCTION STAFF

Editor Kathryn B. Carroll
Design and Production Georgianne Bender
Andrew H. Leman

All contents ©1999 by Business Enterprise Institute, Inc.

Subscriptions to *The Exit Planner* are available for \$79.00 per year. To subscribe or to order prior issues, please contact:

Theresa Carlsen

Business Enterprise Institute, Inc.
650 S. Cherry Street, Suite 1100
Denver, Colorado 80246
(303) 321-2242

TOLL FREE: (888) 206-3009

FAX: (303) 320-6330