Succession Planning: Maintaining Fairness and Harmony in the Ownership Transfer

By Claudio A. De Vellis and Raymond Haller | Wednesday, January 15, 2014

Succession Planning

Much of the country's wealth is vested in the millions of family businesses spread across the nation. Yet, more than two-thirds of family businesses fail to survive into the second generation, and only about 10 percent make it into the third generation. This is often due to the inherent tension that exists among those who actively manage the family business.

A good succession plan counter-balances these oppositional forces and fosters fairness on all sides. The succession process involves planning for family harmony, valuing the business, selecting the appropriate ownership transfer techniques, addressing succession issues and most importantly, actually implementing the agreed-upon plan. This article explores some of the tensions and considers possible solutions.

MANAGEMENT VS. EQUITY: THE INHERIT CONFLICT

The family members who manage the business (active-managers) most often control the cash generated by the business and hence the business itself. Active-managers enjoy the perks associated with having their own business: being their own boss, shaping their own destiny and hopefully making a good living. However, they are also dealing with the challenges of running the business, worrying about cash needs, dealing with customers and attempting to generate new sales. Active-Managers take the good with the bad, but they are ultimately in charge. They are frequently focused on maximizing their compensation and fringe benefits while expanding the business.

Active-Managers may be more interested in retaining earnings rather than distributing earnings to non-managing owners. Sometimes they may feel a sense of entitlement because they may have foregone career opportunities to come into the family business.

The family members who are not involved in the daily operations of the business are passive-owners. The passive-owners usually know less about the daily operations of the family business and are frequently oriented toward maximizing short-term profits that can be distributed to them. Although they may be relatively uninformed about the daily operations of the business and its management, their equity ownership permits them to vote and make top-level ownership decisions that may be counter-productive to the goals of the active-manager or maybe even detrimental to the business itself.

Both types of owners have legitimate concerns and both deserve to be represented and treated fairly.

CORPORATE STRUCTURE THAT ELIMINATES CONFLICT

The key to eliminating conflict is to create a corporate structure that is transparent, provides accountability to the owners, and creates a system of checks and balances.

One method to minimize succession planning conflict is to create a centralized management company, usually considered a holding company, for all the family business ventures; i.e., the operating business, the real estate entities, a marketing company, a delivery company, etc. The management company can then be used to centralize all management decisions for each business and give the active-managers and the passive-owners equal representation.

A holding company can achieve the following objectives:

- Permit different family members to focus their talents in areas of the business which will be most beneficial for their success and the success of the business as a whole, while allowing those individuals with an aptitude for management and administration to handle those necessary tasks, whether these managers are family members or not;
- Reduce duplicative administrative costs by centralizing administrative functions;
- Force lower-tiered managers to be accountable to the management company;
- Ensure that all the owners' interests are represented via a Board of Advisors that sets overall business and investment policies. The members of the Board of Advisors could be comprised of family members as well as non-members, who should be more independent and objective. Board members would be appointed in part by the owners of the company and would oversee the lower-tiered managers;
- Assure that the compensation for family members is commensurate with the functions performed. A Compensation Board, which should consist of outsiders and independent consultants appointed by the Board of Advisors, would handle these matters; and
- Provide a forum for family members to express their concerns and wishes about the family business by having the management company form a Family Board that consists solely of family members. This board would represent everyone in the family and would have the right to appoint one or more people to the Board of Advisors and the Compensation Board. As a forum, a Family Board can also be used to educate the younger generation of family members, identify young talent in the family, set family goals and create a family mission statement. It would also have the ability to make non-binding informal recommendations to the Board of Advisors.

These functions must be modified to suit individual family needs—giving due deference to different management styles, personalities and organizational structure. While no one system can work for everyone, the key is to develop a structure that maintains fairness, or is perceived as fair, while promoting accountability and transparency.

MANAGEMENT SUCCESSION

One of the earliest considerations in the succession process is identifying the candidates who are best qualified to continue operating the family business. Some candidates may be in this position simply because of their relationship to the owner; however, in many cases, they may not be the best qualified for the position. Additionally, there are usually one or two key non-family employees who should be considered to run the business. A candid and objective appraisal of the players and their capabilities is vital to the success of the process.

It may be necessary to hire an outside consultant to ascertain the skill sets and attributes required for the key leadership roles in the family business and to assess the relative strengths and weaknesses of the various candidates for those roles. Even then, a resolution of this issue is difficult due to the emotional and psychological stress involved with having employees who are family members. Most importantly, an owner should be fair and discreet to all candidates and be creative when attempting to build the next management team that will lead the company into the future.

OWNERSHIP TRANSFER

When dealing with any type of business ownership transfer, the most important goals should be to preserve family harmony, to ensure the financial stability of the business and to achieve cohesive company management. Ownership transfers must be accomplished in a clear and complete legal document which must be signed by all relevant parties involved. There must be no lack of clarity in terms of long-term management, ownership and succession. An owner must remember not to punish any of their siblings (whether or not they are actively involved in the family business) who are successful in their own right. This may forever destroy any hopes of family harmony.

If a family business is considering creating a centralized management or holding company, ownership can be transferred easily because the only transfer required would be at the top level of the company. While the original wealth creator is still alive, he or she can begin bifurcating the company common stock or partnership interests into voting and non-voting ownership interests. By doing so, the wealth creator can maintain voting control but still divest themselves of equity for succession and estate planning purposes.

While voting equity holders have veto power within the centralized management company structure discussed above, the ultimate goal is to let the family work out its differences without resorting to the veto override.

FORMAL VALUATION

Before any actual transfer of entity shares takes place, it is extremely important for the owner to get a formal valuation of the entire business by a licensed business valuation professional. This valuation report is necessary so that the owner and all possible beneficiaries of the succession plan know and understand from an objective point of view the fair market value of their business.

The valuation also serves another important purpose: to provide an independent assessment for the IRS as to the value of certain business interests that were discounted for estate and gift tax purposes.

Business valuations are normally completed using three approaches.

- **Asset approach** uses the market value of the assets on the entity's balance sheet and factors in intangible assets, such as goodwill, which may or may not already be on the balance sheet for the point in time of the valuation.
- **Market approach** compares a business to recent sale prices of similar companies in similar industries and conditions (size, geographic area, etc.).
- **Income approach:**projects the income the business can produce over a certain time period based on prior years' income amounts, forecasted and budgeted financial data, and certain economic factors. When this approach is used, income and expenses, such as officer compensation and other fringe benefits that may be considered abnormal at a similar company, need to be normalized. This addition of back expenses typically will increase the value placed on a company.

ESTATE PLANNING AND INHERITANCE

Finally, a family business must consider estate planning and address the issue of equality of inheritance. Economic equality is not always easy to achieve if the substantial family asset is an operating business and not all the siblings wish to participate in the business.

One possibility may be to give the business ownership to the active-managers and to give other assets (i.e.; investment assets, life insurance, real estate or other personal assets) to the passive-owners. This may provide a workable solution if the relevant values of business and non-business assets are equal; but, more often than not, these assets are skewed in favor of the business assets. For example, life insurance may either not be sufficient to equal the value represented by the business assets, or it may prove cost prohibitive in an attempt to equalize the assets.

...ivision of the estate assets does not always have to be equal. If a child has put in the time—the equity required ...tion of the business—then a gift or bequest of a greater portion of the family business to that child may be ... means fair, not equal.

Another option may be to sell the business via a management buyout, an employee stock ownership plan (ESOP), a sale to outsiders through a private equity group, a competitor, or an actual liquidation of the business. All these options could provide the flexibility an owner needs if there is no one to receive ownership of the business because the children have chosen careers that do not involve the family business.

There are various techniques that can achieve the family business owners' objectives of continuing their business, transferring the business to their children or keeping the business and having it managed for their children. Vital to this decision is the understanding of three main tenets of family businesses.

First, the family must understand the distinctions among the duties of those who manage a business versus those who are the passive owners of a business. Second, it is incumbent upon those who manage the business to appreciate their fiduciary duty to maximize profits for the family members who are passive owners. Third, it is important to provide passive owners with a voice and fair representation in the family business, but not so much as to interfere with the management of the business.

Understanding these various roles and responsibilities is the first step in crafting a workable solution to family business planning woes.

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