

Business Succession Planning

October 4, 2010



Most closely held business owners and key executives are too busy dealing with the day-to-day demands of their business operations to focus on the development of a business succession plan.

Unfortunately, few family-owned businesses survive into the second and third generations, primarily due to poor planning for the death, incapacity, bankruptcy, or divorce of the business's founder or other family owners. A business succession plan is critical for the long-term survival of any closely held business, and any such succession plan should address at least the following issues:

How Will An Immediate Need For Funds Be Handled?

It is frequently said that money is the "mother's milk of politics;" the same is true for a closely held business. If the key person or executive in the business (the "Key Executive"), who may well be the business owner, dies or becomes incapacitated, the business is likely to need an immediate influx of cash for several reasons:

- The business may need to hire one or more replacement managers to carry out the tasks handled by the deceased Key Executive.
- The deceased Key Executive may have been a substantial owner of the business and a guarantor of business loans. Those loans may contain a provision that they immediately become payable in full if there is a change in ownership of the business or if a guarantor dies. The business may need cash immediately to pay the existing loans, and banks or other lenders may be reluctant to make replacement loans in light of the absence of the Key Executive.
- Additional funds may be necessary to carry the business through any temporary business downturn resulting from the loss of the Key Executive's experience and expertise in acquiring new projects for the business until the remaining or new owners can gain such expertise.
- A deceased Key Executive's estate may need cash to pay estate taxes in order to avoid the necessity of a sale or liquidation of the business. In this regard, the amount of estate tax should be minimized as far as practicable through lifetime gifts of ownership interests in the business. The use of non-voting interests for this purpose may "leverage" such gifts by allowing the donor to discount the gift tax value to reflect lack of control and lack of marketability.

Most closely held business owners reinvest income in the business itself, so generally there are no substantial

reserves of cash available to meet these needs. Accordingly, in the case of a deceased Key Executive, life insurance can be an important solution to this problem. Use of life insurance may be combined with the creation of an Irrevocable Life Insurance Trust in order to prevent the life insurance proceeds from being included in the taxable estate of the deceased Key Executive.

How Will The Management Of The Business Be Continued?

The business succession plan needs to address the identity of the person or persons who will run the business after the death or incapacity of the Key Executive. Frequently, the business owner's children are involved in the business, and, if two or more children are involved, the business succession plan should make it clear which child will step in as head of the business. The business owner also must confront the difficult determination of whether his or her children or other family members are truly qualified to run the business successfully, or whether the business instead needs to look outside of the family for succeeding managers. Regardless of who is selected as successor manager, at an appropriate time that selection must be communicated to the family, employees, customers, suppliers, and lenders.

How Will Licensing Issues Be Handled?

The business needs to ensure that someone other than the Key Executive holds the necessary licenses to operate the business. For example, if the owner of a subcontracting business is the only employee of the company who holds the necessary contractor's license, the business will be essentially shut down at the moment the owner dies. Thus, the absence of additional licensees within the business could prove disastrous.

How Will Relationships Between Active and Passive Owners Be Managed?

If, as a result of the business owner's death, multiple family members (for example, two or more children) are going to co-own the business, the succession plan needs to address the relationship between or among those successor owners. The business owner needs to recognize the tensions that will exist between the family members who are actively engaged in the operation of the business and the family members who are passive owners. Frequently, the successor managers believe that all of the economic success of the business is due to their efforts in running the business, while the passive owners tend to attribute the success to the contributions of the founding owner. Almost inevitably, these two contrary perspectives will collide.

Accordingly, it would be advisable for the family, as soon as possible, to enter into an agreement which contains "buy-sell" and "dispute resolution" mechanisms to deal with subsequent ownership of the business, which may become a personal and emotional issue after differences arise which inevitably will make agreement more difficult, and costly, to reach. Alternatively, possible tensions may be reduced if the capital structure of the business is changed to provide the passive owners with a "preferred" equity interest which provides a definite and consistent return on their ownership interest.

Of critical importance in any buy-sell agreement is the mechanism for determining the buy-out price. If a formula is used, it should be reviewed by the business's tax advisors to ensure that it will pass muster with the IRS.

How Can Continued Family Ownership Be Assured?

Typically, business owners intend for ownership of the family business to be limited to lineal descendants. However, the death, incapacity, bankruptcy, or divorce of a family owner may have the practical effect of giving an outsider to the family control over an equity interest. This result may be avoided in several ways:

- By having a buy-sell agreement in place which gives the business or the other owners an option to

purchase the interest of someone who dies, becomes incompetent, becomes bankrupt, or whose interest is subject to an order of equitable distribution.

- By distributing ownership interests in the business, whether by gift or bequest in trust, rather than by distributing the interest to the family member outright.
- By encouraging children to enter into premarital agreements with prospective spouses.

The thought of business succession may be in the back of the minds of many closely held business owners and Key Executives. Yet, life's everyday demands, and the understandable human instinct to avoid contemplation of one's death, place that thought at the bottom of the to-do list. However the creation of such a plan, in conjunction with an overall estate plan, is of critical importance to the continued viability of the business operations and the preservation of family harmony.

For further information regarding the issues described above, please contact Eldridge D. Dodson, Jeannette A. Parrott, Gregory T. Peacock, John R. Sloan, or Matthew W. Thompson.

--

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.