Family Transition

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Avoid Unintended Consequences

Family transitions are deals too. Both sides need to win.

Families that don't take the time to write, discuss, and agree on a succession and transition plan are almost always destined to meet with heartache. Misunderstandings, disagreements, and unintended consequences litter the highway of poorly executed family succession plans. Here is an example of a client and their situation.

The father owns 100% of the business. He is in his late 50's, and has some life insurance. The father has an inflated view of the business value, although the business is doing well and is profitable.

The father and his son have had 'discussions' that they will work together for another 7 years, and then the son will buy the business, and basically fund his father's retirement with a 10-year note. As in all too many cases, this plan reflects mostly Dad's ideal outcomes. They have never shared their needs and concerns, only talked in circles about the topic.

It is important to note, **50% of all exits are not voluntary.** Life is inherently messy. There are life events that can throw a wrench into transition and succession plans. Just like the guy in the AllState® commercials, these things come along and create 'mayhem'. Would your business (and family) survive the 5 D's?

- **Death –** Who is going to run the company if you don't show up tomorrow? Will employees stay? Will the bank continue to support the business?
- **Disability** – Will the company keep running profitably if you can't work?
- **Divorce –** It happens. Will the impact ripple out beyond the immediate family to affect the lives of your employees?
- **Distress –** Loss of a key customer could decrease your business value by 50% or more.
- **Disengagement –** The #1 reason owners want to get out is burnout. Can you afford to exit?

Let's look at some scenarios.

If the father died now, the plan is for the company to purchase 100% of his stock with the life insurance proceeds from the existing policy on the father's life. In the event of the father's death, the plan was for the mother to have sufficient assets to live for the rest of her life. However, if the company purchases the father's stock under current ownership, the mother has both the life insurance proceeds and the company, which doesn't sound like good estate planning for anyone. The mother

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would have liquidity, and the son would be in a position of having to purchase the company from her.

This result would be unfavorable to the son and would create unplanned estate tax issues for the mother. What's more, the son is in a position of having to purchase 100% of the company at a point in time when he should have a significant interest in it already.

Options to the "Plan"

The first thing to do is get the son into a significant ownership position now. The father might consider gifting or selling some stock—say 20%—to the son, at which point there would be two owners. If the father works for another seven years, the son will be working with him as a co-owner. That would probably increase the likelihood of retaining the son's interest over the period, and he would have a leg up on any future purchase.

In the event of the father's death in the interim, if the Company repurchased his shares, the son's 20% of the shares would become 100% of the shares then outstanding. Life insurance proceeds would flow to the mother, and the son would have the company, fully paid for, which would certainly provide more flexibility to help the mother as necessary. It would put the son in a more favorable situation than the existing "plan."

By slightly modifying the father's plan, transferring some stock to the son, the potential for long-term success for both management and ownership transition increases dramatically. This modification would engage the son as an owner in the business, and it would provide protection against unintended consequences. That one little modification, providing the son with a significant ownership interest today, would help prove or disprove the father's long-term plan.

Additional components of the succession plan might include the following steps:

- ***Father starts building financial assets outside the business.*** The worse thing a family business owner can do to the next generation is have all their net worth tied up in the business and require the next gen to create liquidity. This puts tremendous financial pressure on the business, and leaves the owner at high risk. The goal is to 'de-risk' in your 50s.
- ***Obtain an independent valuation.*** The valuation would reflect a realistic value for the company and provide a benchmark for the amount of life insurance needed. It would also be available set the price at which the father could sell a minority interest to the son and avoid gift tax consequences.

- ***Develop a buy-sell agreement between the father and the son.*** The father and son could use the above valuation as the basis for creating a buy-sell agreement should a trigger event occur. The parties could decide if it would be necessary or appropriate to purchase life insurance on the son's life as part of the buy-sell process, as well as assess the reasonableness of the existing life insurance on the father's life.

- ***Revalue the business at least every other year.*** The valuation would provide a basis for updating life insurance needs and for resetting the price for the buy-sell agreement. Recurring valuations provide numerous other benefits for shareholder planning, investment monitoring and transparency for all family members.

- ***Operate under this plan for a year or two.*** After a year or two under the new ownership plan, both the father and son would have a better idea regarding whether the plan to sell the company to the son to fund the father's retirement is workable. Regardless, both father and son (and mother too) would have better knowledge about the likelihood of things working out. If things are not working out, better to find out after a year or two than after seven years when available options will be minimal and likely not favorable.

- ***Adjust the plan as needed over time.*** Benefiting from the passage of time, both the father and son will have better ideas of how things are working. Dad might even have the flexibility to retire early if all is going well. The son's ownership could be increased over time to minimize the difficulty of a future buyout of the father's shares. This provides an opportunity for the father's advisers to stay involved, and to encourage following through with the new plan.

The father's initial plan was really just a hope and a prayer that things would work out. The plan wasn't written, communicated, or funded properly. It left the son completely in the lurch, and risked losing him as the father's succession plan. The 'proposed plan' outline provides benefits for the father, son, company and mother, as well.

What I have learned from many years of working with family businesses is that hope and good intentions are a plan for disaster. The only way to build a transition/succession plan is to physically start committing your thought to paper. Because if you don't start, if you don't get things in writing and communicate with your family, everything you have worked so hard for is up for grabs.

Get started now! Mayhem is waiting for you.

Compass Point *is a business consulting firm specializing in family-owned companies. We work primarily in the manufacturing, construction & professional service industries. We provide hands-on consulting & coaching to help businesses close performance gaps; give owners practical, actionable tools that drive growth; develop leaders and position the business for successful ownership transition – all on their terms.*

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