ALERT – SUCCESSION/EXIT PLANNING FOR FAMILY-OWNED AND/OR OTHER CLOSELY HELD BUSINESSES

(*as published in the October 2015 edition of* Contra Costa Lawyer Magazine)

Why should small and family-owned businesses concern themselves with succession planning? The answer is relatively simple. Statistically, only about thirty percent (30%) of all family businesses survive into the second generation. According to recent data, two-thirds (2/3) of such businesses reported not being immediately prepared to fill a vacancy at the top of their organization in the event of an unanticipated occurrence (i.e., death, disability, sudden retirement, etc.).

Besides being able to ensure the continuity of the business, are there other reasons for businesses to engage in and carry out the succession and/or exit planning process? Clearly, the answer is a resounding "yes". Specifically, planning for the continuing existence of the business has many corollary benefits. For example, it can be utilized as a means of funding the retirement of an exiting patriarch or matriarch via a liquidation of such individual's equity ownership in the business. In addition, such planning can serve as a means by which to bring the next generation of family members or trusted non-family member management team/employees into the business in a gradual and structured environment, rather than in response to a catastrophic event. Along those lines, many banks, vendors and sureties are requiring succession plans from their patrons as a prerequisite to a continued business relationship.

Via the succession planning process other goals, objectives and alternative opportunities may be achieved and/or obtained. Through the process of transferring ownership in the business, one can facilitate and complement the estate/tax planning and wealth transfer process. And, in circumstances where the continued viability of the business is in doubt for any reason, the succession planning process may actually involve more exit planning than succession planning including, among other things, the preparation of the business for an eventual sale.

As the parties and their advisors make their way through the planning process, additional benefits of the process may be revealed. By implementing a well thought out succession plan, older generations in a family-owned business are able to not only bring younger generations into the business, but are also able to better prepare such younger generations to own and manage the business effectively and without conflict. This, in turn, aids substantially in maintaining the family's financial interests in the business rather than seeing such interests fall into the hands of non-family members because of inadequate or incomplete planning.

Once the decision is made to undertake the succession planning process, when should it begin? The development and finalization of a comprehensive plan may take as long as twelve (12) to eighteen (18) months; or even longer in some instances. Once the plan is agreed upon, it may take another three (3) to five (5) years to implement, depending on the nature of the succession plan itself. Because of the various concerns and objectives discussed above, the planning process is as important to the development of a plan as is the outcome. It is only through the planning process that the parties involved are able to assess, explore and hopefully resolve the objectives and concerns in relation to the continued financial success of both the business and the exiting owners. For this reason, it is important to start the planning process as early as they can, and not in response to an emergency.

Well-crafted succession plans typically have similar characteristics. They should outline the manner in which the business will be managed after the retirement, significant disability or death of a managing owner and provide for an orderly transition of the business. The plan should involve a mechanism by which to determine whether and to what extent the business has the ability to support the successor owners or next generation, and perhaps future generations, of family members. Also, the plan should establish a process for confirming whether, or under what circumstances, the business should be sold either internally to management/employees or externally to a third party.

There are as many methods and means by which to accomplish a successful succession plan as there are businesses and individuals for whom they are designed to benefit. The circumstances, desires and needs of each business and its owners are unique. Accordingly, each plan, while having in common certain basic objectives, will be equally unique in the manner in which it is implemented.

One method by which the transfer of ownership can be accomplished is through a straightforward redemption of ownership interests. The pros and cons of this approach will involve a fairly detailed tax analysis as to the treatment (and desired treatment) of the redemption proceeds (e.g., ordinary income vs. capital gain, built in gain issues, hot assets, etc.). In conjunction with an estate plan, the transfer may be accomplished via gifting, as either a onetime event or over the course of time. Where management/employees (either as family members or non-family members) are the intended successors to the business, options or bonuses of ownership interests can be utilized in a manner which not only transfers the business, but does so in a manner which is more likely to accomplish an orderly transition.

While outside the scope of this article, under certain circumstances, an employee stock ownership plan (an "ESOP") may be an appropriate option for consideration. As referenced above, in certain situations the only viable option may be to sell the business. If that is the result of the planning process, the next consideration is whether that sale will be to the current management team and/or employees of the business or a third party (e.g., a competitor, an affiliate, etc.), and whether such sale should take the form of an asset or ownership interest sale.

There are many factors to be considered in deciding upon the details of the development and implementation of a succession plan. What is the motivation and competence of the intended successors to own and operate the business? How should the successors be compensated during the transition process? To what extent does the exiting owner wish to have control of the business during the transition process? If key management/employees are to be brought into the business as owners, when and how should that to be accomplished?

While all professional advisors agree that a succession plan is a good idea for any family-owned and/or closely held business, crafting the ideal plan and the method by which it should be implemented is no simple task. In order to assess the ability of the business to support the results desired by the various plan participants, such individuals and their professional advisors need to engage in a thorough process to uncover the relevant facts and pertinent legal issues which will have an impact on the success of the plan. There are no short cuts to that process. However, once the plan is fully developed and the means of its implementation are determined, the business, its owners, potential owners and employees will be well ahead of the game in preparing for the future and coping with unforeseen events.

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