BUSINESS SUCCESSION PLANNING FOR FAMILY BUSINESSES AND BUSINESS FAMILIES

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Lessons learned over 10 years

Tell the family stories

Histories

Values

Family Councils

Family Philanthropy

Two tracks

- Family
- Business

Family Values

- Unconditional acceptance of members
- Sharing the fortune
- Ownership succession

Business values

- Competition
- Reward merit
- Innovation
- Management succession

Generational change in family business

The last generation

Pervasive informality

Failure to use common management tools

Limited use of outside directors

Today's generation

Family businesses are professionalizing

- Recruitment and retention
- Family involvement—60% own interests but are not employed
  - Mission
  - Values
- Governance—64% have outsiders on board
- Succession planning

Families are organizing

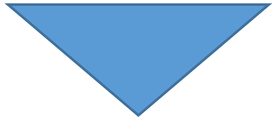
Family Council – 35%

Values statement

Mission statement

The family business in 2018

It is alive and well

The inverted pyramid  remains

BUSINESS SUCCESSION PLANNING

WHY FEW MAKE IT TO THE THIRD GENERATION

- Estate tax
- Liquidity event
- Family disharmony
- Ineptitude or lack of commitment
- No formal succession planning
- The leader stays too long
- THE ECONOMY
- BAD LUCK

OWNERSHIP SUCCESSION
V.
MANAGEMENT SUCCESSION

"Being the owner of a plane doesn't mean you have the right to fly it, and being the pilot doesn't mean you can decide which routes to fly."

– Amy Braden

ONE MAN'S EXPERIENCE

- Failure to prepare succeeding generations
- Narrow focus of advisors
- Large teams of advisors or long retreats don't work
- Protect the viability of the business
- Address the soft issues that affect the family
    - Emotional and relational
    - Commit to the process
    - Be inclusive
    - Be patient
- Get on the ground. Do the job.
- Engage a family business consultant—if necessary.

APPROACHES TO THE PROCESS

- Know your client
  - Stereotypical entrepreneur
    - Ambition, energy and drive
    - Intelligence vs. intellect
    - No systematic decision-making
    - Poor delegation
    - Lack of communication
    - Domination
    - Dynastic
  - Technical entrepreneur
    - Analytical
    - Good business organization and procedure
    - Less emotionalism
    - Cash out and move on

PROBLEMS IN FAMILY BUSINESS SUCCESSION

- Failure to prepare succeeding generations
    - Reluctance to discuss money
    - Failure to communicate
    - Separating family issues from business issues
        - Dealing with in-laws
        - Strays among descendants
    - Difference in ownership and management
- Transitions in Ownership and Management
    - Founder to child
    - Child to siblings
    - Siblings to cousins
    - Family member to outsider
- Lack of formal structures in the business to address
    - Evaluation and promotion
    - Acquisitions
    - Risk Management
    - Succession
- Familial rivalries that affect the business
    - Management
    - Compensation
    - Community Standing

- Appreciate risk aversion

- Be mindful of different transitions – Doud

  - The founder or current leader
  - The family
  - The business
  - The management
  - The ownership
  - The estate

- Understand and avoid Hughes’ three-stage process of business development: periods of creativity, stasis, and decay.

  - Preserve family’s human and intellectual capital
  - Remember that each generation must create wealth
  - Be disciplined and patient to pursue the process
  - Appreciate and manage liabilities. Avoid trying to preserve the status quo
  - Understand that the fundamental issues of wealth preservation are qualitative, not quantitative
  - Tell the family stories that relate to its history and values

- Organize a family council
    - Multi-generational
    - Creates own rules
    - Adopt a statement of values
    - Meet regularly
    - Educate and inform
    - Provide linkage and voice

Have the Business Engage in Strategic Planning

It is the process of developing a business strategy for profitable growth

Key questions:

- In what markets does the company want to compete?
- How can the company compete effectively in those markets?
- How aggressively should the company reinvest its resources?

Benefits:

- Enhances ability of management team to work toward consensus, teamwork, and shared decision-making
- Increases healthy communication on critical business issues

JPMORGAN’S EIGHT PROACTIVE PRACTICES OF SUCCESSFUL FAMILIES

1. Articulate a clear vision
   a. Mission
   b. Values
2. Cultivate entrepreneurial strengths
   a. Venture capital fund
   b. Provide seed capital
3. Plan ahead to reduce risk and act on opportunities
   a. Trust and estate planning
   b. Long-term investing
4. Build unifying structures that connect family, assets, and community
   a. Family office
   b. Investment funds
   c. Philanthropy

5. Clarify roles and responsibilities
    a. Family member
    b. Owner
    c. Manager
6. Communicate
    a. Family reunions
    b. Video conferences
    c. Websites
7. Help individuals develop competencies
    a. Work experience
    b. Stock picking games
    c. Next generation programs
8. Foster independence and provide exit options

CONCLUDING THOUGHTS

- Get beyond the numbers and tax considerations and the documents
- Remember that the client and his or her family haven't done this before
- Remember that what worked for the last generation may not work for the next
- Remember that equal is not fair and fair is not equal
- Challenge the next generation
- Provide exit opportunities
- Avoid surprises – communicate the plan to the family
- Be the counselor, the trusted advisor

THE TRANSFER TAX PART

EXTENDING THE TIME FOR PAYMENT

- §6161
  - Discretionary based on reasonable cause
- §6166
  - Effective
  - Qualification standards

BORROWING FROM THIRD PARTIES

- Rulings – Acceleration = Deduct as you pay
  - Rev. Rul. 80-250
  - Rev. Rul. 84-75
- Cases
  - Graegin
  - Keller
  - Murphy
  - No second-guessing fiduciary
- Conclusions
  - Caveat borrowing from the entity to be valued
- Disadvantages – No income tax deduction
- Advantages
  - Interest deduction without discount on estate tax return
  - Opportunity for positive leverage
  - Time values

VRDNs

- What is it?
  - Floating rate bond issue
  - Credit enhanced by bank letter of credit
  - Buyer has put
  - Weekly re-pricing
  - Low interest

- Parties
  - Borrower
  - Letter of credit provider
  - Trustee for noteholders
  - Placement/remarketing agent

- How it works
  - Terms negotiated by borrower and letter of credit provider
  - Purchasers rely on balance sheet of letter of credit provider
  - Placement/remarketing agent prices, places, and remarkets
  - No registration requirements if bank provides letter of credit

FIXING THE RATE

- The interest rate swap
- Per contract, borrower pays fixed rate and counterparty pays floating rate
- Historical equivalence between swap rate and VRDN rate

BORROWING COSTS

- Issuance fees
  - Placement fee
  - Counsel fees for letter of credit provider, bond counsel, and trustee’s counsel
  - Trustee’s origination fee
  - Rating agency fee

- Annual fees
  - Letter of credit fee
  - Remarketing fee
  - Trust administration fee

FINANCIAL COVENANTS

- No additional indebtedness
- No liens will attach
- Monthly financial statements
- Minimum level of liquid assets
- No distribution except to pay debt service and taxes

REV. RUL. 73-142

- Bosch rule
- Ruling before taxing event is law of case
- Get probate court approval

WHAT CAN GO WRONG

AVOIDING THE TAX

LEAVE IT ALL TO CHARITY

- Outright bequest
- Bequest to a CLT

LEAVE PART TO CHARITY

- Caveat the reverse Chenoweth problem
  - Full (or premium) valuation for estate tax purposes
  - Discounts in funding marital and/or charitable bequests
  - De-control the corporation or the partnership

PENALTY TAXES

- Excess business holdings
  - 20% of voting interests minus interests of disqualified persons
  - 5-year disposal period in cases of gifts and bequests

- Jeopardizing investments
  - Ordinary business care prudence
  - Exception for investments gratuitously transferred to private foundation
  - Change in form of investment = new investment

- Self dealing

SELF-DEALING RULES

- Self-dealing
  - Direct or indirect transaction between private foundation and "disqualified person"
  - Disqualified person
    - Substantial contributor
    - Foundation manager
    - More than 20% owner of a substantial contributor
    - Family member of any of the above
    - Entity or trust over 35% owned by any of the above
- Exceptions from self-dealing rules for estates or revocable trusts
  - Executor has power of sale or property is subject to option
  - Probate court approves transaction
  - Transaction occurs before estate is considered terminated
  - Estate receives at least fair market value of the property
  - Transaction does not leave foundation with less liquidity or is required by binding option
- The example in the regulations
- Favorable rulings and commentary

THE TRANSACTION

- The will
  - Stock or limited partnership interest
    - Married person
      - Stock or partnership interest to QTIP trust
      - At death of survivor, interest passes to CLAT
      - Stock or limited partnership interest is subject to children’s option to purchase at fair market value
      - If option is exercised, consideration is note and collateral is stock or limited partnership interest
        - Terms of note
          - 20 years
          - Interest at rate sufficient to pay annuity plus CLAT administrative expense
      - Widow or widower – same as above without QTIP
- Refinements
  - Executor selects among CLATs of different duration
  - Graduated annuity

THE TRANSACTION (cont'd)

- Advantages
  - Children acquire stock or limited partnership interest immediately
  - Possible discounted purchase price
  - No cash required
  - Interest only is payable for term
  - Principal is never paid
  - Children can control the private foundation which receives the CLAT annuity
  - The owner is not tied to a structure
- Disadvantages
  - Long-term cash flow requirement
  - No GST planning possible unless…
  - Ages of children when CLAT term expires
  - Difficulty in funding annuity after a sale