BUSINESS SUCCESSION

THE ESSENTIALS

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Business Succession - The Essentials
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David Keligian is a tax partner with the Orange County, California law firm of Brown & Streza LLP. David's representation of business owners includes income and estate planning, with emphasis on i) structuring acquisitions and dispositions of businesses and real estate, ii) the resolution of federal and state tax controversies, iii) planning to avoid California residency and taxes for both individuals and businesses, and iv) business succession planning. He has served as an expert witness in tax matters in state and federal courts. David is a Fellow of the American College of Tax Counsel (ACTC – actconline.org), a fellowship which is reserved for tax attorneys who have made an exceptional contribution considered preeminent by their peers.

David is widely published on a range of tax, accounting, and finance subjects, and a well-recognized panelist and lecturer for the California Continuing Education of the Bar, the California CPA Foundation, the USC Tax Institute, the U.S. Federal Court, the California Department of Real Estate, and the California Society of CPAs on various tax and accounting topics.

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Introduction

Most people are familiar with the numbers - 80% of family businesses don't successfully pass to the second generation. Of the 20% which do, 80% of them do not successfully pass to the third generation. The purpose of this book is to better those odds for business owners.

I'm a tax partner at a unique law firm - one focused on serving entrepreneurs and wealthy families with cutting edge income tax, estate tax, and business planning. Brown and Streza is composed of tax, estate planning, and business lawyers - we do not practice litigation, divorce law, or criminal law. We do not represent large publicly traded companies. Our practice has grown and thrived because we are experienced in guiding, serving, and protecting successful closely-held businesses and their owners with thoughtful, proactive processes and planning.

My partners and colleagues agree that **business succession is the biggest challenge our clients face**. Over the years, we have helped entrepreneurs start, grow, and protect their businesses. We help them pass their wealth on to future generations wisely and responsibly. We do this by integrating both business planning and personal planning, because the success and well-being of our clients demands it. The value of our approach has been validated by the success and growth of our firm as our clients' businesses have grown, prospered, and passed to future generations with minimal tax cost.

> "Business succession is the biggest challenge our clients face

Our close work with many successful clients has taught us important lessons about business succession. We have learned as a result of hundreds of client situations, involving all types of business and personalities, in all types of circumstances. The creation of businesses. The acrimonious split up of businesses when there were feuding business partners or family members. Countless joint ventures, business purchases, business sales. The impact of death, divorce, and financial disasters. As counselors, we have the benefit of seeing many examples of what worked, what didn't, and how we use those lessons to help our clients reach their goals.

Business succession - the process of transferring the value of a business from where it is now to where it ultimately ends up - **is the biggest challenge our clients face**. The odds of successfully passing a business from one generation to the next are daunting, and the odds of doing it again - to the next generation - are less than 5%! Most experienced business lawyers and accountants can help with the income tax planning, estate tax planning, and related legal documents - trusts, shareholder agreements, and employment agreements.

But experience proves that there are very complicated issues that have nothing to do with law or accounting. Successful succession planning must take psychology, family dynamics, the impact of key employees, and key customer relationships into account. It involves critical questions. Who will be the best leaders after the founders are no longer around? What conflicts may arise? Have key relationships been successfully transferred? These questions require careful reflection and thought. In some cases, outside specialists - consultants and psychologists - may be needed.

Ultimately, the successful business succession plan is one that gets you closest to meaningful yet realistic personal goals. Deciding what you want is one of the hardest questions for you to answer. This book is intended - based on experience and all we've learned from working with successful entrepreneurs - to guide you by making you aware of important issues to help you *determine what you truly want to do* with the business you've built. Even if you know that answer, you must understand whether or not that goal *is realistic and achievable*, based upon your specific circumstances.

One of the valuable lessons we've learned is that successful business succession planning is a process. By "process," I mean a systematic, almost scientific consideration of a number of different factors to consider in making the correct decision - for you, your family, and your business. The answer is not pre-determined, because it depends on your desires and individual circumstances. Just like pilots, we develop and use checklists to make sure we address the critical factors in each situation we help our clients with.

This book has been written as an introduction to help you through the process to think about and hopefully decide what is best for your situation. Once that decision is made, it is much easier to successfully implement your decision.

Your succession plan is implemented through a number of mechanisms - the creation of trusts, shareholder agreements, leases, employment agreements, structured family meetings, written business or business succession plans, or preparing the business for a third party sale. Those steps are the easy part! The hard part is deciding *exactly what you want and how you can get there.* The process involves making difficult decisions about the ability and desire of family members or long time employees to effectively do what needs to be done to insure the success of the business when you're not around to help.

I decided to use stories in this book. *They are all real* - no names - but real. Hopefully each story illustrates important lessons to developing a successful business succession plan - one that works the best for you and your family.

> *Ultimately, the successful business succession plan is one that gets you closest to meaningful yet realistic personal goals.*

What is Business Succession Planning?

The easiest way to answer the question “what is business succession planning?” is by understanding what it *isn’t*. It is not about how to prepare your business for sale, or maximize its value - that is an end result of going through the *process of making a decision about what is the best course of action for you. If the process results in a decision to sell your company, then there are all kinds of planning, strategies, and actions that will maximize the value of your business as you prepare to sell it. But the threshold question - what is the best succession plan for you* - is the most difficult.

Business succession planning is not about having a “buy-sell” or “shareholder’s agreement” in place. Although these are important legal documents for any business with multiple owners, an up to date buy-sell agreement is typically not, by itself, a business succession plan. It is the **result** of a business succession plan.

Business succession planning is most definitely NOT the most typical plan I see - “I’m leaving the business to my children.” Based on our experience, that “plan” has the highest failure rate, including family acrimony and lawsuits. Imagine - you believe you are doing something generous for your beloved family, but it results in bitterness, hurt feelings, broken relationships, and lawsuits.

A successful plan requires you to devote a great deal of objective thought to a number of issues. Can your children really run your business? More importantly, do they WANT to? Who is most capable of running the business? When push comes to shove, who should have the final say in decisions when you are no longer around? Should certain children NOT be involved in the business?

These are not easy questions, but they are important ones that must be considered and resolved to allow a successful business transition. A business succession plan is NOT just hiring lawyers to draft buy-sell agreements or employment agreements with key employees. Those legal documents may be important parts of a successful business succession plan, but they are not the plan. They are the *result* of a plan.

ANY and *EVERY* business succession plan is the result of a rigorous process. **The best decision is based on your individual desires and circumstances.** Is your goal to have your children continue to run the business you created and grew? Or is it to provide them with financial security, even if that means the business is sold and the proceeds invested in ETFs? The hard part is deciding the best solution to achieve your goals, and whether those goals match reality. The "reality" part includes whether your children have the desire to manage, the ability to manage, and the ability to take over key relationships with banks, employees, and customers. Most importantly, if there are multiple capable children, will they accept one of them having final authority over the others?

> *The best decision is based on your individual desires and circumstances.*

Once that decision is made, the proper legal documents to implement your decision are relatively easy. The hard part is to balance the right business decisions with all the non-business issues and your overall personal planning. A simple (but actual) example. Let's say you have two sons. One is a driven achiever who stepped into the family business and expanded its value tenfold. One is a stay at home dad who has no job and no prospects. But he's a great dad.

Do you try to make sure that each ends up with the same amount of wealth? Is that fair to the driven, achievement driven son who has built up the family business? Does it make sense to keep control of the family business with the son who has contributed so much to its growth? Is that fair? To who? How do you avoid future disputes about your decisions when you are no longer around?

The business succession process is not static. You may carefully, deliberately, and thoughtfully decide that you would like to sell your business. But years after that decision, you may see you have been successful in grooming an outstanding management team - employees who will run the business as good, or better, than you. That realization may change your business succession plan from a third party sale to a completely different strategy.

We have a client with a very valuable business. One of their 2 sons got involved in the business, and during his 20 or so years of hard work in the business, increased its value exponentially. Naturally, during this process we stressed the importance of the parents planning their estate to avoid having a huge estate tax due on their death. That liability might have required the liquidation of the business to pay the tax. Our planning was successful - we passed on 75% of the value of the business to the son who was running it and largely responsible for its success. As to that portion, there will be no estate tax, and the remaining estate tax is now manageable and no longer poses a threat to the business.

The parents still retain voting control. The business continues to increase in value, and the son is working on *his* business succession plan. Our assistance has also involved helping the parents in their wish to transfer wealth to the other son *and explain why he will not be involved in the business*. Because it would be the wrong choice for both the business and that son.

“ *‘Fair’* does not mean *‘equal’*

Inevitably, the parents’ choices mean that the son who will not participate in the business will end up with less net worth than his brother. This illustrates one of our common sayings to clients: “Fair” does not mean “equal.” One sibling greatly increased the value of the business based on his skill and hard work.

This planning has involved over 15 years of meetings, discussions, and incremental decisions. The planning progressed in stages, as the parents grew comfortable with the concept that *as long as they had enough income to support their desired lifestyle*, it made sense to transfer value out of their estate. They understood that a 40% estate tax on the value left in their estate could have forced the sale of the business to pay estate taxes, or at least crippled its ability to operate in a competitive market.

They are just beginning to get comfortable with the idea of passing on their remaining stake in the business and voting control to the son who is running the business. This might take another 3 or 5 years before they decide to pull the trigger. And it is all based on *understanding what they want*. The business succession process is one of defining personal and business and family goals, which your professionals can only assist you with by asking you the right questions. Once those decisions are made, the next step is mixing in estate planning and income tax planning, and trying to arrive at the best balancing of all of these factors.

> *The hard part is to balance the right business decisions with all the non-business issues and your overall personal planning.*

The Business That Wasn't Worth Anything

I took a call from a CPA who wanted one of his clients to come in to see me to discuss "asset protection." (We don't like to use that term at our firm, but in fact it is a lawyer's job to protect their clients from all kinds of potential liabilities and catastrophes). We made an appointment for his client to come in and see me, and right before ending the call with the CPA, I asked: "What does your client do?" The answer I got was "He's a plumber." It was all I could do to avoid screaming at the CPA not to waste my time trying to do sophisticated planning for a "plumber." What kinds of liabilities could a plumber face? Splashing sewage on their already dirty work clothes?

The morning of my appointment with the plumber arrived. As I pulled into the parking lot, I saw only one car. It was the most tricked out Porsche I had ever seen. I don't know much about Porsches, but I could tell this one was expensive. And sure enough, it belonged to my "plumber." It turns out the "plumber" had not worked in plumbing for 15 years. He owned a plumbing company he never visited. He paid a 30 something year old woman $400,000 a year to run it (this was in the late 1990's). ***And he never went there.***

His concern was the skyrocketing worker's compensation rates in California. Despite the rate increases, his business was still making plenty of money - at least $2,000,000 a year, plus the rents the business was paying him to use the real estate he leased to the company.

I asked this obviously wealthy prospect about his estate planning. He owned the commercial building that his plumbing company operated out of, and a few other buildings. He had two expensive homes in Santa Barbara, and lots of cash. When I asked him how much his plumbing company was worth, he said, "Oh, nothing. If my manager ever quits, the company would probably close. I'm not going back into it."

He was paying someone to run his company $400,000 per year. He was pocketing close to $2,000,000 a year in profit, plus the business was paying him rent, *and he didn't have to do a thing!* He had developed a turn-key business - the type of business that is the most valuable to potential buyers. He did something very few entrepreneurs are able to do - create a business that has independent value that is *not tied to them continuing to work in the business.* As far as businesses and business succession planning, this is the holy grail. Yet my plumber didn't think his business was worth anything.

I questioned him about how such a great business could be worth "nothing." I asked him about his children, and what they did. They were all grown. The "plumber" explained that one daughter was in medical school, another daughter was working in the film industry, and his son was a lawyer. I asked him why, given how successful the business was, he had never asked any of his children if they were interested in taking it over? He mulled this over, and finally nodded his head.

The "plumber" then made a statement that was one of the best gems of business advice I ever heard. "You know, I talked to all my children, and told each of them that they were pursuing occupations where there was a lot of smart competition - medicine, the movie business, law. Me, when I was looking into what business to go into, I wanted to find one where everyone else was a freaking idiot!"

(The punch line was too funny not to share!) But the takeaway is that one of the hardest things for a business owner to do is to dispassionately and logically understand *what really drives the value of their business.* One goal of business succession planning is to capture, or transfer, as much value as possible. Yet here was this very savvy, successful entrepreneur who was contemplating walking away from an incredible amount of value. It was because he wasn't being completely objective - he was looking at what the business was worth to him, not what it was worth to other parties who would want to buy it.

He had obviously found and trained a capable manager. But he had not considered back up plans in case she left. There were lots of possibilities he could have considered - giving the manager an ownership stake, selling part of the business to an ESOP that would permit him tax advantages and provide ownership to a group of key employees, grooming one of his children *who had a desire to succeed him* to take over, or selling the business now while it still had the ability to command top dollar.

A successful business succession plan requires the business owner to look at their company through different, completely objective eyes than they're accustomed to. How much is the business worth to a third party? How much is it worth to the employees? Can the business survive if the owner isn't working in it? If not, what can be done about that now? Are there any family members who exhibit both the *desire and ability* to successfully run the business? Can those family members work with existing employees (and just as importantly, will existing employees work for them)?

These are lots of questions to think about. It's hard work and very important. Some of the answers have nothing to do with logic. For example, the perceptions and relationships between family members are critical. Even if children are very capable, can they get along with each other once the founder is no longer around? Very few people can think through all of the ramifications by themselves.

Many clients have an emotional attachment to their business. That is understandable, but if their children are not interested in the business, it is better to look at the business as a source of family wealth, assuming the owner desires to transfer wealth to their children.

I had a memorable lunch with a very successful client who was trying to decide what to do about his estate planning. I explained there were basically three options - leave a chunk to the government, or to charity, or to his children. Being non-charitably motivated, his quick answer was that he wanted to leave it all to his children. But then he made a common, but telling, comment: "I don't want all that money to ruin them. And I don't want them to know how much I have."

His story was common - he started with nothing. He founded and successfully grew a number of companies, but he had struggled many times, sometimes sleeping in his car because he couldn't afford rent. He had succeeded wildly, and was in the process of building a beach house on the nicest stretch of ocean in Laguna Beach. The building project had stretched for at least 5 years, and at lunch he made the comment that he "didn't think he could live in it" because the house was so "over the top."

I asked him about his children. They were in college, attending USC. My first question was, given their age and what they saw their father was doing with the beach house, whether his children hadn't already figured out that their father was *loaded*? I next asked him whether he expected them to go out and struggle the way he had, living in their cars if need be, trying to replicate what their father had done?

I asked him whether he would be disappointed if, instead of trying to mimic their father, they became successful artists or investors or what have you? As long as they didn't blow the wealth, and understood that they were stewards of that wealth not just for themselves but their children and grandchildren, was that such a bad thing?

These type of questions show why business succession planning is not easy. The questions - if they yield honest, thoughtful answers - dictate the next steps. If children are not involved in the family business, and show no interest or inclination to do so, or don't have the necessary skills, planning on them inheriting the business is a bad plan. The process requires complete objectivity, which includes assessing the skills and motivation of family members.

What Do You Want?

Aligning Your Personal and Business Goals

We have a very successful entrepreneurial client. He emigrated to the U.S. from Europe. As a teenager, he fought the Nazis. He arrived in the U.S. after World War II with nothing. He worked multiple jobs, got an education from distinguished universities (more than one) in Southern California, and went on to found a company which went public. He earned world-wide recognition. He went on to take a portion of that company private, and operated that company on a world-wide basis. He had operations in Asia, Europe, Canada, and the U.S. He was expanding into South America. He was making a fortune - every month.

He knew the business. He knew his margins and operations, literally down to the penny. He was rightfully proud about it. The magical thing about his business was that it kept him vibrant and alive. Well into his 80's, he would travel two weeks out of every month. It was heavy duty travel - off to Singapore for a week, then to Australia, then back. The following month he'd travel in the opposite direction - to multiple facilities in Europe to review his operations there. His business kept him focused, grounded, happy, and rich.

There was one catch. Our client was a total type A person - he made absolutely every decision, no matter how small or detailed it was. He was very, very good in his decisions - they made him lots of money. He was a rock star, and thoroughly enjoyed every aspect of running his business to the smallest detail. Unfortunately, his personality was such that despite his worldwide business and having many employees, *he had no one in his entire organization that would be capable of running the business if he were not there.*

I like to say that the very best advice I can give is what I would do myself if, knowing what I know, I were in the client's situation. For this remarkable man, the best advice I could give him was that he should sell his business. The reason was that despite his love of business, this remarkable individual's main goal was to leave a financial legacy for his family. If something should happen to him, his family would lose a huge amount of wealth because his business could not operate anywhere close to where it could with him running it. My fear was that in his absence, the business would fall apart, with forced sales of various divisions to bargain hunters.

He didn't like this advice, but in his gut he knew it was right. His reaction was to market the business at an absurdly high price - one which he figured no one in their right mind would pay. To him, problem solved - he was following his lawyers' advice, he would keep running the business, all was well!

Until a buyer offered him every penny of his asking price. Throughout the sales process, he did not really believe the sale would close. In fact, after signing all the sales documents (a four-hour process that took place on the biggest conference room table I had ever seen), he kept asking me "Do you think this sale will go through?"

He asked me two more times at the closing dinner in a fancy downtown LA restaurant. His wire transfer hit his bank account the next day. Success! The American Dream fulfilled! The poor immigrant who came to America, built a hugely successful business, and cashed out for a fortune. Except now he had no business to run. He didn't like that. He lost the major motivating force in his life. We are working with him trying to find a small business he can step into and resume his passion for running a business.

This story illustrates a powerful point - our client made a decision that was in the best interest of his family, which was his most important goal. All in all, it was the best decision under the circumstances. It illustrates how important and sometimes difficult it is to align personal goals with business goals and family goals. Sometimes hard choices must be made. For example, picking one child out of three who will actually lead the business after you are gone, even if other children are also working in the business.

Many business owners have the dream of doing what my client did. They keep looking ahead - after years and years of building a business, going through the ups and downs, avoiding (or surviving) disasters, they think that "someday" they will sell the business, take a chunk of money, and "retire." Maybe travel the world. Maybe play lots of golf. Maybe move out of California to a ranch in

Montana to avoid California's high income taxes.

But objectivity requires you to be completely honest with yourself. What if you've been so focused on your business that you haven't taken trips, and you have no hobbies, and you hate cattle? What if you like going to your business and being the boss? What if, when you can't work anymore, you will go absolutely stir crazy? There are many examples of people who die a very short period of time after "retiring." If you haven't carefully thought about what you want - what will truly make you happy - you can find yourself making a decision you end up regretting.

Our most successful clients don't need to sell their businesses. If they are successful, their business generates income they used to fill up their pension plans, buy real estate, and set aside investments. Their decision about business succession is much easier for them because it isn't driven by economic need. It is based on what makes the most sense for them, given what they want.

Basing your retirement solely on "someday" selling your business and cashing out is a risky strategy. At the time you decide you want to sell, the market may be bad. You may want to retire, but current business conditions may force you to stay in the business until things "get better." This is one reason why devoting attention to business succession is important even if you believe you will be running your business for many more years. The best planning incorporates financial considerations. Are you setting aside retirement funds to lessen your dependence on a future sale? Are there business-related investments you can make, such as buying the building you use?

One key strategy to consider in all of business succession is the "work backward" approach. As writer Stephen Covey says, "begin with the end in mind." If your goal is retiring with sufficient assets and income to support your lifestyle for the rest of your life, you need to know how much in after tax assets you will need to generate the income you want. There are many financial planners who can help you determine this amount. The most important part of it is being realistic.

Are you really going to move from the California coast to a place in Arizona to save taxes and "downsize"? Is that realistic? Where do your children live? Where do your grandchildren live? Have you ever even been to Arizona? If you like it so much, why aren't you there already? How much of a cushion should you plan for? If you think you need $5,000,000 in investments, are you protected if a financial crisis depletes 40% of the value of your investments in a few months?

> *...begin with the end in mind.*
>
> **STEPHEN COVEY**

A Planning Failure

The consequences of failing to decide what you want, plan for it, and implement the plan can be drastic. A financial planner referred me in to a client who needed help selling his business to his two key employees. Unfortunately, he was pretty much forced to. He had promised a stake in the business to these key employees, but never implemented any plan. To his credit, he treated them as if they were - kind of - owners. He split profits with them.

But they were dissatisfied with not actually owning something. They were tired of promises. And more importantly - after years of work, they controlled a good chunk of his customers. Maybe 40% of them. If they walked, he still had a business. But he had too much overhead, and frankly, he had gotten lazy over the years. He played a lot of golf. He took a lot of days off. He didn't want to change gears and work hard for ten more years trying to build back to where he was today. His key employees basically forced him to sell. And they were not nice about it.

The financial planner did a sophisticated "Monte Carlo Analysis" that showed that what the client was going to receive from the sale wouldn't support his lifestyle through retirement. He would have to keep working and trust his new bosses to let him stay on board. A forced sale is not good business succession planning.

We're convinced that had we been able to help this client earlier, he would have been in a much better position. He retired before he had a plan in place to do so. Earlier in the game, he could have transferred a portion of his business to his key employees, prevented them from taking the customers with non-compete agreements, satisfied their egos as true co-owners of the business, and earned the same income he was earning before being forced to sell to them. Procrastinating on implementing a succession plan that would have been successful was very costly to this person.

Successful business succession plans take a considerable amount of time to be successful. **Business succession is a process, not an event.** For example, one client with four daughters had decided, based on the strong interest and aptitude one daughter had shown in the business, that she would be the designated successor. It took at least ten years for him to transition her to step into all the key customer relationships that he had built up over a lifetime of business.

That included having her step into banking relationships and supplier relationships. The business succession process was implemented, and it resulted in a sound succession plan. The business is stronger as a result of the planning, because there are now two family members who have the vital relationships needed to keep the business going.

There was much more to it than that, since the planning involved the decision that only one other daughter would work in the business, in a subordinate role. The business also needed certain real estate owned by the parents to operate, which involved implementing a buy-sell process so that, once the parents were gone, the daughter running the business wouldn't have the real estate sold out from under her by her siblings. There was also estate planning to mitigate the loss to estate taxes. The lesson is that a "plan" to leave one daughter as the designated successor is worthless unless steps are taken to implement that plan well before it is needed.

Part of that process is training, teaching the right values, and transferring the founder's wisdom to successors. If successors understand how hard it is to build the right reputation in an industry, and the time and effort it takes to successfully cultivate good relationships with customers, vendors, and employees, the business has a better chance of success. That mentoring is one of the most valuable legacies a founder can give.

> *Business succession is a process, not an event.*

More on Successors
Two More Real Life Examples

The first example involved a successful hardware and lumber company, where an estate planner had implemented a successful estate planning technique that resulted in the gift-tax free transfer of a successful, valuable business to three children. Equally.

We became involved because the children were (surprise!) fighting. One daughter was a teacher with no business experience and no involvement in the business. One son was a partying drug addict with no business experience and no involvement in the business. The third son (let's call him "Bob") was running the business. Because the business also owned the real estate used in the business, we were asked to see if there was a way to transfer the real estate to the first two, and leave the business with Bob. Because of an ill-advised structure (hint: don't own real estate in S corporations), that was not possible.

The two non-involved children were ganging up on Bob. They wanted to know why there weren't more meetings, why there wasn't more money coming to them from the S corporation, why Bob took vacations, why Bob took days off, why, why, why? Bob explained the need to conserve capital, that the business was competing with big box competitors like Home Depot, and many other explanations that fell on deaf ears. There were multiple lawyers involved, and our firm's role was as income tax advisors who gave everyone the bad news that splitting the real estate from the business had a prohibitive tax cost.

In the middle of this meeting, a stranger walked into the conference room. The stranger announced that he was "an experienced businessman," and was a "friend of the family" (actually the stranger had dated the daughter who was a teacher). The stranger said that he would "tail Bob" to make sure "Bob knew what he was doing." Imagine Bob's response to that! My feeling was that I was done and the litigators and a lot of ugliness would take over.

Surprisingly, after a few months, there was another meeting. Surprisingly, the "friend of the family" turned out to be a good businessman who was the CEO of a publicly traded company. Surprisingly, he stood up in the meeting and made a speech about what a great job Bob was doing - keeping the company profitable, managing margins, successfully competing with much larger competitors. I looked at the other lawyers in the room, and we were all thinking the same thing - problem solved! It's a miracle! This is wonderful! No litigation! Until....

Until Bob spoke. After getting a world class endorsement from the family friend for the wonderful job Bob was doing, Bob announced he was done running the company and demanded it be sold. Which it was. To a competitor. For a fraction of its actual value. Because even Bob's ignorant and ungrateful siblings understood the business would evaporate without Bob. This story illustrates two powerful lessons.

First, dividing a business equally between children who are involved in management and those who aren't always has an unhappy ending. I've never seen that plan work. My partners have never seen that plan work. The child who is the designated successor must be able to make the right decisions without having to debate them with people who - pardon me - have absolutely no clue.

Second, even if you give control to the child operating the business, they must have the desire to do so. As capable an executive as Bob was, when I was able to talk to him, the truth became clear. Bob never wanted to run the family business. But when the technically "good estate plan," but **bad business succession plan**, was implemented, Bob realized he had no choice. Bob realized his siblings were incapable of running the business. Bob realized

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> *Second, even if you give control to the child operating the business, they must have the desire to do so.*

that even though he didn't want to, he was the only one who could run the business. Which, out of a sense of family loyalty and duty, Bob did. Until Bob had his fill of his constantly complaining siblings.

The second example involved a referral to a very successful family business. Mother (who was the CEO) and Father wanted to transfer the business to their three sons, all of whom were involved in the business. I walked them through an advanced transfer technique involving the sale of the business to a defective grantor trust (which is a HORRIBLE marketing name, but which allows the transfer of very valuable assets like real estate and operating businesses to heirs at minimal gift tax cost).

It was a great technical plan for this client. Mother and Father told me to roll! They wanted it done as soon as possible. I told Mother and Father that I needed to talk to them alone. Because their three sons (Son 1, Son 2, and Son 3) were in the meeting, Son 2 promptly got up and excused himself acknowledging my request that I needed to talk to only Mother and Father. Sons 1 and 3 stayed in the room, glaring at me, trying to make small talk, and not moving. I smiled and said I would continue the meeting - as soon as Son 1 and 3 left. Which they finally did. I told Mother and Father I would not do the planning unless they resolved a major issue.

Here was the problem - Son 1 was the sales guy. Tremendously effective and capable. It was clear in our meeting that Son 1 viewed himself as the future CEO. Son 2's role was explained to me as "he works on the computers." Son 3 was the operations guy. Tremendously effective and capable. It was clear in our meeting that Son 3 viewed himself as the future CEO.

In the course of a short one-hour meeting, it was clear to me that Son 1 and Son 3 were extremely competitive with each other. They both thought they should be CEO. They were both capable of being the CEO - but there could only be one CEO. I explained to Mother and Father they first needed to figure out a way to make sure that the business could be managed without Son 1 and Son 3 trying to kill each other. I told them I would not proceed with the defective grantor trust sale without them resolving this issue.

Mother's proposed solution was that Son 2 could be the "tie breaker." I told them that would be like putting a baby lamb between two ravenous wolves. I had learned the lesson of my first story, and would not proceed with the planning. Picking a successor is extremely difficult when there are multiple children involved in the business, and is even more difficult when there are multiple capable children. The most a lawyer can do is identify the issue, not necessarily resolve it. That might require counselors or consultants or psychologists. Which is why good succession planning requires a team approach.

"Good succession planning requires a team approach

The Team Approach

Deciding what you want is complicated when you view it through the filter of what is achievable given legal issues, tax issues, financial issues, family dynamics, and business realities. That is why we strongly advocate using a team approach. Here are the benefits the team approach provides you.

ATTORNEYS
Whatever you do will require legal advice and documents to successfully implement. The planning and documents will encompass much more than sale documents. There can be estate planning documents, employment and bonus agreements to tie up key employees, shareholder's agreements, agreements to cement important relationships with key suppliers or key customers, and all the advice that goes into these areas.

CPAs
Income taxes, estate and gift taxes, and cash flow forecasts are always important. Tax and business projections are critical, both during the time you are running your business and for your succession planning.

PSYCHOLOGISTS/COUNSELORS
As lawyers, we're reasonably skilled in interviewing and counseling about business issues. Less so about personal issues. We know about family dynamics, but we're not trained in that area. What if you own a successful family business - one where your spouse and children are actively involved - and you're considering a sale? Don't you think it might be important to talk to your spouse and children and get their feelings and viewpoints? You might be the type of person who may be able to do this on your own, but a skilled professional who's dealt with family dynamics in many situations can certainly help you.

We're not talking about a "shrink." We're talking about a professional who specializes in counseling owners and family members about business situations, but who has specialized training. I know one such professional - now a practicing psychologist - who has a law degree and is a CPA. He practiced in both areas, then got a doctorate in psychology. His specialty is exactly this type of situation. If you use such a person, it doesn't matter whether you agree with their input or not. The point is that they will certainly make you *think and ponder your choices.*

MANAGEMENT CONSULTANTS

It can be difficult for a business owner to be objective about their business. This includes determining a realistic value for it, making sure the owners aren't overlooking opportunities or properly capitalizing on the business' strengths, and determining how to deal with weaknesses and threats. Objectivity is crucial.

The hardest area to apply objectivity to is people. If you have worked with your employees for many years, they may seem like family to you. And you may have employees who ARE family. It can be very hard for an owner to objectively evaluate which people should assume responsibility and perhaps one day run the entire business. Do they have the ability to do so? Do they have the desire to do so? Will others in the business follow them? Will the bankers pull lines of credit if you aren't personally involved?

People issues are the hardest issue to deal with in any business. You may have a knack for judging and evaluating people. But can you do so equally well when you're evaluating the potential of a non-family member as compared to a family member?

FINANCIAL PLANNERS AND INVESTMENT ADVISORS

CPAs can sometimes help in financial planning, but typically don't handle investments or provide investment advice. Investment professionals are important because they can help you determine how much in investments and investment income you will need to support your lifestyle as you proceed with your business succession planning.

Although many of our clients used their business to build substantial outside investments, some didn't. They focused on building the value of their business and will have to face the question of how to prudently invest substantial sales proceeds. It is better to become acquainted with potential advisors long before you give them substantial sums to invest.

RISK MANAGERS AND INSURANCE PROFESSIONALS

Many clients who believe they are protected from business risks with insurance really aren't. Risk management is very complicated, and a true professional will be able to advise you where you have gaps in coverage, or are completely unprotected from common risks.

Sound advice about life insurance is also critical. It's not just about protecting your family if you should pass away and the business is jeopardized. Life insurance can play a key role in employee benefit planning, creating "golden handcuffs" and other incentives to retain and reward key employees. It also provides a means of equalizing wealth transfers if the right decision is leaving the business to one child and leaving other assets to other children.

INVESTMENT BANKERS AND BROKERS

There is a reason I listed this category of advisors last. That reason is that they are invariably focused on just maximizing the value you receive in a sale. They are usually good at advising you on how to maximize the transaction value of your business, although we believe focusing on maximizing the sales value of a business is something that should guide your decisions the entire time you own your business.

Running Your Business

Based on our observations of our most successful clients, here are some valuable tips about successfully running your business.

UNDERSTANDING

The most successful businesses are those whose owners have a clear understanding of what fundamental factors really drive the value of their business. They proactively improve the areas that add that value. They emphasize repeatable processes that help them add to the value of their business. They tend to have stable and growing relationships with their key customers, because they know it is much easier to grow sales with existing customers than try to find new ones.

PROCESSES

"The E Myth" by Michael Gerber is a must read. Many business owners have heard the phrase "work on your business, not in it." Regardless of whether Gerber came up with this phrase or not, it is what The E Myth is about.

Gerber compares the average closely held business to McDonald's. McDonald's is one of the most successful companies in the world. McDonald's follows the same processes in all its restaurants, from Des Moines or Decatur to Tokyo. Mc Donald's has a process for everything it does. It has a precise set of procedures for its employees to follow when, for example, they make French fries. So precise, in fact, that such processes may replace employees with robots.

The point is not robotics. The point is that McDonald's has come up with the best system it is capable of devising for the preparation and serving of French fries and all its other menu items. And it makes sure its employees are trained to *follow the process.* So the McDonald's French fry you buy in Des Moines or Decatur or Tokyo *is prepared exactly the same way and tastes exactly the same.*

The relevance to this for a closely held business is that the owner should develop and implement similar processes for each area of their business, whether it's casting metal parts or selling used equipment. *Once that process is developed and the employees are trained in following that process,* the business owner is freed from constant supervision and worry in that area. The owner no longer has to devote so much attention or worry to that area, and can focus on working on something else.

This is how a business becomes valuable independent of it owners. It is a very valuable objective for a business owner. It is an appealing characteristic for third party buyers. It adds value to the business. Even if the owner has no desire to sell, it frees them from part of the day-to-day stress of managing every detail. It adds to the strength and continuity of the business. It gives the business owner the comfort of knowing that if something happens to them, the business won't fall apart.

PEERS

We've found many of our successful business owners feel a sense of isolation - as if they're trying to solve an endless number of business questions by themselves. Many successful business owners who experience this feeling overcome it through several avenues.

A few have gained great value through instituting outside advisory boards. This only works if the process is robust. As an example, one client has quarterly meetings. His outside advisory board consists of industry experts in accounting, finance, and consultants who directly work in his industry.

There are quarterly meetings, lasting a day or a day and a half. The board is compensated, and they have full access to financial and other information prior to the meetings. They are flown out to nice places, with nice meals and nice accommodations. A formal agenda is circulated before each meeting, and minutes are taken. Most importantly, the advisory board is very proactive - they question the CEO, they advise him, but most importantly, they hold him accountable for action items. If, for example, there is a discussion about the shortcomings of the COO, the CEO is provided with action steps to counsel and mentor the COO and must report back about those steps at the next advisory board meeting.

If the advisory board is properly selected, compensated, and empowered, it can provide incredible value to an otherwise isolated business owner. The board can provide objective advice on a number of areas, including on whether key family or non-family members are capable of assuming leadership roles.

This same owner also participates in Vistage, a group of senior executives that meets once a month and is led by a group leader. They discuss common business issues, and each participant gets the advantage of seeing how other CEOs in diverse industries have dealt with similar issues. Your business may not need such specific processes. You may be fine talking to your legal counsel, CPA, and a few other trusted advisors. But one risk we repeatedly see in closely held businesses is running the business with too narrow a focus.

A good practice is a periodic SWOT analysis - where the business STRENGTHS, WEAKNESSES, OPPORTUNITIES, and THREATS are systematically discussed and assessed. The more viewpoints you get on these topics, the more information you have to improve your business.

MANAGEMENT SUCCESSION

Recall my story about the financially successful client who had to sell his business because it's success was totally dependent on his continued participation. Having a strong management team in place who can independently run your business has multiple benefits.

First, it's a form of disaster planning. You gain the peace of mind knowing that what you've tried to build up won't disappear if something unexpected happens to you. Second, if you're so inclined, it allows you to actually take time off from your business without having to sell it. Third, it adds a potential new buyer to your exit plan - your existing management, who have proven they have the ability to successfully run the business. Finally, proven management greatly increases the value of the business to third party buyers.

Management succession is a process. It is not just retaining and training good people, it is going through the process of figuring out how to tie them to your business for the long term. It may involve grants of equity, coming up with “golden handcuff” employee incentives, and a number of other strategies. It should be a priority, which means it demands thought, attention, processes, and an action plan.

RELIABLE FINANCIAL REPORTING

Reliable financial reporting is a critical item. Not only does it help you run your business more reliably, it increases the value of your business. Reliable financial reporting will allow you easier access to financing, and also increase the value of your business should you decide to exit via a third party sale.

When a buyer is looking to buy a business, they want to have confidence in the financials. If they don’t, they may still buy the business but they will do so at a discount, or on more onerous terms, than they would have otherwise.

ONGOING LEGAL COMPLIANCE

Legal compliance may sound dull. It usually IS dull. But sometimes dull can make, or save, you lots of money. I’ve seen situations where someone forgot to exercise a lease option, and the company lost its facility and was forced into a costly move. Boring details like having up-to-date employee manuals and making sure there are no new laws that impact your business can turn into company-threatening events if your compliance is not up-to-date. My firm has a comprehensive annual meeting process, with a detailed checklist, to guard against such catastrophes.

Succession Options

The most common succession options are:

1. Leave the business to family
2. Leave or sell the business to employees
3. Sell the business to other co-owners
4. Sell the business to outside third parties

Each option has its unique do's and don'ts. None of them are simple. All are manageable. If you have a sound business succession plan, the right choice is much easier. We plan on preparing additional guides about the processes and planning techniques for each of these options. But the most important process is the one of succession planning explained in this book, because that is what will lead you to the right option.

Communication

Experience shows that lots of potential fights and lawsuits among family members can be avoided if the business succession plan is properly communicated to family members. A good point to keep in mind is that probate and trust litigation is one of the most rapidly growing areas in the legal profession. I see lawyers handing out their cards and saying "I do probate and trust litigation," and I remember 6 months ago they were telling people they were "premises liability experts."

One cause of such litigation is that while they are alive, it is difficult and uncomfortable for parents to explain to their children why, for example, they are leaving the family business to Julie instead of Johnny. But it is important.

Wills and trusts can set forth decisions about succession issues, but not their rationale. In the past few years, when I see clients that have business succession issues, I recommend they prepare a written business succession plan. It contains their goals, their reasoning, their decisions about business succession, and how those decisions will be implemented in buy-sell agreements, leases, and other legal documents.

The plan is memorialized and incorporated into minutes of business entities, and more importantly it is communicated and discussed with family members in a formal, structured family meeting or meetings. It may be uncomfortable, but the benefit is that all family members know that the business succession decisions are the result of a deliberate, thorough thought process, as opposed to "Julie's undue influence on her elderly parents as they lost capacity," as our newly minted "probate and trust litigator" might couch it in a pleading.

Conclusion

Business succession planning is not easy, but the hardest part isn’t the legal strategies to minimize income and estate taxes and shield assets from creditors. It’s sorting through your personal goals, the personalities, motivations, and capabilities of potential successors, and going through the objective process of trying to come to the best decision. I hope this guide has been helpful to you.

Both my firm and I would be happy to meet and discuss business succession issues with you in a no-cost consultation, or for advisors such as CPAs or financial planners, present a continuing education seminar for your firm. I know our approach to succession planning will provide you with valuable insight.

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Business Succession Checklist

- ☐ Do you have a systematic process to analyze your business succession planning?
- ☐ Are you beginning with the end in mind? Does your plan achieve your personal goals?
    - Are you thinking you'll just "leave the business to the children"?
    - You can't have multiple CEOs!
    - Which children have the desire to manage the business?
    - Which children have the ability to manage the business?
    - Can you objectively judge the above points? If not, you need qualified professionals to assist you.
    - How will key employees and other stakeholders react to your succession plan?
- ☐ Do you understand what really drives the value of your business?
- ☐ Do you have a plan for transitioning key relationships to your successor?
    - Employees? Do you need incentive/ownership planning to keep them on board?
    - Customers?
    - Suppliers?
    - Banks?
    - Trusted advisors?
- ☐ Do you have a team of advisors who will work collaboratively to help you?
    - Attorneys?
    - CPAs?
    - Psychologists/counselors?
    - Management consultants?
    - Financial planners and investment advisors?
    - Risk managers and insurance professionals?
    - Investment bankers and brokers?
- ☐ Does your business have reliable financial reporting and controls and a process for insuring legal compliance?
- ☐ Can you clearly communicate your succession plan to all, preferably in writing?
    - Obtaining "buy-in" before the transition is important.
    - Attorneys can use your written plan to make sure all legal documents are consistent with your plan.

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