Avoid Family Business Transfer Traps: Use A Tested Exit Planning Process.

A BUSINESS OWNER'S GUIDEBOOK

JOHN BROWN | Business Enterprise Institute, Inc.

"I have a friend who is a serial entrepreneur. He was a board member in a household name dot-com from the 1990s. He sold his stock – too early, I warned him at the time – for $30 million. (It would have been worth $90 million a few months later.)
But that didn't matter to him – he planned to use that money for his next company which he promptly built and sold for $250 million. He rolled that into his third venture which he cashed out of for a cool $1 billion. ***His long-term goal, and the ability to execute that vision, are what led him to incredible success.*** He once said something that has stayed with me: 'I am always surprised at how many people have no goals. They simply let life's river flow them downstream.' There is a Latin phrase associated with military actions: ***Amat Victoria curam.*** It translates as ***Victory loves careful preparation.*** You would be amazed at what you can accomplish with planning."

Source: http://www.ritholtz.com/blog/2011/06/7-life-lessons-from-the-very-wealthy/

"Never forget implementation. In our work it's what I call the 'missing 98 percent' of the client puzzle," stated, Al McDonald, former McKinsey Managing Director. *("execution: Translating Future Plans Into Reality, Convene (*http://www.convenenow.com/wp-content/uploads/2014/11/Convene-White-Paper-Execution-Plans-To-Reality.pdf*)*

A Recipe For
A Successful Family-Business Transfer

<u>The Six Ingredients</u>

Ingredient 1: The Seven Step Exit Planning Process™

Ingredient 2: Parental Financial Security

Ingredient 3: Ownership Based on Merit, not Emotion

Ingredient 4: Fairness to *All* Children

Ingredient 5: A Capable Successor, Prepared Business and Ready Owner

Ingredient 6: A Back-Up Plan

The Cast of Characters

Parent / Owner
    Owner's Spouse
Child Active in the Business (BAC or Business-Active Child)
    BAC's Spouse
Children Active in the Business (BACs)
    BACs' Spouses
Child Not Active in the Business (NBAC or Non-Business-Active Child)
    NBAC's Spouse
Children Not Active in the Business
    NBACs' Spouses
Non-Family Key Employees
Parents' Exit Planning Advisor

Myth or Reality?

Put a check in the column next to the statement that applies to your family / business.

There's joy in working together.			Children don't get along.
The business offers better employment opportunity for the kids.			Children don't share same career goals.
The business is the family's focal point--the glue that holds us together.			Children have different visions of the business's importance in their lives'.
Ownership fulfills childhood dreams.			Parents depend on cash from the business to achieve financial security.
Owner wants to "retire" gradually.			Children want ownership and control before they are ready.
Parents want an income stream that continues after the owner's exit.			Children don't have same desire to or aptitude for running the business as parent did.

Additional Factors:

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Ingredient 1: The Seven Step Exit Planning Process™

Step One: What are your goals? Establish what you want, need and hope to achieve before, as and after you exit.

1) The greatest threat to successful family business transfers is the failure to focus on the goals and aspirations of the current ownership group—the parents.
2) Setting and prioritizing these goals is step one, but the purpose of the entire exit planning process is to achieve them.
3) Goals includes the role parents envision for themselves as and after the business is transferred.

Step Two: Accurately determine:

1) Your company's value;
2) Its cash flow; and
3) The value of your non-business financial resources.

Step Three: Increase (and protect) the transferable value of your business through a variety of Value Drivers including incentive planning for the key employee group and/or business-active child (BAC).

Step Four: Do nothing to preclude a sale to a third party (as a back-up plan) should the transfer to a child fail through no fault of your own.

Step Five: Carefully design and implement the sale/gift of business interest to your BAC.

Step Six: Put in place contingency plans to ensure the continuation of your business should you or your heir apparent die before the transfer is complete.

Step Seven: Coordinate your estate and gift planning with your exit plan. Provide for NBAC and BAC as your sense of fairness dictates.

Ingredient 2: Parental Financial Security

By definition, an exit plan must yield financial independence. If it does not, it isn't a plan; it is a liquidation or a train wreck, but not an exit plan.

The acid test for any exit is financial independence. Only those owners who achieve financial independence when they leave their companies can be said to have *successfully* exited their businesses.

Ingredient 3: Ownership Based on Merit, Not Emotion

Performance Standards:

- Motivate and reward employees to increase enterprise value and cash flow—over time.
- Award cash bonus to non-family key employees / Ownership to family key employees.
- Design performance standards which further parent's goals and objectives.
- Can determine allocation of ownership among children.

The Child Who Meets Performance Standards:

- Demonstrates his/her ability to operate the business successfully.
- Earns ownership under same standards as non-family members earn cash.
- Can show that the part of the parents' estate s/he receives by gift or inheritance should not include the business interest owned or promised to him/her.
- Can show that s/he earned ownership. It was not a gift.

<u>Ingredient 4: Fairness To All Children</u>

The BAC's Point Of View:

"I deserve the company *<u>and</u>* *I should share equally in the rest of the estate with my siblings."*

- All of the children were offered an equal opportunity to participate in the business and become owners, but I was the one who grabbed it! I'm the most ambitious! I took the risk!
- Why should I share the rewards with my siblings who chose different, less risky and less arduous career paths?
- You didn't want a co-owner: why should I have to share?
- ____
- ____

<u>Ingredient 4: Fairness To All Children</u>

(continued)

The NBAC's Point Of View:

"I should get an equal part of the family assets—including the business."

I don't want ownership IF:

- I'm offered another and equal choice.
- I know I'll receive my inheritance when my parents die and the BAC's share of the non-business estate is reduced.

Because:

- I'd rather own (or receive) assets that are more liquid and less risk-oriented than ownership in a closely held business.
- If I own part of the family business, I can't make any decisions regarding the future course of the business. What's the point?
- I'll own a security that generates no immediate income or other benefits.
- I can't sell my interest, except to my brother/sister (the BAC). Do you really think s/he will have the money to buy me out? And even if s/he did, do you really think we'd agree on a price?
- ____
- ____
- ____

Ingredient 4: Fairness To All Children
(continued)

Common Parent Reaction: Spread out ownership among the children.

Problems:

- The child running the business has a fiduciary duty of fairness to the other sibling-owners and minority owners.
- Sibling-owners resent the use of their share of the profits without their consent.
- Can siblings who couldn't share a 98¢ toy when growing up, now share a multimillion dollar business?

Ingredient 4: Fairness To All Children

(continued)

Can Children Share Ownership?

Think about your children:

	Yes	No
Does each child view business success through the eyes of the family and each of its members, rather than through his or her own eyes?		
Does one child has effective day-to-day control over the business operation?		
Is each child's salary is based upon job description and performance?		
Has each child been active (alongside parents) in the business long enough to make each child comfortable with the roles they play within the business?		

Think about your business:

	Yes	No
Is the business large (and profitable) enough to support all children and give each child separate areas of responsibility?		
Is the business large enough to be considered an investment (mature, solvent, stable)?		
Is the business large enough to be run by non-family managers as well as one or more children?		
Does it have sufficient cash flow to handsomely reward the business-active child while providing an income stream to other children who are simply passive investors?		

Your children:

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Your business:

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Ingredient 4: Fairness To All Children

(continued)

Challenges of One-Child Ownership

Value

- The value of the business may be significantly greater than the combined value of your remaining family assets.

Timing

- There are income tax and estate tax benefits to transferring significant amounts of the business to the BAC during the lifetime of the parents.
- NBACs rarely receive *their share* of the family wealth until after the parents die.

Successor Owner's (BAC's) Contribution

- If part of the business's value is attributable to the BAC's efforts:
  - How do you determine the value of the BAC's contribution to existing business value?
  - Is it not fair to consider that part of the business to be the BAC's interest *before* your make an assessment of the gift?
  - See table on next page.

Other Challenges

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Ingredient 4: Fairness To All Children
(continued)

Determining the BAC's Contribution

	No	Yes	
Is the BAC, in effect, paying for the business now through "sweat-equity" (lowered compensation, more working hours, and greater risk)?			If so, the current gift is not really a gift, but recognition of that child's efforts.
Is the BAC using hard-earned cash to pay for part or all of the business? Are you asking her to pay cash for value she created?			If so, he/she should not have to pay for that effort by receiving a reduced share of the ultimate estate.
Is the BAC adding to the business's value through his or her efforts?			If so, he/she should not have to pay for that effort by receiving a reduced share of the ultimate estate.
Has the BAC, by continuing the business after you leave, become a critical element in your retirement plan?			The answer is "yes" if the BAC is responsible for ensuring that the business can pay you deferred compensation and purchase your stock. In that case, the means by which you tie the child to the business — golden handcuffs — may be the transfer of stock.
Do the BAC's contributions affect how you will allocate the business and non-business assets among all children, including the BAC?			If not, you are penalizing the BAC for contributing to the value of your business.

Ingredient 4: Fairness To All Children
(continued)

What's fair?

In light of:

- The real differences in the children's contribution to the business?
- The timing of the gifts?
- The risk associated with business vs. non-business assets?
- Other

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As a standard, "fairness" is hardly objective. Each child defines fair in terms of what the other children get and how that child perceives what she deserves compared to what others deserve.

- Not surprisingly, definitions of fairness vary.
- If you allow different perspectives of fairness to simmer, stew or control family discussions, expect indecision, division, squabbles and possibly, all-out war.
- You and your spouse must ultimately determine what is fair--taking into account the perspectives of all the children.

What's fair?

For me and for my spouse:

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For the BAC:

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For the NBAC:

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Who can help us determine what's fair?

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Ingredient 5: A Capable Successor, Prepared Business and Ready Owner

Capable Successor: Has s/he demonstrated an ability to manage day-to-day operations?

And:

- Drive business growth?
- Anticipate and respond to outside threats, e.g. new competition?
- Navigate during economic downturns?
- Exercise leadership?
- Manage the management?

Prepared Business: Have you planned for the future of the business without you?

- Repeatable systems
- diversified customer base
- Management capable without your presence
- All Value Drivers implemented

Ready Owner: Have you thought of your future without the business?

- Will a transfer to this child achieve all of your exit goals?
- Are you ready to leave?
- Do you have an idea of what you want to do on The Day After?
- Are you prepared to transfer control if BAC performs as specified?

Ingredient 6: A Back-Up Plan

What's your plan if. . .

1. You die or become incapacitated before the transition is complete?

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2. Your business is so valuable that your child cannot financially manage a buyout?

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3. One child acquires ownership of the business: Can you provide assets of appropriate value to your other children?

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4. Over time, you learn that your BAC no longer has the drive or interest necessary to run the business successfully?

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5. You discover that the management style and practices of your BAC differ significantly from yours?

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6. A child (BAC or NBAC) gets divorced?

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Thank you

For over 30 years, John H. Brown has skillfully guided hundreds of business owners through the most important (and emotional) transaction of their lives: the exit from their company. John started his legal career in Denver, Colorado as an estate planner for owners of closely held companies. Working with real owners in a variety of situations to test and refine his theories, John constructed the Seven Step Exit Planning Process™ that he first described in his seminal work on exit planning, "*How to Run Your Business So You Can Leave It In Style*." After releasing a second book, "*Cash Out Move On*," John orchestrated his own exit from the law firm he had co-founded and created Business Enterprise Institute. Today, John continues to consult with business owners on how to leave their companies in style.

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