WARD AND SMITH, P.A.
ATTORNEYS AT LAW

What Could Go Wrong? The Importance of Business Succession Planning

Written By **Merrill G. Jones, II** (mgj@wardandsmith.com) **and** **Zachary F. Lamb** (zflamb@wardandsmit

April 20, 2018

Most business owners expect that their company will continue to operate after they stop working.

However, successfully transitioning control of a business rarely occurs without thoughtful planning. Consideration must be given to the needs of the business as well as the personal needs of the business owner and the business owner's family. Typically, a business owner must utilize a team of advisors such as attorneys, accountants, and financial advisors to develop and implement a plan that achieves the owner's desired goals.

Over the years, we have been privileged to assist with many successful business transitions. Unfortunately, we also have been engaged on numerous occasions to rescue situations where little, if any, planning has occurred. Since disasters often teach the best lessons, this article will follow a hypothetical business owner and what happens to the owner and his family as they encounter various milestones on the business owner's journey. Though this hypothetical is inspired by actual experiences, the characters are completely fictional.

Meet the Family

The protagonist of our tale is Father. He was born into a poor family and was forced to support himself at a young age. After high school, he took a blue collar job at the local widget factory. He was a dedicated employee with many insightful ideas about how processes at the factory could be improved. However, his managers ignored his suggestions because of his lack of formal education.

Confident in his abilities and driven by his circumstances, Father saved every spare penny he earned until he had enough to convince a bank to give him a loan so that he could open his own widget factory. His widget factory was an instant success, and he happily poured himself into his business. He employed dozens of employees and cared for each of them like family. He reinvested most of his profits back in his business. Soon, he purchased the real estate and building where his factory was located.

In contrast to his business success, Father's home life was challenging. He married his high school sweetheart and quickly had two children, Son and Daughter. Soon thereafter, his wife divorced him. Father loved his family, but he welcomed the ability to focus more time on growing his business.

Planning Problem One: The False Start

Twenty years go by and Father is in his early 40s. Despite his divorce from their mother and devotion to his business, Father has managed to maintain good relationships with Son and Daughter. Despite Father's frequent invitations to groom Son as his successor, Son has made it clear that he has no desire to have anything to do with Father's business. Daughter is in college, and it's unclear whether her life path will involve the business.

Father begins pondering the future of his business. He has accepted that Son won't take over when Father is ready to release the reigns. Lately, Father has been impressed more and more with Jim, one of his managers and Father begins to believe that Jim could carry on the business after Father steps aside. Father quickly decides that he wants to gift some stock in his company to Jim. Father remembers how driven and inspired he was to grow his business and believes that Jim will be similarly inspired if Jim becomes an owner. Father is a man of action and quickly has the documents prepared to assign a 10% interest in his business to Jim. However, Father never thinks to require that Jim enter into a buy-sell agreement.

Six months go by, and it becomes apparent that making Jim an owner didn't have the intended effect. Jim has alienated other key managers by flaunting his ownership. Jim also spends more time out of the office. Though Jim has not yet questioned any of Father's management decisions, Jim's demeanor towards Father has grown less respectful and deferential. Father wishes he had a mulligan and could go back and keep the stock he gave to Jim. Unfortunately, that's not possible. Instead, Jim requires that Father buy back the stock Father gave him and demands that he be paid fair market value. Father ultimately agrees to pay thousands of dollars for an appraisal of the business to determine the value and satisfy Jim. After Father buys back Jim's stock, Jim quits working in the business.

What Could Father Have Done Differently?

Thoughtful planning could have avoided many of Father's problems with Jim. Had Father sought our counsel, we would have encouraged him to clarify the objective he thought would be achieved by making Jim an owner. If Father's purpose was to motivate Jim to grow the business and its profitability, then we would have explored other options that potentially could provide that motivation without the drawbacks of transferring actual ownership to Jim.

For instance, a phantom stock bonus plan that incentivized Jim with additional compensation if the business achieved certain milestones might have been an appropriate solution. If Father were adamant that he wanted to make Jim an owner, then we would have strongly encouraged Father to require that Jim enter into a buy-sell agreement, which would have given Father the option to buy back Jim's shares at a set price. Such an agreement would have made it much less costly for Father to remove Jim as an owner.

Planning Problem Two: Kicking the Can (and the Bucket)!

After his experience with Jim, Father is reluctant to give much attention to succession planning for his business. He forms the opinion that he will work until he dies, then his family can figure it out.

Ten more years pass, and Father's business continues to be successful. Daughter has completed college and shown interest in the business. Quick to shower Daughter with the privileges he never had, Father hires Daughter at an executive level directly out of college. Daughter's educational background has nothing to do with widgets, and she has no experience in the industry, so Daughter's leap up the company ladder to the top without touching the bottom rubs several of the other executives and employees the wrong way. Nonetheless, Father doesn't care about those opinions and is elated to have Daughter working with him.

Father's family life takes another big turn when he meets and quickly marries Stepmom. Though Son and Daughter are reluctant to welcome a new addition into Father's life, they soon see the joy the relationship brings to Father, and the family gets along fairly well. Son and Daughter would never admit it publically, but Father's insistence that Stepmom enter into a premarital agreement waiving any marital claims that she would otherwise have to Father's assets did wonders to warm Son's and Daughter's hearts towards her.

Though Father chooses to avoid facing many of the difficult decisions of business succession planning, Father does engage an attorney to put his Last Will and Testament in place. After struggling for months with how to structure his estate plan, Father decides on the following provisions:

- Upon his death, all of his stock in his company will go to Daughter.
- All of his other assets, net of all debts and taxes, will fund a trust for Stepmom's benefit.
- Upon Stepmom's death, all of the remaining assets will pass equally to Son and Daughter.
- Father names Son and Stepmom as his co-executors and co-trustees.

Within a year after signing his Last Will and Testament, Father suffers a sudden heart attack and dies unexpectedly. As his estate is administered and his instructions are followed, things start to unravel for Father's family.

Where Father's Planning Went Wrong - Part One: Tax Troubles

At the time of his death, the value of Father's business is significant—so significant that a federal estate tax liability arises when Father's Last Will and Testament gives the business to Daughter. Father's Last Will and Testament directed that all estate taxes be paid from his residuary estate, which are all of his nonbusiness assets intended to fund the trust for Stepmom. As a result, many of Father's nonbusiness assets must be sold to pay the estate tax. This leaves fewer assets in the trust to support Stepmom, which causes her stress about her financial security while also straining the relationship between Son and Daughter because Son sees Daughter receive much greater value from Father's estate than Son stands to receive.

What Could Father Have Done Differently Regarding Taxes?

Father failed to consider how estate taxes could impact his estate plan. Had he done so, he might have engaged in a lifetime gifting strategy to transfer some of the business ownership to Daughter at a discounted value, which would likely have reduced the tax liability. Additionally, Father might have obtained life insurance to provide a source of funds from which to pay the estate tax, as well as to supplement the assets that pass to Stepmom and Son.

Where Father's Planning Went Wrong - Part Two: Landlord-Tenant Relations

The trouble for Father's family continues when they discover that, though Daughter receives the business, the trust for Stepmom receives the real property on which the business operates. Father never put a lease in place between himself as the owner of the real property and his business despite the real property being absolutely vital to the business's operations. Sensing their leverage, Son and Stepmom, as co-trustees of the trust that owns the real property, require Daughter to negotiate a lease, and they demand an above-market rent. Daughter attempts to negotiate a lower amount, but ultimately must agree to the above-market rent because she has no other meaningful option and walking away would mean shuttering the business. In light of the high rent payments, Daughter has little profit left to invest and grow the business.

What Could Father Have Done Differently With Respect to His Real Property?

Father could have avoided this problem by putting a lease in place between himself as property owner and his company as tenant prior to his death. The lease could have set the rent at a reasonable amount and provided the business with a term of use that was long enough to allow Daughter to explore alternative arrangements after Father's death. Eventually, Daughter would have to negotiate with Son and Stepmom about the rental terms, but having a lease in place would have given Daughter a period of time to get her footing before having to sit at the negotiating table.

Life insurance could have also been helpful in this situation. Splitting the ownership of the business and the real estate invited conflict. Perhaps, Father could have purchased sufficient life insurance so that he could have left both the business and the real estate to Daughter and compensated Son and Stepmom with the proceeds of life insurance.

Where Father's Planning Went Wrong - Part Three: Handoff Hiccups

Within a year of Father's death, the business is floundering. Daughter's obvious lack of experience in the industry coupled with her sense of entitlement quickly alienates many of the key employees, who quit to join a competitor's team. Daughter has no idea how to right the ship and is too prideful to seek help. Ultimately, she is forced to close the business. Dozens of employees, whom Father viewed as family, are now unemployed. Moreover, with the business closed, the real estate now sits vacant so that the trust for Stepmom no longer receives rental income.

What Could Father Have Done Differently to Put Daughter In a Position to Succeed?

The transition of control of a business is not easy to accomplish and often fails. The new owner needs training, experience, and the respect of, and for, the business's workforce. Father could have helped Daughter secure all of these. Rather than simply giving Daughter an executive position out of college, he could have forced her to "work her way up" in the business, which would have given her a fuller picture of the business's operations while endearing her to the business's other employees. He also could have guided Daughter into certain training and continuing education programs that would have been helpful to her. Father would also have been in the best position to chastise Daughter when she acted inappropriately towards other employees. Finally, Father could have implemented incentive compensation arrangements with the key employees, coupled with appropriate noncompetition agreements, which would have made it much more difficult for the key employees to leave Father's business.

Conclusion

Business succession planning is not simple. More business owners get it wrong than get it right. Sometimes even the best plan will fail due to personalities or circumstances that could not be avoided. Nonetheless, businesses whose owners plan well are much more likely to enjoy a successful transition than those whose owners plan poorly or fail to plan at all. The attorneys at Ward and Smith have substantial experience assisting businesses and their owners with a wide array of succession. Let us help you plan for successful succession at your company.

--

 For further information regarding the issues described above, please contact Merrill G. Jones, or Zachary F. Lamb.

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.