Someday, this will all be… whose?

Planning for succession is never easy for the founder of a business. Keeping a business going and the natural feeling that the founder is the only one who could make it work is a worry.

However, a business enterprise founded by a father and mother may not endure for a second generation without some effort to establish a plan of succession.

The most basic, and perhaps the most important, aspect of succession planning is the thoughtful designation of executors and trustees of the will and trust, which will typically own and control a family business on the incapacity or death of the founder. If, as is typically the case, the executor/successor trustee becomes the majority shareholder of the business, the successor fiduciary will have the power to alter the business operations, change the management of the enterprise and later the compensation structure.

If a second spouse, for example, is named as sole successor fiduciary, a child from a previous marriage who has worked at the business for many years may suddenly find themselves terminated as an employee at the business, even though they are a significant beneficiary of their parent's estate plan. By using co-trustees, it is sometimes possible to create a balance of power in business.

Each state has different legislation on this issue. In California, for example, if the trust names the second spouse, a child from the first marriage and a third-party advisor as co-trustees, then state law normally requires all three trustees to agree on any action. This would include such things as changes to the board of directors and the family business.

The unanimous-action rule of Probate Section 15620 can be altered so that a majority of the trustees can act on behalf of the trust estate. An alternate plan is to name A and B as co-trustees, but provide that if A and B reach an impasse, a designated third-party "tie-breaker" special co-trustee resoles the disagreement. A final alternative is a “double suicide” provision in which A and B are named co-trustees but either trustee can, after an extended period of notice, cause both trustees to be removed in place of a third-party trustee, such as a bank.

Understanding the importance of voting power is critical. If one child eventually ends up owning a majority interest, with another child having a minority interest, the majority shareholder can elect a majority of the directors and select corporate management, thereby dictating who will control and get paid for operating the business. (In the case of a limited liability company, the rules of corporate governance may be different.)

Finally, the ability of a successor to “cash out” of the business after the founder dies can be critical to the continuation of the business. If a child (or their trust) has more than a 33 percent share of a corporation, that child may be able to force an involuntary dissolution of the business, resulting in a forced sale of their interest. A better solution may be a buy-sell agreement among the children that gives them a right or option to be bought out at a fair price over a reasonable period of time.

The structure of such an agreement is important. If an unhappy child can force a buy-out immediately after the founder’s death, when there is an estate tax audit of the value of the business underway, it can be very awkward to simultaneously fight with an unhappy child about the value of their share. A skillfully drafted buy-sell agreement can avoid this problem by deferring the right to compel a buy-out until a multi-year period after the date of death of the founder, so that the value is defined under the buy-sell has little or no influence on the estate tax valuation.

Deferring the valuation will also permit all parties to have an understanding of how much the business is really worth without the founder’s skill and expertise. Having an optional buy-out may also permit children who are minority shareholders to decide to either "cash-out" for a fixed payment or stay involved in the family business.

It is even possible to draft an estate plan so that the terms of the buy-sell agreement are effectively imposed by the founder's will and trust. If the founder wants to give a majority control to child A but wants children B and C to hold a minority interest in the business, the founder can grant B and C option rights to be bought out based on a defined formula commencing five or 10 years after the founder dies. Child A may have in interest in keeping children B and C happy and cooperative with their minority shareholder interests.

In addition to legal structures for succession of a family business, the importance of giving the next generation opportunities to participate in the business operations while the founder is still alive must not be overlooked.

Encouraging the next generation to participate in business and legal meetings is a first step. Allocating real control of a particular division of a family business to a son or daughter so they can obtain practical hands-on experience is a good step. An extended vacation by the founder during which a successor child is left in charge or operations can be a further means of testing the chosen successor's ability to actually run the business.

Keeping a business going for more than one generation is seldom easy, but with planning, the successors to a family business can continue to build on the foundations laid by their parents or grandparents.