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Helping Manitobans Succeed

Succession in Family Businesses

Core Succession Options for Existing Owners

- When exiting a business, three main options are available
    - 1. Transfer of ownership to family
        - Transferring ownership of your business to a family member can help ensure a seamless transition and support business continuity if you have a desire to stay involved with the business for a period of time
        - This can potentially jeopardize your financial security if your successor is not able to pay for the business outright or is not well-suited to take over and run the business
        - Combining family and business can exacerbate conflicts both in the business and at home
    - 2. Sell to existing employee
        - Gradual share transfer to employee-owners through employee ownership plans
        - Helps ensure current employees maintain their jobs after new management takes over and that business knowledge remains within the company
    - 3. Selling Outright
        - Selling your business outright to a neutral third-party based on the business valuation received
        - Typically faster and less emotional for the owner

Should The Business Be Sold?

- Reasons to Sell
    - To obtain optimal value
    - There is a lack of commitment from the family to continue the business in future generations
    - There is no competent successor in the family to continue running the business
    - When the risks of failure within the business are high
- Potential Obstacles to a Sale
    - An owner's inflated perceived value of the business due to emotional attachment and sweat equity in the business
    - Lack of qualified buyers and/or a need for broker's assistance
    - Company's dependence on owner as operator and builder of the business
    - Capital gain on sale

Succession – Estate Planning for Owners of a Family Business

- Typical goal: minimize taxation and preserve the value of the business
- Requires situational planning focused on uniqueness of the family and its business

- Critical Issues
    - Active and inactive members of the family business
    - Commitment of members of the next generation to the family business
    - Diagnosis of business survivability

<u>Strengths and Weaknesses of Family Businesses</u>

- The strengths and weaknesses of the business itself are important to know when developing the succession plan for a family business, as they directly impact the future stability, performance, and leadership of the business.
- Strengths of being a family business for succession
    - Accountability
        - Management is held supremely accountable because the family relies heavily on the business for their income
        - The business is typically the life's work of one of the family members and is often meant to provide jobs and income to future generations. Those within the family must work to preserve and build the business
    - Synergy of management and ownership
        - Management is often ownership – or related to ownership – meaning business values are entrenched in their minds. There are typically few people with decision making authority or voting power that are not heavily involved in the business
        - Synergy brings many advantages to a business. Such as saving resources due to efficiency, lack of power struggle, lack of need for close supervision from ownership to management
    - Long-term perspective
        - Managers of family businesses tend to prioritize long-term growth, whereas managers of non-family businesses often focus primarily on maximizing short-term revenue, or on a more balanced approach, focussing on both short-term success with long-term growth and security
    - Strong value and ethics that are consistent with those of other employees and the business
- Weaknesses of being a family business/difficulty in succession
    - Small pool of successors/sibling rivalry
        - Keeping the business in the family significantly reduces the pool of potential successors. Among this pool of candidates, it's possible that not all (or maybe even none of them) are interested in taking over the business.
        - The structure of the family tree may result in power sharing among siblings/cousins/parents as opposed to having one defined leader and decision maker. This may lead to conflict and/or a power struggle.
        - Conflict among family members can harm both the success of the business and the health of family relationships
        - The stepping back or death of the founder or founders may lead to problems, because, regardless of the acumen of the next generation, the respect given to the founders may not transfer easily to the next leader. Part of that may be due to

family dynamics. For example, one may have greater difficulty showing the same respect to one's sibling that one showed to one's parent.
  - Unwillingness of the owner to let go of the business
    - Often the business in question is the owner's life's work, making it emotionally difficulty to let go. This deep personal investment can negatively impact the succession process

The Five Levels of Practical Succession Planning

- 1. Clarify the Owner's Goals
  - Find the "what" "when" and "how" regarding the owner's objectives to be accomplished
  - Determine and understand the business owner's objectives
  - Establish a realistic plan based on the current family business and family context
- 2. Plan for Financial Security of Owner and Spouse
  - Develop strategies ensuring stable income post-transition
- 3. Establish a Management Team
  - Distinguish between ownership and day-to-day management
    - Management and ownership are not always the same. For example, it may be planned that interest in ownership is left to all children, but the day-to-day management of the business may be left to one child or even a non-family member
  - Consider a gradual role transfer and retention plan of key employees
  - Key mechanisms to consider: employment agreements, stock options, advisory boards
- 4. Define Ownership Transfer Mechanisms
  - How will the transfer be done? (for example, gifting, selling, or a mix)
  - Address roles in the business for individuals that have been active or inactive in the business in the past
  - Possible use of an estate freeze
    - An estate freeze is executed by exchanging property that is likely to grow in value for property with no growth potential. The intent is to transfer the future growth of the assets and their associated liability to others – in this case the family member taking over the business.
    - Before considering an estate freeze, be sure that you (the business owner) do not require the future growth to fund your lifestyle.
    - The use of this ownership transfer mechanism comes with tax implications. During this process it is best to consult an accountant for information related to tax minimization.
- 5. Tax and Estate Planning
  - Optimize transfer methods to minimize taxes
  - Consult an accountant for best information on tax and estate planning

The Blueprint for Family Succession Planning

- 1. Collecting Information
  - Parties involved should review copies of current business governing documents, related-party contracts, and estate planning documents that might affect governance, ownership,

or succession of the business. This process helps business owners get their personal and business records organized, established and current

- 2. Valuation
  - Obtain a reliable valuation of the stock of the business to obtain a reliable valuation of the overall business
- 3. Business Continuation Plan
  - If there are any key family members who are important to operations or future success of family business, identify them early in the process
  - Look to establish mechanisms to address the disruptions that would be caused by the sudden death or incapacity of one of those key family members
- 4. Restructuring
  - Based on the valuation received, determine whether the business should be restructured or reorganized
  - In this step of the blueprint, it is important to account for other advantages/disadvantages of restructuring
- 5. Governance and Buy-sell Structures
  - Design the rules that will regulate governance, ownership and owner exits after control has transitioned down from the senior generation
  - Key activities include unit voting, governing board, executive authority, beneficial ownership
- 6. Key Contracts
  - Should negotiate restatements of key contracts with third parties that should account for the update in ownership
- 7. Update Senior-Generation Owners Estate Plans
  - Update estate planning documents, including wills and revocable trusts, consistent with business restructuring and decisions that the clients have made about future governance structures and ownership rights
- 8. Plans for Senior Generation Owners Retirement
  - Before control is transferred, ensure that the senior generation members will have sufficient economic means to support them indefinitely in retirement
- 9. Lifetime Transfers to Next Generation