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SUCCESSION BUSINESS PLANNING

I. Introduction: Unlike with the stockholders of public companies, a small business owner normally finds no readily available market or market price for his or her closely held business. When one partner dies, retires, becomes disabled or wants to leave the business, the common practice is to create a market and to establish a pre-determined price to smooth the transition and to find cash for the departing partner or his or her surviving family members.

Another consideration in succession business planning is that many owners do not want to be in business with the family of the deceased partner or with some unknown third party. They may prefer that the business should fall to some "heir apparent" or preferred successor.

A common way to handle such issues is to create a so-called "buy-sell agreement." There are many variations in such agreements depending on the particular circumstances and tax consequences. This article is designed to help you begin the process of thinking about your own business succession issues.

II. Basic Succession Business Planning Issues to Consider:

1. Is your business capable of continuing after your death – either with a surviving partner, with one or more key employees, or with one or more members of your family? Do these surviving parties get along? Are they capable of running the business without you?

2. Would you be comfortable in working with a family member designated by your partner if he or she should die first?

3. How do you propose to deal with key employees? Should one or more of them control the business if you should die? If so, how do you structure it? And what do you do if that key employee leaves?

4. Will sufficient assets be available from the business, or more likely, from key person life insurance proceeds, to provide for your surviving spouse or children?

5. Will the business be able to survive after paying off your spouse or children for the value of your business interest? Would you be able to survive if the business has to pay off the spouse or children of your deceased partner?

6. What happens to the business if you want to retire, or if you become permanently and totally disabled? What happens if your partner should retire or become disabled?

7. What happens if you find a proposed buyer for your share of the business? What happens if your partner finds such a buyer?

III. Once you have confronted these basic questions, you also will need to sort through some general legal considerations:

1. Business Structure: How is your business structured? When you form your business, you want to do so in a way that will provide limited liability protection. Why? To the extent possible, you want to try to keep your personal assets from being exposed to business lawsuits and creditor claims. Examples of small business entities with limited liability protection are:

- Subchapter S corporations;
- limited liability companies, or LLCs;
- limited liability partnerships, or LLPs;
- limited partnerships, or LPs; and

- professional corporations, or PCs;

You must comply with different legal formalities for each of these business entities. You should consult with your tax advisor to determine the form of ownership that makes the most sense for your business. Examples of more dangerous small business entities with NO limited liability protection are general partnerships and sole proprietorships. I normally advise against these disfavored forms of ownership. Regardless of what form of ownership you use, you will want to have adequate business liability issues.

As a practical matter, you may be forced to expose at least some of your personal assets to liability if you own a small business with minimal credit and no significant earnings history. Landlords and lending institutions may insist on personal guarantees from the owners of such a business. Depending on the circumstances, you may be able to avoid unlimited exposure by negotiating limitations in the terms of the personal guaranty.

2. Major Legal Consideration: Avoiding Probate: If no agreements and documents are in place to cover what happens when you die, then your shares of stock, LLC membership units or other forms of ownership will have to pass to your heirs through probate. That potentially could tie things up for a year or more.

If you have multiple business owners, you may be able to resolve your succession planning questions and also to avoid probate by creating a properly structured "buy-sell agreement." Some of the possible provisions of such an agreement are discussed later in this article.

If you don't have a buy/sell agreement, you at least want to have some kind of transfer on death agreement with the company to transfer your business ownership interest upon death. So, for example, a common way to handle this problem is to transfer your ownership to a trust. If it's not prohibited by professional licensing rules, you may want to make your trust the owner of the

business when you're still alive. This will avoid having a probate issue upon death. But this approach could be problematic if you and your spouse have a joint trust and the spouse doesn't want to be part of the business. Under those circumstances the transfer on death agreement may make more sense.

3. Income and Gift Tax Issues: Transfers to others on death also may have income tax or gift tax considerations. You need to consult with an accountant to address these tax issues.

4. Federal Estate Tax Issues: An overriding consideration for some relatively large businesses is the effect of the federal estate tax. The federal estate tax laws have gone through major changes in recent years.

a. Current Exemption Amounts: In 2019, no estate tax will be owed to the federal government if an individual has a gross estate worth less than $11,400,000, or if a couple has a gross estate worth less than just over $22,800,000. The top rate is now 40%. So, for many truly small businesses, no federal estate taxes would be due if an owner should die at a time when these exemption amounts remain in effect. Congress, of course, retains the power to change the exemption amounts and rates. So, it is important to keep an eye on any changes in estate and gift tax law.

b. Techniques to Limit Estate Tax Exposure: Many lawyers, accountants and financial advisors – fearing the worst and acting out of an abundance of caution - are recommending that business people create something called an irrevocable life insurance trust -or "ILIT"- to remove at least part of the value of their business interests from their gross estates. Others recommend alternative techniques for minimizing tax exposure. These are complex legal and factual decisions that should be made only in consultation with your lawyer and an independent tax advisor.

IV. So, against this background, what should you do?

1. Need for Shareholder Agreement or Operating Agreement: At a minimum, you should have a Shareholder Agreement or Operating Agreement in place. This kind of business succession document is sometimes called a "Buy-Sell Agreement." If you do not have such an agreement, it creates all kinds of headaches for your survivors if something happens to you.

2. What to Include: The balance of this article will cover some of the customary provisions that you might want to consider in drafting an agreement.

3. Sample Hypothetical Business: Assume that two people own a widget business – it can either be an LLC or a Subchapter S Corporation.[1]

4. Name of the Agreement. If the business is an LLC, then the controlling agreement is called an Operating Agreement. If the business is a Subchapter S Corporation, the agreement is called a Shareholder Agreement. As I have mentioned, the document also is commonly called a "Buy-Sell Agreement."

5. Permitted Transfers: Although you generally want to prohibit any transfer of each other's business interests not specifically authorized by your Agreement, you most likely will want to allow for voluntary transfers to the owners' respective revocable trusts. And if the owners or their spouses have created ILITs for the business, you will want to allow those trusts to become business owners at some point. This flexibility could be important for estate planning.

6. Right of First Refusal: To make it more difficult for your partner to sell to someone whom you do not know or approve, you will want to have a right of first refusal. This is an option given to the business or the other business owner to match any bona fide offer to buy the business interest of the selling owner.

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[1]For simplicity, I may refer to the two business owners here as "partners." But as a matter of law, they are not the "partners" of a general partnership. For an LLC, the business owners are called "members." For a Subchapter S Corporation, they are "shareholders."

7. Retirement: The right of first refusal also might be triggered automatically if one of you chooses to retire.

8. Drag-Along Rights. If you hold the majority of the stock or membership units in the business, you may want to include what are called "drag-along" rights. A "drag-along" provision permits you to notify minority owners of the proposed sale and to force them to sell their minority interests on the same terms as the bona fide offer. The reason for including such rights is that the business as a whole is likely to have greater value to a proposed buyer than just a majority interest. The typical buyer would prefer not to have to deal with minority business owners.

9. Mandatory Cross-Purchase upon Death: You will want to have a mandatory purchase of your ownership interest – either by the business or the surviving partner - if you should die. Typically, in a cross-purchase agreement, you will provide for the cost of this mandatory purchase by having key person life insurance in place to insure against the death of the other partner. And the other partner will purchase life insurance covering your life. That way, if either of you should die, the surviving partner will have insurance proceeds to purchase the deceased partner's business interest from his or her surviving spouse, children or trust, if one is in place. If the insurance is insufficient to cover the fair market value of the deceased party's interest, the surviving partner can sign a note to pay off the balance over time with interest.

10. Permissive Cross-Purchase upon Disability: You also might want to consider a similar cross- purchase arrangement - perhaps on a voluntary basis - if one of the partners should become totally and permanently disabled. Ideally, if you have the money, you should purchase disability insurance on each other to cover the cost of such a buy-out.

11. Determination of Fair Market Value: And finally, you definitely want to have a mechanism or formula in place for determining the fair market value of each membership unit or share of stock for any of these purchases. In some businesses, a

multiple of earnings approach may make sense; in others, you may consider a more asset-based approach. To avoid conflicts, you probably should agree on the fair market value, in writing, at the end of each calendar or fiscal year. And then have a procedure for resolving conflicts if you haven't kept up, or if the last agreed upon value is too far off the mark.

V. Conclusion: All these are just suggestions for customary provisions. I do not intend for this article to provide an exhaustive list of everything you might need. You should seek professional advice from your lawyer and accountant in developing an agreement for your particular business.

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