Helping Clients Plan for the Sale of a Family-Owned Business

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Along with the usual issues in mergers and acquisitions, the sale of a family business requires the management team and their lawyers to navigate family dynamics, unpack complex ownership structures, and deal with long-neglected legal issues. At each step, they must address both income and estate taxes in an ever-changing regulatory environment. The best results occur when the owners assemble a team of trusted, professional advisors who work collaboratively throughout the pre-sale process as well as during the transaction.

Often the trusted legal advisor to a family-owned business is the best "quarterback." He or she may be a skilled transactional generalist who rarely sees exit transactions and may or may not have any insight into the family's estate planning strategies. But regardless of the trusted lawyer's background, the family's confidence makes him or her a key player on the interdisciplinary team of advisors. That lawyer's history with the owners can be the best recipe for a successful transition as long as there is a clear understanding of the business goals and family dynamics, and an effort to communicate these key issues to the other specialists.

This article will help the trusted lawyer frame issues for the family and consider what specialty outside advisors should be added as key players on the team.

Begin With the End in Mind and Always Ask 'Why?'

When the client knows their financial, family dynamic, retirement, transition, tax planning, and public image goals, their lawyer can help them achieve those goals. When the goals are not clear, then the outcome will always fall short of expectations.

To help clarify the owners' goals, the questions every advisor should ask are:

- Why are you doing this?
- What is your end goal?
- When is your ideal exit?
- Who are the stakeholders?

The ownership of the *Washington Post* is an interesting case study in family business ownership dynamics. For three generations, the company stayed focused on the core goals of maintaining voting control, editorial integrity, and long-term appreciation. To achieve the long-term appreciation goal, the company had to raise capital by selling equity to outsiders. The company created multiple classes of equity. The family held on tight to the voting class but took the non-voting class public. The family issued non-voting equity to key, non-family management team members to help align the management team with the family's growth and editorial integrity goals. The *Post* had many exit opportunities over 50 years and each time they weighed the financial opportunities against their goals. Often, they sold or acquired significant assets and bought or sold corporate stock. But they did not sell control of the voting shares in the company outside the family. At each generation, a strong leader emerged to take a majority ownership in the voting shares and run the company. Other family members were enriched without being involved. This company regularly and repeatedly weighed opportunities, crises, and change against its goals before taking action.

Some very clever tax and securities lawyers worked behind the scenes tirelessly for the family owners. Securities laws, estate tax planning, income tax planning, and the basic rules of corporate governance had to align to accomplish the goals while balancing market and finance needs.

The Importance of the Timeline

It's important to ask clients at least once a year about their timeline for an exit. They rarely answer "Never." Some are focused on a five-year plan. Some look farther out as they see a talented son or daughter excelling in the early stages of a career with synergies to the business. A few want out NOW and are already shopping for offers. In each case, the timeline informs the lawyer's next steps.

In each scenario, lawyers should follow the journalist's rule of always asking: Who, What, When, Where, and Why. A lawyer, acting as a counselor, and not just as a clever technician or scribe, will understand those goals before proceeding with an action plan.

I want out NOW. Impatience triggers several urgent legal and tax planning actions:

Build the legal team to include a tax lawyer, an estate tax lawyer, an accountant, and a financial planner to work through late-stage gifting and trust planning to mitigate the tax consequences of the sale. (See below).

- Put together a legal team to conduct a "mock" due diligence. Include employment, real estate, technology, corporate, benefits, environmental, and other specialists who do a holistic check up on the selling company.

- Address any simmering conflicts about the sales decision, the company's ownership, and the "fairness" of the transaction. Airing out those issues before a seller is at the door can prevent embarrassing roadblocks later.

- Be assertive about providing legal advice on the three early-stage contracts that clients often sign without talking to you: Broker Contract; Form of NDA; Term Sheet.

Remind these clients that the earlier you are involved, the more headaches they will avoid later. The broker/investment bank contract often contains confusing commission terms, tough breakage fees, restrictions on sales after termination, and very “broker friendly” soft goals. The NDA (a form often provided by the broker) may or may not properly protect your client adequately during the pitch period or in the early stages of diligence. And the Term Sheet (often drafted by a broker or the inside business team) is rarely focused on key tax planning, management transition, and employee issues. Protect your client by offering your services early in the process.

The Five-Year Plan. A client who shares their five-year plan offers you the opportunity to add value and optimize their exit in many ways, including engaging an estate tax lawyer early to help clarify gifting and inheritance goals.

Consider doing a business law “checkup” to get ahead of the operational issues that will eventually be examined in due diligence. That might include a review of whether they really know the difference between employees and independent contractors. A refresher course in protecting their intellectual property either by filing patents, protecting their copyrighted or trademarked material, or defending their trade secrets may also be necessary. The checkup could focus on more basic items such as a review of their minute book, tuning up corporate documentation practices, and obtaining good standing status in the states where they operate. It can help to show the client a long-form due diligence checklist to give them perspective around what a buyer will look for in a sales transaction.

Note that in a five-year timeline, the lawyer has time to address risk management, asset segregation, intercompany agreements, family dynamics, and employee retention issues. There is also time to do an entity inventory (see below). It may make sense to create equity-based compensation for key employees or cash bonus plans that help the leadership align their actions with the family’s goals.

Long Horizon View. The lawyer working with the long horizon view client can help them look at family dynamics in greater depth. Most families have next generation heirs with a variety of personalities, skill sets, and goals. It is very challenging to accommodate diverse members of the same generation in leadership of a single business, but it usually isn’t necessary. Providing financial security for heirs is different from providing leadership opportunities or even ownership in the business. Note that it is never a good idea to force heirs into working for the company. An experienced team of estate tax lawyers and financial advisors can recommend tools to allow family succession without the kind of drama captured in the mini-series *Succession*.

Inventory the Mix of Companies

Family-owned companies sometimes resemble Grandma’s attic. They can be a jumble of diverse active businesses, real estate, recreational assets, and abandoned concepts. Often these assets are commingled illogically. The in-house or outsourced CFO will become your right hand in the exercise of assigning assets and operations to the correct legal entity as you create an inventory of the companies in a spreadsheet. For the benefit of your clients and your own future reference, draw up a detailed diagram of the entities and their ownership.

Consider whether it makes sense to spin off some of the mix of companies and assets to different branches of the family. A film production company is not necessarily a good fit under a holding company principally managing tech assets, or a portfolio of commercial real estate.

Step back and evaluate whether the inventory and diagram make sense. Take this time to segregate the assets to be sold into a group of legal entities with clearly stated ownership. Partner with the management, tax, and risk management teams to suggest a reorganization plan.

Death and Taxes

The unhappy truth is that lifetimes do eventually end, triggering many consequences. Few successful business owners will be unconcerned about estate taxes, especially now that a reduced federal exemption amount ($6,020,000 for gifts made and decedents dying after Dec. 31, 2021, down from $11,700,000) has been proposed in Congress. While at the writing of this article the changes in the estate and gift tax laws remain uncertain, they can be minimized only with advance planning.

There is a tension between the owners' need to retain sufficient assets to support their desired life-style and the techniques available to minimize estate, gift and income taxes, thus there is no "one size fits all" approach to planning. This is especially true where the owners have the planning complexities posed by multiple marriages, differently competent children, creditor issues of beneficiaries, and concern about the ability of certain beneficiaries to manage their affairs. The creation of trusts should always be considered, with their many benefits weighed against the additional administrative burdens they may impose.

Since the sale of a business is typically a gain recognition event, some owners choose to divert funds that would otherwise be paid in taxes to a charity (or charities) of their own choosing. For some charitably-inclined owners, this may be the time to create a family foundation. For others, funding an account in a donor advised fund will be sufficient. For those who wish to give more than money, involvement with philanthropy is often a rewarding way to use skills the owners have developed over their careers in new ways.

Encouraging your clients to thoughtfully consider what they would like the future to look like for both themselves and those they care about can only improve the transition.

Summary

Good legal leadership in the sale of family-owned companies is a multi-disciplinary exercise requiring a strong, trusted quarterback who understands the family dynamics and a team of specialists in tax, estate tax, securities law, employment law, and other disciplines. Navigating personalities, politics, and one or more generations' worth of legal neglect makes these projects fascinating and challenging legal projects. Help your client begin with the end in mind and assemble a talented team of advisors and you will succeed as a counselor and not just a lawyer.

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