

BUSINESS SUCCESSION PLANNING¹

I. INTRODUCTION

Ninety percent of the 21 million U.S. businesses are family-owned, and one-third of the Fortune 500 are either family-owned or family-controlled. Yet only 30 percent of family-run companies today succeed into the second generation. An even smaller 15 percent survive into the third. The reason: the lack of an orderly succession plan.²

The triggering events: disability, divorce, death, or simply the desire to retire. What happens to the business when the owner is gone? How will ownership be transferred? A well-thought out succession plan may set up a smooth transition between the current and the future owners of a business and can be essential to its continuation, no matter what its size and structure.

II. TIMING

Start early. Five years in advance is good. Ten years in advance is better. I advise my clients to include an exit strategy in their governing documents when they begin the business, e.g., before money is an issue. The point is, the longer you get to spend on business succession planning, the smoother the transition process is likely to be.

III. THE TRIGGERING EVENTS

Lifetime transfers (disability, divorce, retirement)³ or death.

¹ **THE INFORMATION CONTAINED HEREIN IS MERELY AN EDUCATIONAL SERVICE TO PROVIDE BASIC, GENERAL INFORMATION AND IS NOT LEGAL ADVICE OF ANY SORT. FURTHER, BY EXPLORING THIS INFORMATION, YOU UNDERSTAND AND AGREE THAT NO ATTORNEY-CLIENT RELATIONSHIP IS BEING FORMED. © Mitchell S. Milby c/o Clark Ashworth Milby, RLLP, 1401 Elm, Ste. 3404, Dallas, Texas 75202 (214) 220-1210, mmilby@camfirm.com**

² United States Small Business Administration, 2006.

³ Disability (power of attorney, trust, sale), divorce (spouse gets half – mandatory buy-sell), retirement (sale or gift).

IV. THE PLAN

The structure of the company and the recipient of the business are the two primary factors that affect the choice of transferring method.

A. The Sole Proprietor

Q: *Who are the recipients?*

Answer #1. family member(s) or employee(s)

Do not assume that the intended recipient has the desire or ability to run the business.

Q: *If keeping the business in the family, is spouse, child, or other relative interested in running the business?*

Practice Tip: Do not confuse ownership with management. A possible solution may be to hire management to run the business and retain ownership with the family.

If a child is the intended recipient, consider the following: only *after* the child spends a period after graduation working outside will he or she begin working in the business, initially learning the ropes and only later will the owner begin grooming for leadership and eventual ownership. Ideally, by that time the owner will know if they have the desire and ability, and the owner will be in a position to retire.

Q: *Is there a need to train the successor(s)?*

If so, heed the advice of the now defunct firm, *Crosby, Stills & Nash*: “Teach Your Children Well,” *e.g.*, train the recipient or hire a team of managers while the recipient develops skills necessary to run the business.

Practice Tip: If trade secret information is disclosed as part of the training, consider a non-disclosure and non-compete agreement.⁴

⁴ Visit www.camfirm.com for a discussion on enforceability of noncompetes in Texas.

Q: *How long to stay active in the company management and in what capacity?*

Identify certain "trigger dates," including when: (1) ownership transfer begins, control (>50% ownership) shifts, remaining balance is transferred; and (2) transfer of management responsibility begins and is completed.

Q: *Gifts or selling?*

"Gifting" allows the owner to transfer the business over time -- in a way that may reduce or even eliminate any estate or gift taxes.⁵ In addition to the potential of minimizing their own taxes, gifting allows an owner to oversee management succession as well as the change in ownership, *e.g.*, the owner has the opportunity to maintain control while giving the recipient(s) increased responsibility over time.

Selling? Insurance policies may help your successor finance the purchase as well as pay for the ensuing taxes.

Answer #2. Third party – not employee or family.

See Partnerships, Corporations, and LLCs below for this answer.

⁵ The effect of gift and estate taxes is beyond the scope of this article.

B. Partnerships, Corporations, and LLCs

Whether the business is a partnership, corporation, or a limited liability company (LLC), all partners, shareholders, or members, respectively, face a different set of decisions than a sole proprietor. Does the ownership percentage of the business automatically transfer to a spouse or offspring upon death or, as part of an agreement, is a partner, corporation, or LLC obligated to buy the shares?⁶ What about voluntary retirement, divorce, or disability?

1. Buy-Sell Agreements

Buy-Sell Agreements (Buy-Sells) are the most common form of succession planning whereby the business or one or more of its owners buys out an owner's share of the business for a predetermined price on the occurrence of a specified event within a fixed period of time. If properly drafted, a Buy-Sell not only avoids probate administration of a decedent's business interest, but it minimizes disruption to business operations in two ways.

First, a Buy-Sell ensures that outsiders, *i.e.*, heirs, will not enter into the management of the business.

Second, a Buy-Sell ensures that there will be a purchaser for the business interest when the specified event occurs. This benefits the heirs, as ownership in a partnership, privately-held corporation or LLC⁷ is not readily marketable to the public; therefore, the heirs will not be forced to sell the ownership interest at less than its real value to cover costs of administration.

Practice Tip: be sure that the decedent's will or revocable trust does not devise the business interest in a manner inconsistent with the Buy-Sell, as this may defeat your goals and possibly result in probate litigation.

Buy-Sells most commonly fall within two categories: **mandatory** and **first option**.

⁶ Unless an owners' agreement specifically provides that a portion of the total number of shares offered in an option agreement may be purchased, an owner is not required to sell part of his or her shares under a first option agreement. *See Rainwater v. Milfeld*, 485 S.W.2d 831, 835-836 (Civ. App.--Corpus Christi 1972, no writ) (rejecting contention that when owner's entire amount of stock is offered under first option agreement, any stockholder has right to buy proportionate share of offer without regard to whether balance of stock is purchased by other owners).

Restrictions of stock, in the form of first option agreements, have been held to be ineffective once a business is dissolved. *See Mischer v. Burke*, 456 S.W.2d 550, 554-555 (Civ. App.--Houston 1970, ref. n.r.e.) (after dissolution of business there was no longer any need to protect owners' right to choose associates).

⁷ Publicly held corporations and LLCs are beyond the scope of this article.

a. Mandatory

A mandatory buy-sell agreement obligates the business or its owners to purchase the ownership interest from the owner or owner's estate on the occurrence of a Triggering Event.

b. First Option

A first option buy-sell agreement is exactly like it sounds – it reserves for the owners or the business only the option to purchase the interest in preference to outsiders. In contrast to a mandatory buy-sell agreement, an option agreement does not require the owners or the business to purchase the interest; therefore, the interest may be offered to outsiders once they have been offered to and refused by the business or owners. Options may be made to the business or the owners or they may be successive, first to the owners and then to the business, or vice versa.

Q: *How will the Buy-Sell be Funded?*

Insurance is a common method to provide funds with which to purchase a disabled or deceased's owner's interest.

Q: *What is it worth?*

The price to be paid for the interest may be set forth in the agreement or may be dependent on what could be obtained from an outside offer.

Fixing the method for the transfer price of the interest avoids disagreements at the time the interest is transferred and potential litigation in the future. Some of the methods suggested for share valuation include the following:

1. The book value at the time of transfer. *Caveat:* may not include goodwill or actual depreciation of assets.
2. Joint agreement (annual) on a set price to be paid once the transfer occurs. *Caveat:* can be tricky if majority owners intend to shut out minority owner.
3. If a first option agreement, matching of an outside offer.
4. Appraisal by a third party. *Caveat:* specify how the appraiser is to be chosen, the method of appraisal used, and an alternative method of valuation should the appraisal mechanism fail.

Practice Tip: Spouses must sign the Buy-Sell for business to exercise its right to buy.

The author, Mr. Mitchell S. Milby, Esq., focuses his practice in business law, including entity formation, business negotiations and contract drafting, and trial work arising out of business disputes. He has represented foreign and domestic corporations, Dallas-area businesses, municipal government, and individuals for over a decade.

Mitchell is an **AV-rated attorney** (Martindale-Hubbe) and a **Fellow in the Texas Bar Foundation**. In his first year of practice he received the Dallas Association of Young Lawyers **Special Recognition Award**.

He was recently selected as a **“Best Lawyer Under 40”** by his peers in the Dallas Bar, appearing in D Magazine.

Representative litigation

- defense of architects and engineers;
- construction defect claims;
- contract disputes, including covenants not to compete;
- shareholder derivative lawsuits;
- environmental contamination claims;
- intellectual property (copyright and trade secrets) disputes.

Before forming Clark Ashworth Milby, RLLP, Mitchell’s career included:

- Partner in one of the Top 100 U.S. Law Firms, per The American Lawyer
- In-house counsel to the Dallas Police Department
- Dallas criminal prosecutor (he tried over 80 cases to verdict in 1 year)
- Special Agent, Federal Bureau of Investigation, San Francisco division

Professional Affiliations

- State Bar of Texas
- Federal Court – Northern, Eastern, and Southern Districts of Texas
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Education

NORTHWESTERN SCHOOL OF LAW, LEWIS AND CLARK COLLEGE
1994 Juris Doctorate; Honors: Certification in Environmental and Natural Resources Law

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