



## **Successful Succession Planning for Family-Owned Businesses**

**March 26, 2019**

**6:00 p.m. – 8:00 p.m.**

**CBA Law Center**

**New Britain, CT**

**CT Bar Institute Inc.**

CT: 2.0 CLE Credits (General)

NY: 2.0 CLE Credits (AOP)

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## Lawyers' Principles of Professionalism

As a lawyer I must strive to make our system of justice work fairly and efficiently. In order to carry out that responsibility, not only will I comply with the letter and spirit of the disciplinary standards applicable to all lawyers, but I will also conduct myself in accordance with the following Principles of Professionalism when dealing with my client, opposing parties, their counsel, the courts and the general public.

Civility and courtesy are the hallmarks of professionalism and should not be equated with weakness;

I will endeavor to be courteous and civil, both in oral and in written communications;

I will not knowingly make statements of fact or of law that are untrue;

I will agree to reasonable requests for extensions of time or for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;

I will refrain from causing unreasonable delays;

I will endeavor to consult with opposing counsel before scheduling depositions and meetings and before rescheduling hearings, and I will cooperate with opposing counsel when scheduling changes are requested;

When scheduled hearings or depositions have to be canceled, I will notify opposing counsel, and if appropriate, the court (or other tribunal) as early as possible;

Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the court (or other tribunal) and opposing counsel of any likely problem in that regard;

I will refrain from utilizing litigation or any other course of conduct to harass the opposing party;

I will refrain from engaging in excessive and abusive discovery, and I will comply with all reasonable discovery requests;

In depositions and other proceedings, and in negotiations, I will conduct myself with dignity, avoid making groundless objections and refrain from engaging in acts of rudeness or disrespect;

I will not serve motions and pleadings on the other party or counsel at such time or in such manner as will unfairly limit the other party's opportunity to respond;

In business transactions I will not quarrel over matters of form or style, but will concentrate on matters of substance and content;

I will be a vigorous and zealous advocate on behalf of my client, while recognizing, as an officer of the court, that excessive zeal may be detrimental to my client's interests as well as to the proper functioning of our system of justice;

While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation;

Where consistent with my client's interests, I will communicate with opposing counsel in an effort to avoid litigation and to resolve litigation that has actually commenced;

I will withdraw voluntarily claims or defense when it becomes apparent that they do not have merit or are superfluous;

I will not file frivolous motions;

I will make every effort to agree with other counsel, as early as possible, on a voluntary exchange of information and on a plan for discovery;

I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;

In civil matters, I will stipulate to facts as to which there is no genuine dispute;

I will endeavor to be punctual in attending court hearings, conferences, meetings and depositions;

I will at all times be candid with the court and its personnel;

I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;

I will endeavor to keep myself current in the areas in which I practice and when necessary, will associate with, or refer my client to, counsel knowledgeable in another field of practice;

I will be mindful of the fact that, as a member of a self-regulating profession, it is incumbent on me to report violations by fellow lawyers as required by the Rules of Professional Conduct;

I will be mindful of the need to protect the image of the legal profession in the eyes of the public and will be so guided when considering methods and content of advertising;

I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance;

I will endeavor to ensure that all persons, regardless of race, age, gender, disability, national origin, religion, sexual orientation, color, or creed receive fair and equal treatment under the law, and will always conduct myself in such a way as to promote equality and justice for all.

It is understood that nothing in these Principles shall be deemed to supersede, supplement or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which lawyer conduct might be judged or become a basis for the imposition of civil liability of any kind.

*--Adopted by the Connecticut Bar Association House of Delegates on June 6, 1994*

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# Successful Succession Planning for Family-Owned Businesses (EYL190326)

March 26, 2019

## Agenda

- |                  |   |
|------------------|---|
| 5:30 - 6:00 p.m. | Registration  |
| 6:00 - 6:10 p.m. | Introduction and Bios   |
| 6:10 - 6:45 p.m. | Presentation on Exit Goals<br><b>Andrew N. Karlen</b> , Law Office of Andrew N. Karlen                      |
| 6:45 - 7:20 p.m. | Presentation on Financial Tools<br><b>David J. Fasi</b> , UBS Financial Services Inc.                       |
| 7:20 - 7:55 p.m. | Presentation on Legal Drafting<br><b>Benjamin P. Michaelson</b> , Zangari Cohn Cuthbertson Duhl & Grello PC |
| 7:55 - 8:00 p.m. | Q&A   |

# Faculty Biographies

## **David J. Fasi, Vice President – Wealth Management, UBS Financial Services Inc., Hartford, CT**

David joined Fasi Wealth Management at UBS Financial Services in 2012 after spending 8 years serving the risk management needs of his corporate clients. His primary focus is working with owners of closely-held and family-owned businesses, with a focus on exit planning and generational planning. He is a CERTIFIED FINANCIAL PLANNER™ professional, along with a Certified Exit Planner (CEPA®) and maintains a consultative approach to the business.

Within his community, David is active within a number of professional organizations, including the Association for Corporate Growth (ACG), the Estate and Business Planning Council of Hartford (EBPC), and the Exit Planning Exchange (XPX).

## **Andrew N. Karlen, Law Office of Andrew N. Karlen, Rye Brook, NY**

Andrew N. Karlen, Esq. has been advising family-owned and other closely held firms, their owners, and stakeholders for over 25 years. He helps clients make important decisions and navigate key transitions in their business and personal lifecycles, often working collaboratively with advisors from other professional disciplines.

Exit Planning, the crafting and execution of a plan for an owner to leave the business on their own terms, is a vital part of his practice. The company is likely their largest asset, and the way they exit will profoundly affect them, their family, the business, and its employees.

He is president of Attorneys for Family Held Enterprises (AFHE), a national organization of attorneys and other professional advisors who provide multi-disciplinary legal counsel and advice to privately held enterprises, their owner-managers, and family members. Attorney Karlen holds the Family Firm Institute (FFI)'s Certificate in Family Business Advising with Fellow Status and is a Business Enterprise Institute (BEI) Certified Exit Planner. He has spoken at AFHE, FFI, and BEI annual conferences, as well as for continuing education programs for attorneys, CPAs, and financial planners in the New York metropolitan area.

Mr. Karlen began his career as an attorney with the U.S. Securities and Exchange Commission. Following government service, he was an associate and partner with several prominent Westchester law firms. In 1992, he established his own practice, which expanded to become Karlen & Stolzar, LLP where he was a partner until 2017, when he resumed practicing as a solo practitioner.

Licensed to practice law in New York, Connecticut and Florida, Mr. Karlen earned a JD from New York Law School and an LLM (Corporation Law) from the New York University School of Law, as well as a BS in accounting from the University of Bridgeport.

## **Benjamin P. Michaelson, Zangari Cohn Cuthbertson Duhl & Grello PC, New Haven, CT**

Benjamin Michaelson focuses his practice on business transactional, governance, and shareholder dispute matters for family and entrepreneurial businesses. He is a Shareholder and the Managing Partner of Zangari Cohn Cuthbertson Duhl & Grello P.C., a 20 attorney firm with offices in New Haven, Hartford, and Providence. Mr. Michaelson has spent his entire legal career in complex business law matters, focusing on family business governance, shareholder divorces and disputes, as well as major transactions (mergers & acquisitions, joint ventures, and the like). Additionally, he represents clients on wide ranging business matters including entity

formation, operating agreements, shareholder agreements, licenses, restrictive covenants, executive employment matters, director and officer liability, strategic partnerships, partnership disputes, and other business related matters.

Mr. Michaelson and the Zangari Cohn firm represent a number of the most high profile family businesses in the State of Connecticut. Such representations include navigating the pervasive legal and non-legal issues surrounding governance issues, shareholder disputes, buy-outs, family member employment, succession planning, trusts and estates, and annual trust maintenance and probate matters for such families. Mr. Michaelson also heads up the firm's involvement with the Connecticut Business Owners Exit Planning Survey, which it co-publishes annually in an effort to track business owner readiness to exit their businesses, either by sale, transition to family members, or other exit options.

In 2000, Mr. Michaelson received his Bachelors of Science in Business Administration, with a focus on Family Business Management, from Bryant University. While earning his Juris Doctor from the University of Connecticut School of Law in 2005, Mr. Michaelson was on the editorial staff of the Connecticut Insurance Law Journal. Prior to practicing law, Mr. Michaelson participated in his family manufacturing business, and later as an engineer in a technology and software development company. Mr. Michaelson is a member of the American Bar Association and the Connecticut Bar.

# Successful Succession Planning for Family Owned Businesses

**Andrew N. Karlen, Esq.**

March 26, 2019  
Connecticut Bar Association  
CBA Law Center  
30 Bank St  
New Britain, Connecticut 06051

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## Abbreviations

- **“BSP”**: Business Succession Planning.
- **“FOB”**: Family Owned Business.
- **“SGO”**: A senior generation owner of a FOB.
- **“BAC”**: Business active child - a child who is active in the FOB, or where the context requires, collectively children who are active in the FOB.
- **“N-BAC”**: A child who is not active in the FOB.

# Introduction

- **“Family Enterprise”** – The term **“Family Enterprise”** includes families who are managing money together, often through a family office, usually following the sale of their bricks and mortar business. As stated above, these materials assume that the family enterprise is a bricks and mortar business.

## Introduction (Con't)

- **Assumptions** – These materials assume that the (i) family owns and operates a “bricks and mortar” business, (ii) the contemplated transfer is from the first to the second generation, and (iii) the successor(s) must pay the SGO for the business (the SGO cannot afford, or does not want, to gift the business).
- **Variables** – There are many variables that affect the advice and attorney gives in any given situation, such as the size of the business, size of the family, level of wealth; number of children involved in and not involved in the business.

# TAKE-AWAYS

## Basic Understanding of:

- **FOB/BSP Challenges.**
- **Some of the causes of these challenges.**
- **Issues you may face in a business succession planning engagement.**
- **The utility of a multi-disciplinary approach to business succession planning engagements.**

## Economic Impact of FOBs

- Account for 64 percent of U.S. gross domestic product, generate 62 percent of the country's employment, and account for 78 percent of all new job creation.
- Approximately 35% of Fortune 500 companies are family-controlled.\*

\*Conway Center for Family Business; <https://www.familybusinesscenter.com/resources/family-business-facts/>

## **Succession Planning is more important than owners realize**

- **The number of baby boomer owners that will be leaving their businesses in the next 10-years is staggering.**
- **A large percentage of FOBs do not survive from the first to the second generation.**
- **Even less survive to the third generation and beyond.**

- **Why do so few FOBs survive to the 2<sup>nd</sup> generation?**
- **Why do even less survive to the third generation and beyond?**

# Business and Family are Fundamentally Different

	<u>Business</u>	<u>Family</u>
Purpose/Mission	<ul style="list-style-type: none"> <li>• Profit ; exists to further the business with systems that are clear in definition and strictly followed,</li> </ul>	<ul style="list-style-type: none"> <li>• Support, love, nurture</li> <li>• Exist to help individual family members with many dimensions that are vague and require compromise.</li> </ul>
Membership	<ul style="list-style-type: none"> <li>• Individuals are included because there is a need and they are accountable for performance</li> </ul>	<ul style="list-style-type: none"> <li>• Membership is automatic and perpetual</li> </ul>
Role/Job Description	<ul style="list-style-type: none"> <li>• Jobs clearly defined based on organization's needs</li> </ul>	<ul style="list-style-type: none"> <li>• No real titles; roles per each person's capabilities.</li> </ul>
Hierarchy/Decision-Making/Accountability	<ul style="list-style-type: none"> <li>• Decision-making authority and "chain of command clearly defined and consistent.</li> </ul>	<ul style="list-style-type: none"> <li>• Decision-making authority shifts according to the circumstances.</li> </ul>
Priorities	<ul style="list-style-type: none"> <li>• Goals established;</li> <li>• All employees work to achieve them</li> <li>• Goal achievement takes precedence over individual</li> </ul>	<ul style="list-style-type: none"> <li>• Each person free to pursue his or her goals as long as they do not undermine the needs or interests of other family members.</li> </ul>
Goals/Rewards	<ul style="list-style-type: none"> <li>• Goals clearly defined;</li> <li>• Accountability;</li> <li>• Evaluation</li> <li>• Rewards or lack thereof are established</li> </ul>	<ul style="list-style-type: none"> <li>• Goals may be informal</li> <li>• Even if explicit, no rigid performance evaluation;</li> <li>• Goals tend to focus on individual and collective growth, rather than subserviently serving the family unit.</li> </ul>
Rewards	<ul style="list-style-type: none"> <li>• Rewards are related to greater compensation and/or authority</li> </ul>	<ul style="list-style-type: none"> <li>• Rewards emphasize love, nurturing and self-actualization.</li> </ul>
Longevity	<ul style="list-style-type: none"> <li>• Organization exists only as long as the business exists,</li> <li>• Usually goal is to keep it going indefinitely</li> </ul>	<ul style="list-style-type: none"> <li>• Family will always exist as family, but the goal is to separate and have the children start their own nuclear family.</li> </ul>

\*<http://www.productionmachining.com/columns/family-systems-versus-business-systems>

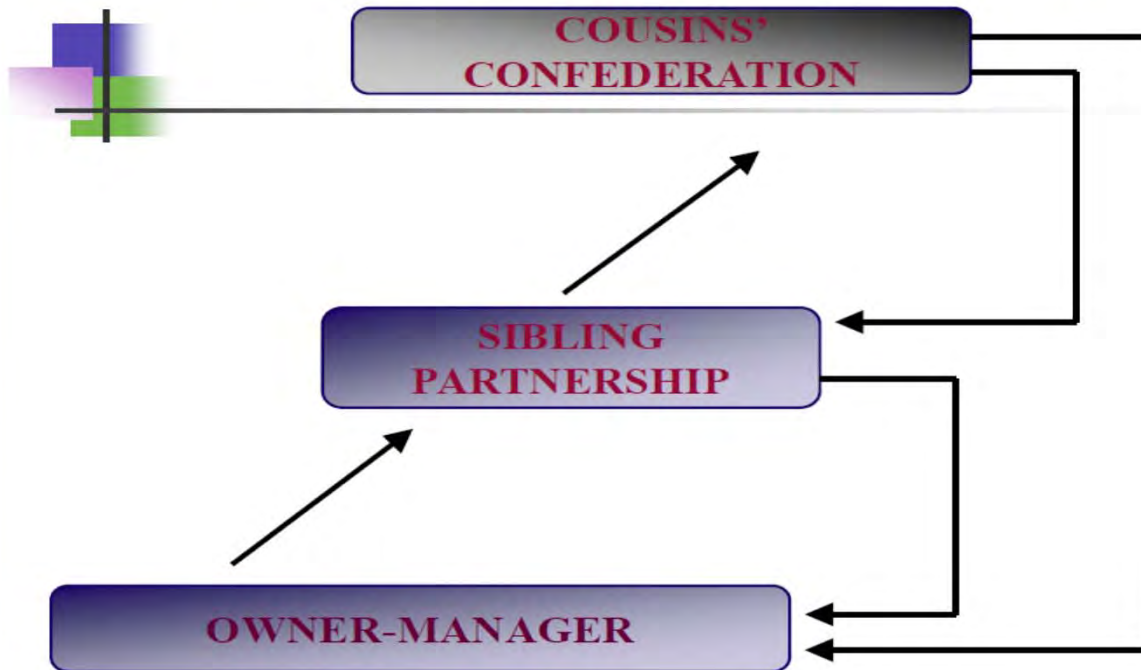
## Family Business Characteristics

- Transferring not only their wealth but also their values surrounding their wealth (e.g. philanthropy) is of primary importance to FOB owners.
- Sense of connection and identity felt by owners and their family members is a driving force
- Longer term view than public companies; focus on the next generation, not the next quarter.
- Less likely to lay people off and more likely to hire despite the possibility of an economic downturn

## Family Business Ownership Stages

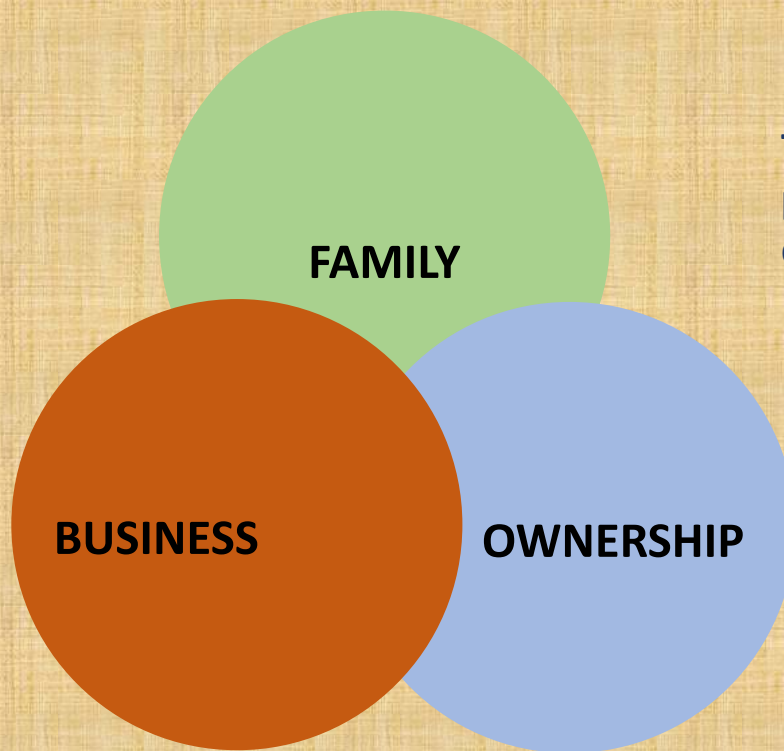
<b>Owner-Manager Stage</b>	<ul style="list-style-type: none"> <li>• Business owned and managed by the same person or people;</li> <li>• Not much difference between personal and business checkbook.</li> <li>• Not necessarily a sense of continuity.</li> <li>• Often have no boards - central to the family and business functioning.</li> </ul>
<b>Sibling Partnership</b>	<ul style="list-style-type: none"> <li>• Increased complexity in management and ownership.</li> <li>• Relationship among peers must be defined; new leadership model required.</li> <li>• Siblings must decide that they want to work together and how they will evaluate and compensate each other.</li> <li>• Influence of spouses emerges as a factor in decision making;</li> <li>• Business must support two or more families;</li> <li>• Ways to resolve conflict and ways to professionalize the business</li> <li>• Decisions re how their families will have access to the firm, e.g. entrance criteria for owners' children;</li> </ul>
<b>Cousins' Consortium</b>	<ul style="list-style-type: none"> <li>• Cousins - no longer grew up in the same family of origin.</li> <li>• Competition not only between siblings but also between family branches.</li> <li>• The business owning family has become much more complex requiring a "servant leader" ("A servant-leader focuses primarily on the growth and well-being of people and the communities to which they belong." (Website of the Robert K. Greenleaf Center for Servant Leadership, <a href="https://greenleaf.org/what-is-servant-leadership/">https://greenleaf.org/what-is-servant-leadership/</a>)</li> <li>• Rules for how leadership transitions will be handled.</li> </ul>

## Ownership Stages of a Family Business



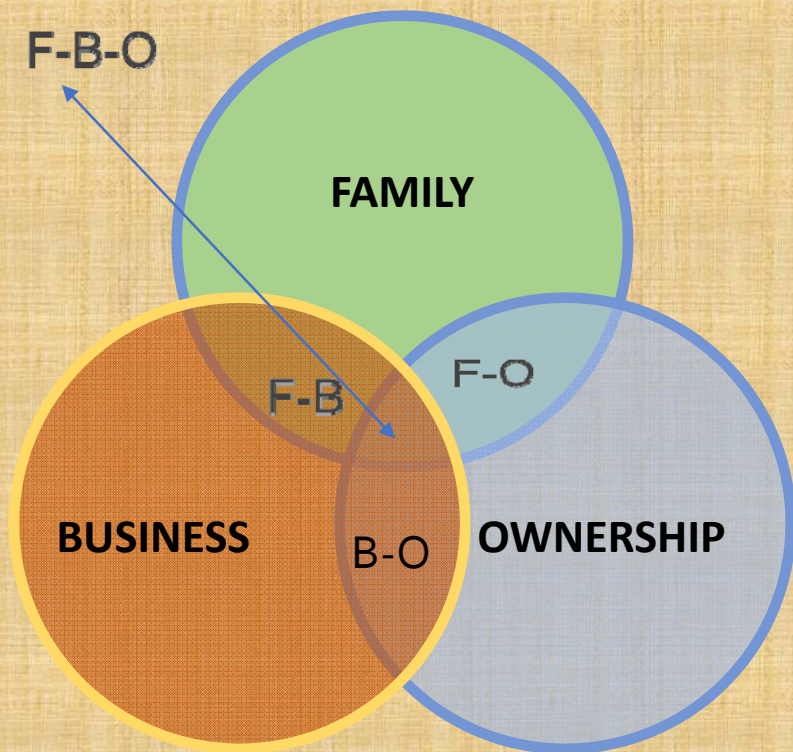
From Professor John L. Ward

# Family Business Three-Circle Model



The three main perspectives from which the participants in a family business make decisions relating to the business

# Family Business Three-Circle Model



There are 4 overlapping intersections, in addition to the three circles. Thus, there are 7 different (and sometimes competing) perspectives from which individual participants may view the issues, decisions and each of their own best interests.

## Multi-Disciplinary Approach: Professional Advisor Team

- No one professional has all of the answers.
- Team approach minimizes time and cost if properly facilitated and led.
- Advisor Teams typically consists of some combination of the following:

- |   |  |
|---|--|
| <ul style="list-style-type: none"><li>• CPA</li><li>• Financial Planner</li><li>• Insurance Advisor</li><li>• Investment Advisor</li><li>• Business Attorney</li><li>• Estate Planning Attorney</li></ul> | <ul style="list-style-type: none"><li>• Valuation Specialist</li><li>• Business Broker</li><li>• Investment Banker</li><li>• Business or Management Consultant</li><li>• Banker</li><li>• Family Business Consultant</li></ul> |
|---|--|

# **Common Issues and Challenges in Business Succession Planning**

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## **SGO Establishing Goals**

- **SGO not ready to leave the business.**
- **SGO as business owner as well as husband, father, uncle, etc.**
- **Issues and conflicts more intense; Decisions more emotional.**
- **Core issues less evident, particularly if focus on business only.**
- **Reluctance to disclose family information.**
- **More stakeholders (particularly in larger families).**

# SGO Establishing Goals

- SGO may perceive transfer as involving not only the business, but his/her community and family leadership status.
- Concern that children won't get along after parent(s) leave.
- BAC lacks the competence to own and run the business.
- BAC may not want the business.
- Disapproval of BAC's work ethic.
- SGO and BAC have different levels of risk tolerance.
- SGO's choice of business successor may disgruntle family members or key employees.

# SGO Establishing Goals

- **Important to learn about the family: past, present and upcoming generations; “skeletons,” nationality, religion; relationships; conflicts; prior transfers.**
- **Resistance to Business Valuation.**
- **SGO may be reluctant to share his/her financial status with other family members.**

## Considering and Developing Policies About the Relationship Between the Family Business and the Business Family

- **Ownership Criteria** – e.g. Should spouses of children be permitted to own an interest in the business? Should N-BACs or employees be permitted to own interests in the business?
- **Employment Criteria For BACs** – e.g. children must graduate from college before joining the business; must work outside the business for a specified time before joining it; require that there be an open position for which the BAC is qualified?
- **Professionalization**, i.e. adopt the kind of structures, governance, systems, and processes that one would expect to see in a modern firm, while maintaining the culture and characteristics that have fueled its success.

## Considering and Developing Policies About the Relationship Between the Family Business and the Business Family

- **Policies Re BACs – e.g. must be supervised by someone other than a parent; process to educate BAC's about what it means to be, and what is expected of, an owner; process to select and groom BACs for management and/or ownership?**
- **Liquidity, e.g. for a certain period during each year, N-BACs and others who own interests in the business can sell those interests (so that they will not remain as unhappy or disruptive owners).**
- **Business Governance, e.g. board of directors; board of advisors; clear and documented roles and authority.**
- **Family Governance, e.g. in larger families, a family council and family constitution.**

## Building and Maintaining Business Value

- **Building and maintaining business value - supports the succession plan.**
- **May be difficult for SGO to maintain objectivity in:**
- **Establishing performance expectations for the successor and determining whether and when he/she has met these criteria and is ready to assume leadership.**
- **Establishing new policies that will be necessary as the business transitions to the next generation:**
  - **Professionalizing the business**
  - **Entry criteria**
- **Addressing concerns of individuals and constituencies, e.g. other BACs.**

## Sale to Insider (BAC and/or Key Employee)

- Typically Insiders don't have and can't borrow much money.
- Planning takes time: is the SGO willing to stay several years, to allow time to implement: strategies and plans to:
  - Acquire the necessary cash (grow value and cash flow)
  - Minimize income tax consequences
  - Minimize the risks to both parties
  - Transfer management responsibility while retaining control.

## Sale to Insider(s) (Con't)

- Should the BAC pay for the business interest to be transferred to him/her?
- How long has the BAC been involved in the business? Has the BAC earned an interest in the business by "sweat equity"?
- Are the BAC's efforts continuing to add value to the business?
- Is BAC's continued high performance essential to SGO's planning? If so, what level of contribution must the BAC continue to make to ensure the achievement of the SGO's exit objectives?
- What, if anything, needs to be done (i) for key non-family employees or non-BACs, or (ii) to incentivize and "golden handcuff" them?

# Contingency Planning

- “Backup plan” protect SGO and successor in the event one of them dies or becomes disabled:
  - Written continuity instructions.
  - Buy-sell agreements.
  - Life, disability and key person insurance.
  - Arrangements with banks regarding personal guaranties and continuing credit.
  - Steps to assure that key employees and relationships will remain in place.
  - Buy-back agreement, so that if the transfer is aborted, the company will re-acquire the BAC’s ownership interest at the lowest defensible price.

## Contingency Planning (Con't)

- SGO's estate plan should provide for transfer of business to the designated successors if SGO dies or is disabled before transfer completed.
- Subsequent circumstances may cause SGO to abort transition to a BAC and sell to a third-party:
  - Increased business value makes it infeasible for BAC to buy business.
  - Business becomes too complex for any one person to run and control.
  - It turns out that the BAC lacks the necessary drive, interest or temperament.
  - Irreconcilable differences between SGO and BAC emerge, e.g., in management style.
  - SGO unable to provide assets of equal value to other children.

# Wealth and Estate Planning

- **Consideration of personal goals and values, including fairness to all children**
- **“Fair vs. Equal”:** Business may represents greatest portion of SGO’s net worth.
- **Fairness to all children is a key ingredient in a successful transfer.**
- **Typically, the fairest solution is leaving the business entirely to the BAC and equitably distributing the balance of the estate to the inactive children (and perhaps to the BAC as well).**
- **Critical that parents explain their reasoning to all children; assure them that they love each of them equally; may consider holding a family meeting using advisors to facilitate the discussion.**

## Transfer to Child: Advantages

- Owner can receive amount he/she needs or wants even if not supported by business value.
- Owner can remain in control until fully paid.
- While receiving income and in control, Owner has time to prepare him/herself, the business and the successor for post-transfer life.
- Options if something unexpected happens, e.g., sudden disability
- Values-Based Goals, e.g. family identity fulfilled.
- Buyer prequalified

## Transfer to Child: Disadvantages

- Transferring to child who can't or won't operate the business properly.
- Family dynamics can cause Owner to transfer control before achieving financial independence and before children are prepared to run business.
- Payment takes longer than third-party sale; Owner exposed to general business risk.
- Children may be unable to run business without Owner, or squabble among themselves.
- Tax planning critical.
- Family discord – communications among family members must be managed.

## Family Business Consultants

- **Come from diverse professions of origin, mental health, organization development, accounting, law, financial, academia.**
- **Typically have cross training in one or more other disciplines.**
- **Help business families understand and successfully navigate the complexities that surface when business and family come together.**

# Family Business Consultants

- **A few indicators that Family Business Consultant should be considered:**
  - **Conflict between SGO and BAC.**
  - **Dysfunctional communications.**
  - **Business not professionalized.**
  - **Two or more family branches involved in business.**
  - **Destructive pattern in prior generation about to be repeated.**

## Some of the Legal Tools Used in Succession Planning (Con't)

- Employment Agreements
- Stock Bonuses
- Cash Bonuses
- Deferred Compensation
- Buyback Agreements
- Phantom Stock
- Stock Appreciation Rights
- Salary Continuation Plans
- Confidentiality Agreements
- Restrictive Covenants

## Some of the Legal Tools Used in Succession Planning

- Management team incentives (with “Golden Handcuffs”)
- Stay bonuses
- Vesting; Forfeiture
- LLC Operating Agreements
- C corp to S corp
- Recapitalization
- Shareholders’ Agreements
- Personal Guaranties
- Indemnification
- Promissory Notes
- Estate Planning Documents

# Closing Thoughts

- **Representing a FOB is about much more than BSP:**
  - **It includes all the things that attorneys do for other businesses.**
  - **Ideally, the attorney will have established a relationship as the SGO's or family's counselor at law.**
  - **As a trusted advisor the attorney will be positioned to help prepare the SGO, business and family for succession and to advise them in the BSP process itself.**

***Representing Family Businesses can afford an attorney the opportunity to work collegially with professional advisors from other disciplines to have a profound and lasting impact on the family, the business, its employees, other stakeholders and in some cases, the community.***

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# THANK YOU

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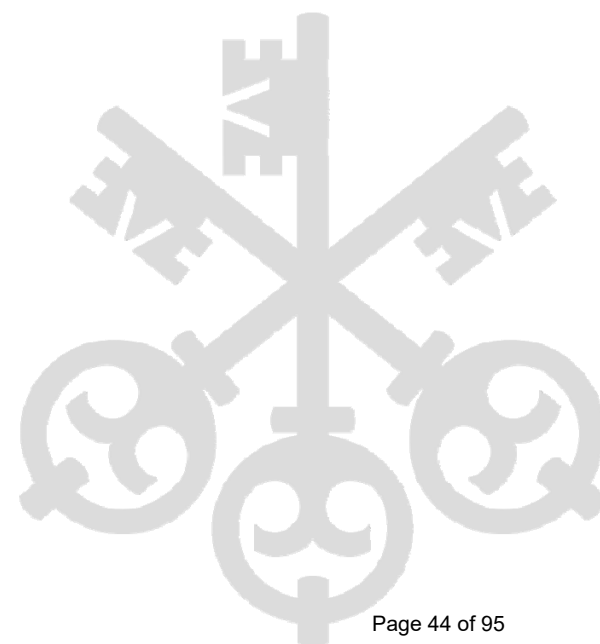
# Resources

- Family Firm Institute ([www.ffi.com](http://www.ffi.com))
- Attorneys for Family-Held Enterprises ([www.afhe.com](http://www.afhe.com))
- Family Business Centers; most at colleges and universities around the country; some independent, e.g. New York City Family Enterprise Center
- Purposeful Planning Institute ([purposefulplanninginstitute.com](http://purposefulplanninginstitute.com)).
- Institute For Family Governance [babetta@ifgworldwide.org](mailto:babetta@ifgworldwide.org).
- Galliard Family Business Advisor Institute (<https://galliardinstitute.org>).
- Exit Planning Exchange ([www.exitplanningexchange.com](http://www.exitplanningexchange.com))

# Successful Succession Planning for Family-Owned Businesses

The Need for Planning & The Role of a Financial Advisor

David J. Fasi, CFP®, CEPA®



March 26, 2019

# Background

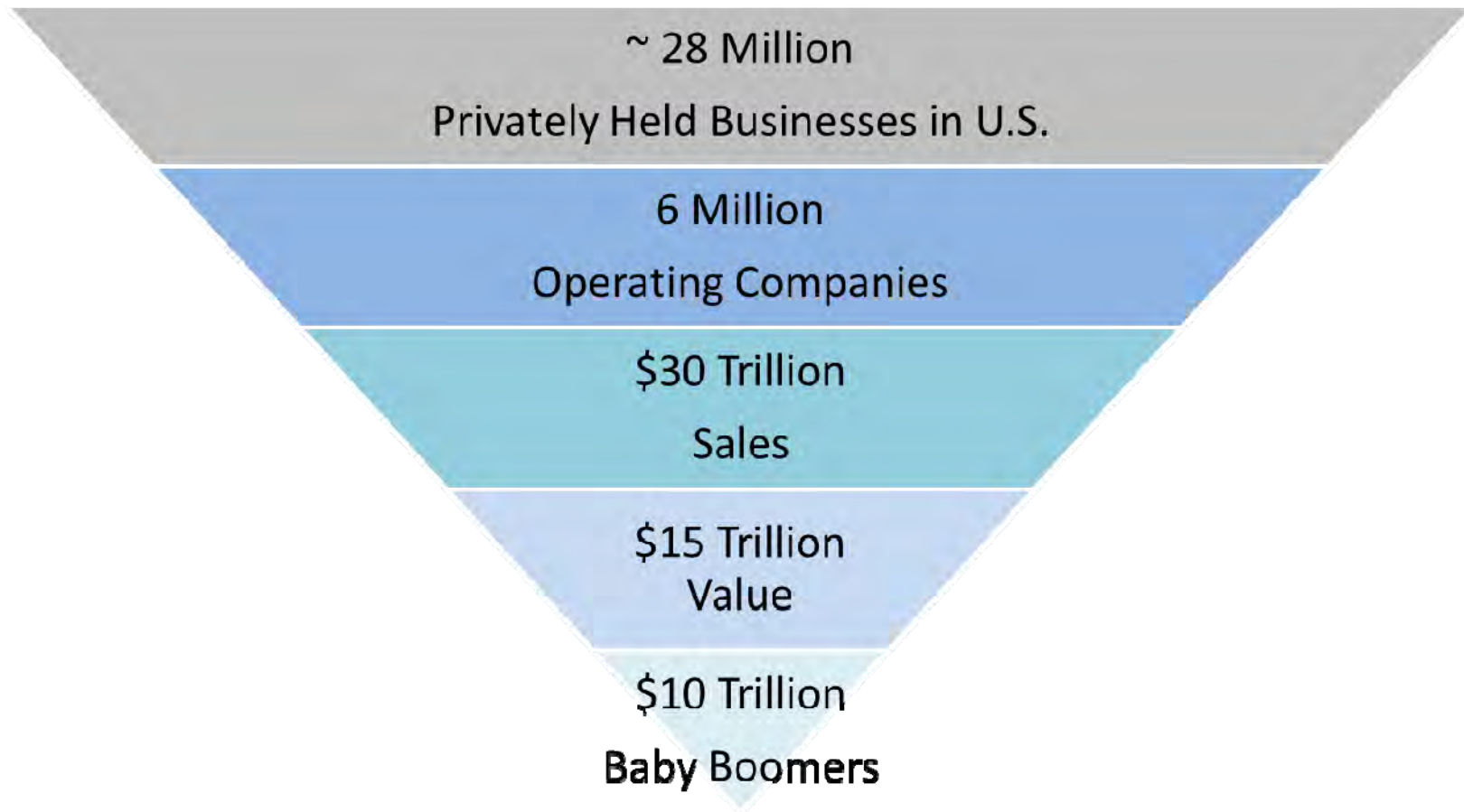
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- The Opportunity for Business Owners & Families
  - An unprecedented transfer of wealth over the next 10 years
- The Challenges
  - Up until now, very little planning has been done to prepare owners for their transition
- Collaboration
  - The need for advisors to work together across their disciplines for the collective benefit of our clients
- The Need for Planning
  - Planning allows for more control over the timing and terms of a transition
- The Role of a Financial Advisor in Transition Planning

# The \$10 Trillion Dollar Opportunity

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An overview of privately-held businesses in the United States



**Source:** Exit Planning Institute (CEPA® curriculum material)

# Opportunity vs. Risk

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- Family-Owned Business Success Rates Through the Generations
  - 2<sup>nd</sup> Generation: 30%
  - 3<sup>rd</sup> Generation: 12%
  - Beyond 3<sup>rd</sup> Generation: 3%
- 80% of Businesses Never Sell (< \$50MM sales)
  - Of the 20% that do, many will receive a lower valuation than expected
- Lifestyle Businesses vs. Value Businesses

**Source:** Exit Planning Institute (CEPA® curriculum material)

# The Income Conundrum

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A hypothetical illustration on the realities of lifestyle businesses

- Assumptions:
  - John Doe is the owner of Doe Inc., a manufacturer of widgets with \$10MM in annual sales
  - He takes home \$1MM in the form of compensation (10%)
  - Mr. Doe sells the business for \$5MM and retires to spend more time with his growing family
  - John invests the proceeds from the sale of his business into a balanced, diversified portfolio earning 6% a year on average



\* This example excludes taxes and fees from the sale of the business

# The 5 D's and The Need for Planning

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You can't win the fight against Mother Nature and Father Time

We all intend and hope to leave our business on our terms and our timetable, but that is often not the case...

- The 5 D's
  - Death
  - Disability
  - Divorce
  - Distress
  - Disagreement with Partners

# Other Documented Succession & Contingency Plans

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Planning for death, disability, divorce, distress, and disagreement among partners

- Buy-Sell Agreements
  - Are they funded?
  - Is funding adequate?
- Life & Disability Insurance
- Long-Term Care
- Excess Liability Coverage (Umbrella)

# Statistics Speak for Themselves

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- On Average Owners Have ~ **80%** of their Net Worth in their Business
- Approximately **70%** of Owners Expect to Transition Within 10 Years
- **80%** of Business Below \$50MM in Sales Never Sell
- ~**70%** of Owners Don't Have Any Exit Plan
- **3 out of 4** Owners are Unhappy with their Decision to Sell Within 12 months

**Source:** Exit Planning Institute (CEPA® curriculum material)

# The Need for Planning

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Transitioning a business may be the most significant financial event of an owner's life

- Most Owners Only Get 1 Chance to Sell A Business
- Questions to Ask
  - Do you know when you will transition out of your business?
  - To who? For how much?
- Valuation
  - Do you know what your business is worth?
  - Have you had an independent valuation done?
    - If so, when?
- Budget for Planning: Work on your business, not just in it
  - Effective planning will help provide an ROI that is multiples of what you invest in it<sup>1</sup>

<sup>1</sup> – The \$10 Trillion Opportunity (R. Jackim, P. Christman)

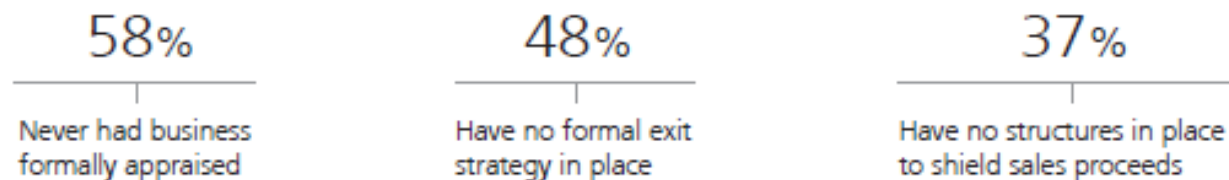
# UBS Investor Watch 1Q 2018

## Business Ownership: Who's in, who's out, and who's holding back?

### Selling the business is the preferred exit strategy



### Many business owners are unprepared for a sale



Source: UBS Investor Watch | U.S. Insights on Investor Sentiment 1Q 2018

# And the Survey Says...

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## 2018 Results from the *State of Owner Readiness* Surveys by the Exit Planning Institute

- Plan to Transition within **5 Years** / **10 Years**
  - Wisconsin: 46% / 72%
  - North Texas: 45% / 71%
  - Long Island: 48% / 68%
  - Georgia: 37% / 53%
- Percentage of Owners with **No Plan** or **Nothing Written**
  - Wisconsin: 80%
  - North Texas: 56%
  - Long Island: 82%
  - Georgia: 71%

**Source:** Exit Planning Institute (2018 "State of Owner Readiness" regional surveys)

# Work On Your Business, Not Just In It

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- Some Reasons Owners are Reluctant to Plan for the Inevitable
  - Busy running their business
  - It's more work
  - Don't want to think about it

# Some Ways We Can Help

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## Guiding

We can help guide the business owner through the planning process that leads to executing on a business transition.



## Coordinating

We can coordinate the resources, expertise, and structure needed to help execute a business owner's vision of a successful transition.



## Collaborating

We can enhance collaboration across advisors in order to harness the best ideas which can help contribute to the development of a comprehensive financial plan.



## Facilitating

We can help facilitate idea flow and communication around this idea flow among all trusted advisors and those providing resources in the transition.



## Planning

We can help develop a comprehensive financial plan, which will serve as the focal point of conversations between the business owner and his/her advisors.



## Summarizing

We can help develop an executive summary which highlights the action steps needed to realize the owner's vision of a successful transition.

# Financial Planning Considerations

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## Five Simple Questions

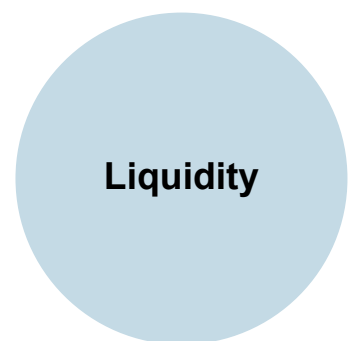
- What Do You Want to Accomplish in Your **Life**?
- Who are the **People** that Matter Most to You?
- What Do You Want Your **Legacy** to Be?
- What Are Your Main **Concerns**?
- How Do You **Plan** to Achieve Your Life's Vision?

# Three Strategies: Liquidity. Longevity. Legacy.

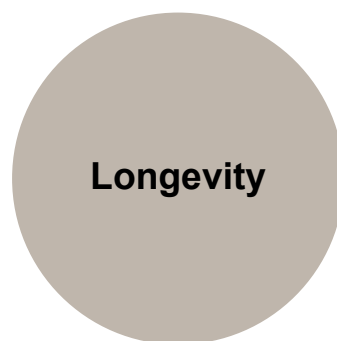
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## Asset Allocation through Life's Stages

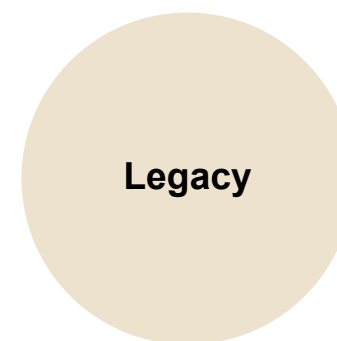
### Three key strategies



To help provide cash flow for short-term expenses to help maintain your lifestyle



For longer-term needs to help improve your lifestyle

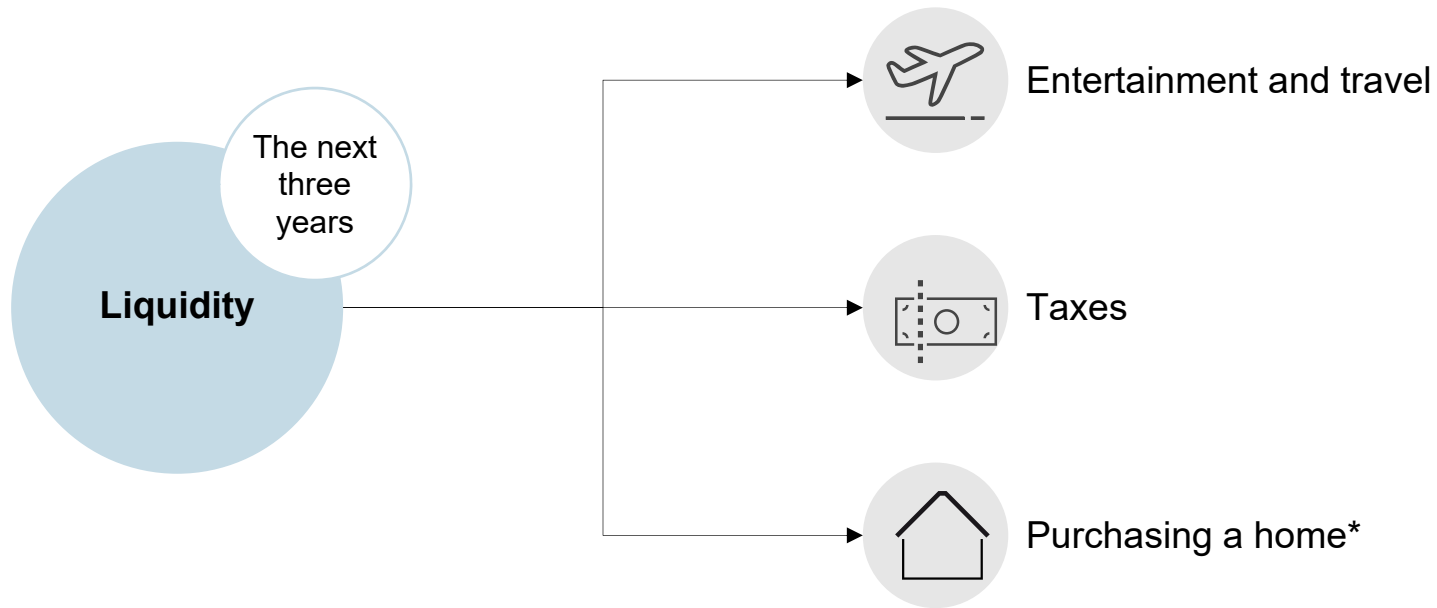


For needs that go beyond your own to help improve the lives of others

Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

# Three Strategies: Liquidity. Longevity. Legacy.

## Asset Allocation through Life's Stages

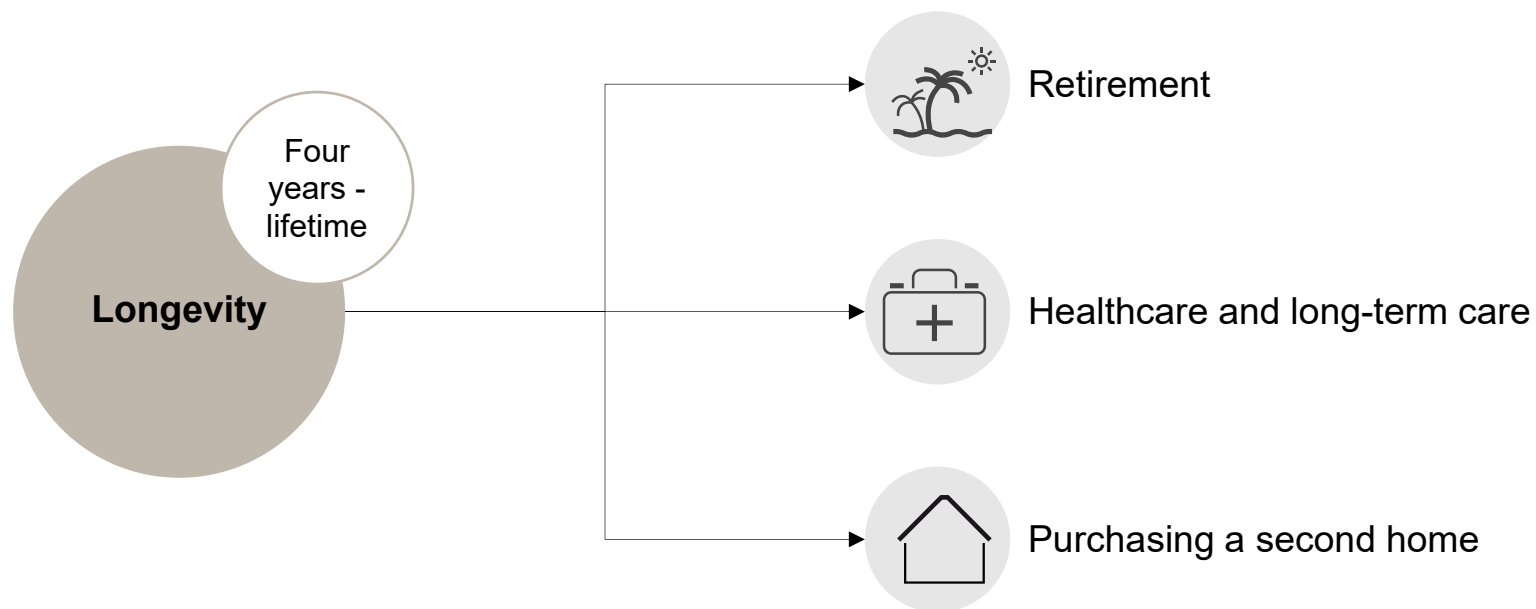


Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

\* Borrowing is subject to credit or collateral approval.

# Three Strategies: Liquidity. Longevity. Legacy.

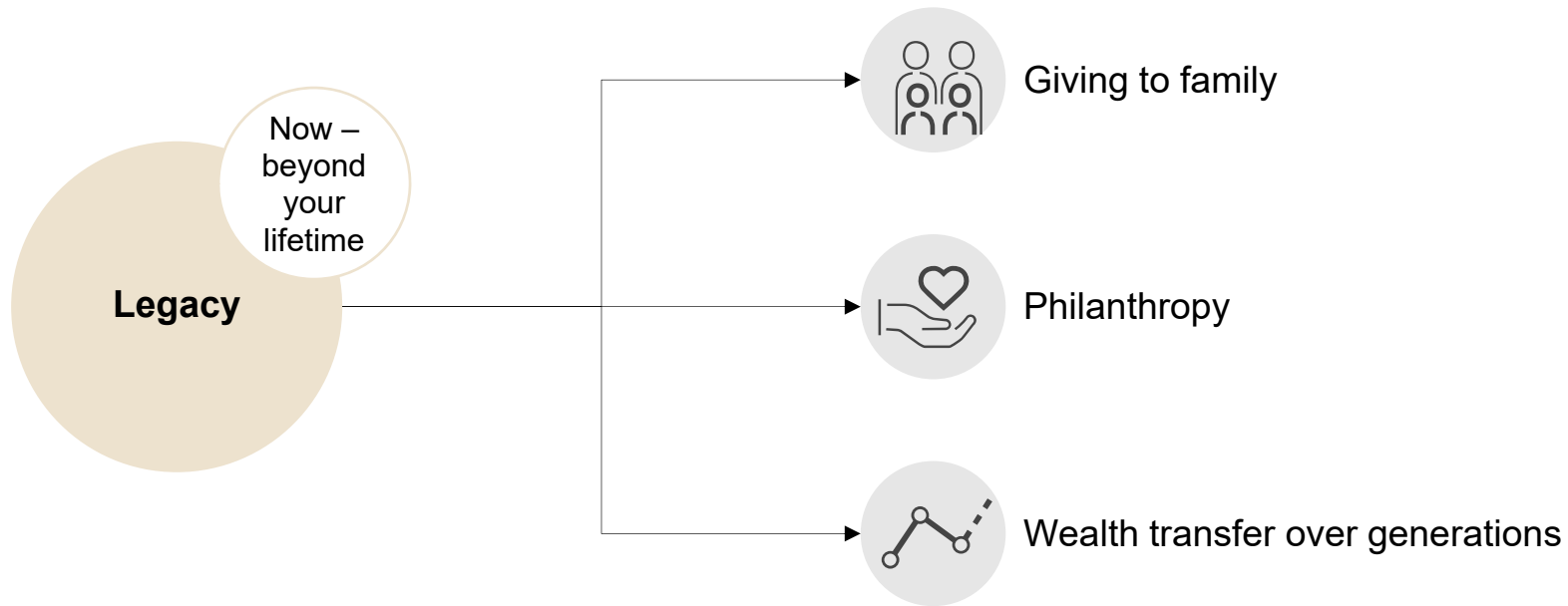
## Asset Allocation through Life's Stages



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# Three Strategies: Liquidity. Longevity. Legacy.

## Asset Allocation through Life's Stages



Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

# Summary

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- Opportunity
  - Tremendous opportunity for privately-held & family-owned businesses in the next 10 years
- Risk
  - Historically very little planning has been done for owners looking to transition
- Collaboration
  - Incumbent on all of us as advisors to work together for the collective benefit of our clients
- Succession Planning
  - Helps give you more control over the timing and terms of a transition
- Financial Planning
  - Aids in aligning your personal, business and financial objectives

**"Failing to plan is planning to fail," – Benjamin Franklin**

# Thank You

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Vice President - Wealth Management

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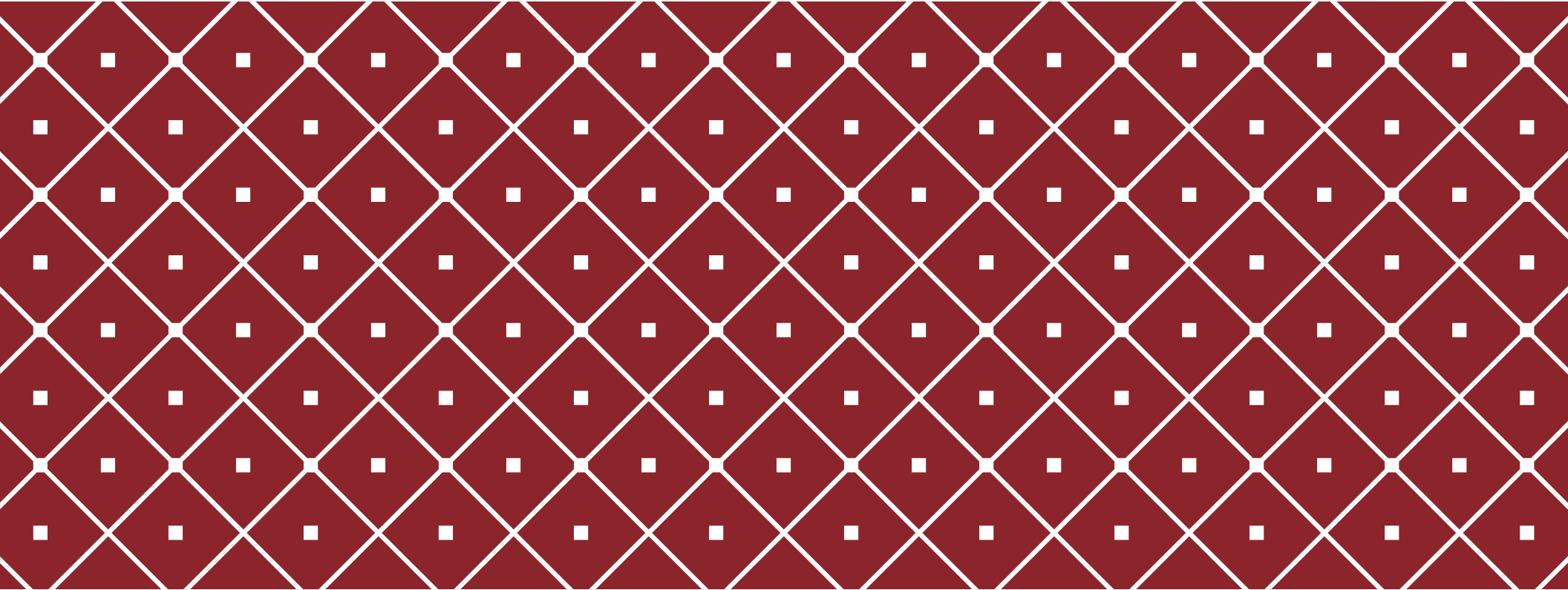
# Disclaimers

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# SUCCESSFUL SUCCESSION PLANNING FOR FAMILY-OWNED BUSINESS

**Types and Structures of  
Legal Agreements**

## THE PURPOSE

To discuss how to structure shareholder or operating agreements to reduce the risk of ambiguity, including the method of valuing the business, defining triggering events that give rise to a buy-out, possible discounts in certain situations, dispute resolution mechanisms, and related considerations



## WHY IS THIS IMPORTANT

- 78% of owners planning to sell their business within 5 years do not have an exit plan.
- 25% of owners planning to sell their business have no idea how they will exit their business.
- Only 5% of owners believe it will be hard to sell their business.
- Despite national upward trends in the business sale market, Connecticut is less active for buying and selling a business.

*Source: CT Business Owners Exit Planning Survey, 2018 Year End Report*

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# THE DOCUMENTS WE WILL BE DISCUSSING

- **Exit / Succession Plan** (*The Major Agreement*)
- **Estate Plan** (*Power of Attorney, Will, Trusts, Etc.*)
- **Key Agreements** (*Loan Facility, Franchise Agreement, Lease, Etc.*)
- **Employment Agreements** (*Retiring Generation, Family Employment Terms, Etc.*)
- **Governance Documents** (*Bylaws, Certificate of Incorporation, Cert. of Organization, Etc.*)
- **Equity Agreement** (*Shareholders' Agreement, Operating Agreement, Partnership Agreement*)



# EXIT / SUCCESSION PLAN

- **What Is It?**
- **Why Is It Important?**
- **What Are The Key Provisions?**



## EXIT / SUCCESSION PLAN – WHAT IT IS.

- A comprehensive far-reaching plan of action.
- The trust and estate plan for the business.
- Addresses key overall matters necessary to tee up family and business success.
- Not a contract as much as it is a strategic plan for the family, for the business.



## EXIT / SUCCESSION PLAN – THE IMPORTANCE.

- Inattention to succession planning is a substantial problem for many family businesses in the United States, with 69% expecting a transition to the next generation but only 23% having an actual, robust, plan. (PWC U.S. Family Business Survey, 2016).
- Communication of the plan with all stakeholders.
- Maintain and evolve an actual plan, instead of a theoretical idea, during the continuing normal course of managing the business.
- Identify the game plan for “The Four D” scenarios (Death, Disability, Divorce, Departure).



# EXIT / SUCCESSION PLAN – KEY PROVISIONS.

- Name the successor (and how to transfer to next generation).
- Plan exit strategies (transfer to current management, strategic buyer, ESOP, etc.).
- Roles of key persons (founders, key family employees, non-family employees, advisors, etc.)
- Retirement goals of current owners (e.g. contractor entrepreneur that won't leave)
- Training or mentorship of future successor / leader (e.g. whole foods company).
- State the Plan (take the confusion out of the process, e.g. distributor with 5 children in the business)
- Problem areas in the business (what needs to be improved to help complete the strategy).
- Problem areas in the plan (what must be improved to help complete the strategy).



# ESTATE PLAN

## **Control Issues**

- Power of Attorney
- Executor / Trustee Selection and/or Probate Avoidance

## **Tax Implications**

- Estate tax liquidity
- Estate tax payment plan

If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in 2 or more (but not exceeding 10) equal installments. (26 USC s6166)

## **Gift or Sell the Business?**

- One, the other, or a bit of both.
- Cash flow issues.
- Full lender financed or seller financed?

## **Is exact parity for non-owner family necessary?**

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# KEY AGREEMENTS

**What Key Agreements?**

**What Provisions Matter?**

**What Does This Matter?**

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## KEY AGREEMENTS – WHAT THEY ARE.

- Lending facilities.
- Personal guarantees.
- Facility leases.
- Major supplier agreements.
- Significant customer agreements.
- Company form agreements.
- Franchise agreements.



# KEY AGREEMENTS – IMPORTANT PROVISIONS.

- Covenants.
  - What promises are made regarding ownership?
  - Net worth of owners?
  - Other transition affecting provisions?
- Assignment.
  - In Connecticut, a contract that is silent on assignment is generally freely assignable.
  - A change of control is not considered an assignment unless the agreement provides otherwise.
  - Fix change of control provisions in internal agreements, and negotiate / amend third party agreements.

This agreement may not be assigned by either party without the express written consent of the non-transferring party. The transfer, by operation of law or otherwise, of a controlling interest in \_\_\_\_\_ shall be considered as a prohibited assignment under this section, except that any transfer of equity in \_\_\_\_\_ to a lineal descendent or a trust for their benefit shall not be deemed a prohibited assignment under this Agreement.



## KEY AGREEMENTS – THE IMPORTANCE.

- Breach of covenants, especially in lending documents and leases can have significant impact on the future success and viability of the business.
- Anti change of control provisions can void important purchase, sale, and/or joint venture agreements, having a significant impact on the future success and viability of the business.



# EMPLOYMENT AGREEMENTS

## **The Importance.**

- Set expectations and requirements to join employment in the family business.
- Set expectations and requirements to join management in the family business.
- Set expectations and requirements for departing shareholder family member.

## **Key Provisions.**

- Any requirements for family members to get any jobs.
- Any requirements for family members to get management positions (e.g. minimum education requirements, outside experience requirement, “work up” through the business, etc.).
- Any oversight position, board position, or prohibitions for retiring shareholder.



# GOVERNANCE DOCUMENTS

- **What Is It?**
- **Why Is it Important?**
- **What Are The Key Provisions?**



# GOVERNANCE DOCUMENTS – WHAT IT IS.

- Certificate of Incorporation and Bylaws
- Certificate of Organization
- Certificate of Limited Liability Partnership



# GOVERNANCE DOCUMENTS – WHY IMPORTANT.

Owners should not make any lifetime transfers until governance issues are in place. If this is not done, then issues of shareholder, director, and officer control and reporting requirements can lead to unintended consequences.



# GOVERNANCE DOCUMENTS – KEY PROVISIONS.

- Equity structure, voting vs. non-voting, to separate issues of control from issues of equity value and allow for transfer of equity but not control.
- Equity voting rights
  - Appointment of board members (directors, managers, advisors, etc.)
  - Major transaction approval.
  - Proxy rights.
  - Voting trusts.



## KEY PROVISIONS (CONT.)

- Board rights
  - How selected (by ownership or by family line, or other).
  - Who can be seated (only family members, only outsiders, a combination of both).
  - Limit or increase authority of the board.
  - Use or prohibit board committees.
- Officer authority
  - Limitations by board, budget, lines of authority, etc.



# EQUITY AGREEMENT

- **What Is It**
- **Its Importance**
- **Key Provisions**



# EQUITY AGREEMENT – WHAT IT IS.

- Shareholder / Stockholders Agreement
- Operating Agreement
- Agreement of Limited Partnership
- Partnership Agreement



## EQUITY AGREEMENT – WHY IMPORTANT.

- Protect the business for the entire family.
- Modify common and (certain) statutory law to fit the family's plan.
- To modify the shareholder > director > officer lines of authority.
- To maintain confidentiality of certain items not wanted in the public filings.
- To structure how ownership disputes can be addressed, quietly.
- To protect the interests of minority equity holder families.



# EQUITY AGREEMENT – KEY PROVISIONS.

## **Dispute Resolution**

- Privacy!
- Required Negotiation.
- Required Mediation.
- Required Arbitration.



## EQUITY AGREEMENT – NEGOTIATION.

Prior to instituting any legal action between the Parties relating to the interpretation, validity, or performance of this Agreement, including, without limitation, any claim between the Parties, or any other dispute arising out of this Agreement, a Party shall issue a written notice of dispute to the other Parties identifying the dispute, providing supporting evidence therefore, and identifying their terms to resolve the dispute (a “Dispute Notice”). Upon receipt of a Dispute Notice the receiving party shall have 30 days to respond in writing and shall identify their position with respect to the items in the Dispute Notice and shall provide supporting evidence therefore, and identify their terms to resolve the dispute (a “Response Notice”). The Parties shall then attempt to resolve the dispute through no less than 3 separate one hour good faith discussion between them and counsel of their choosing unless mutually resolved sooner, within 30 days after the receipt of the Response Notice or expiration of the period of time for such Response Notice to have been issued. If the Parties are unable to resolve the dispute during such 30 day period, which may be extended only by written mutual agreement of the Parties, each Party may proceed to enforce all remedies available under this Agreement.



## EQUITY AGREEMENT – MEDIATION.

If a dispute arises out of or relates to this Agreement, or the alleged breach of this Agreement, and if the dispute is not settled through negotiation, the Parties agree first to try in good faith to settle the dispute by mediation within 30 days administered under [name applicable rules or define them] before resorting to enforce all remedies available under this Agreement. In the event that Parties are unable to agree on a mediator, a mediator shall be appointed by \_\_\_\_\_. The process shall be confidential and shall be based on terms and rules acceptable to and defined by the mediator and/or mediation service provider.

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## EQUITY AGREEMENT – ARBITRATION.

Any and all disputes between any of the Parties, and/or their successor or assigns, to this Agreement that may arise out of, are as a result of, or otherwise relate to this Agreement or the ownership of the Stock, including, without limitation, the issue as to whether or not any one or more disputes is arbitrable and the sole and exclusive right to hear and decide any request for prejudgment remedies, shall be settled and sought only (i) by arbitration in the City of \_\_\_\_\_, Connecticut; (ii) under the Commercial Arbitration Rules and Mediation Procedures of the American Arbitration Association (“AAA Rules”) in effect at the time of the signing of this Agreement, including any supplementary rules or procedures that may apply when considering the subject matter of the dispute; and (iii) before a single arbitrator, mutually agreeable to the parties, who shall be a member of the bar of the State of Connecticut for at least 20 years, and who demonstrates substantial subject matter expertise or experience in the area of dispute. The arbitrator shall be empowered to convene an immediate pre-hearing conference for the purpose of initiating the managing and monitoring of the arbitration process in accordance .....

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# EQUITY AGREEMENT – KEY PROVISIONS. (CONT.)

## **Valuation**

- By Written Agreement (bad idea!)
- By Appraisal
- By Formula
- By Appraisal With Interim Formula



# EQUITY AGREEMENT – KEY PROVISIONS. (CONT.)

## Payment Terms For Equity Transfers

- Cash by third party financing.
- Terms of Seller financing.
- Life insurance buy-out.
- Limitations on payments.



# EQUITY AGREEMENT – KEY PROVISIONS. (CONT.)

## Transfer Restrictions and Requirements

- Keep it in the family
- Optional or mandatory redemption upon certain events:
  - Death
  - Disability
  - Divorce
  - Departure
- Qualified transfers to family and/or trusts for the benefit of the family (make sure it is a Q-Sub trust if an S-Corp) etc.



# EQUITY AGREEMENT – KEY PROVISIONS. (CONT.)

## **Family Employment Roles**

- Who can work.
- Qualifications to be manager.
- Qualifications to be a director.
- Mandatory retirement.
- Retirement process of notice.



# CONTACT INFORMATION

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