

WEALTH MANAGEMENT



Beyond 'equal': Achieving fairness in family business succession

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As an entrepreneur, building a successful manufacturing business and raising several children who achieved their own success can seem like the fulfillment of the American Dream. It can also present significant estate and succession planning challenges.

Suppose Owen, founder of a manufacturing company, has three children: Anna, who is Owen's right hand in running the business and is Owen's intended successor; Brian, who works for the business on the shop floor but is not really management level; and Catherine, who was never interested in the business, instead following her dreams and becoming a veterinarian. Owen amassed a significant net worth but, like many business owners, most of the value is in the company. Owen is also like most business owners in wanting to treat his children equally in his estate plan but also wanting to ensure that Anna can continue to run the company successfully.

Dividing shares in the company equally among the three children will give Anna a minority interest. Thus, Brian and Catherine, the two who do not have the same knowledge of the business, may out-vote Anna on business decisions. This is problematic, as Brian and Catherine may be interested in selling the company and receiving a more liquid inheritance than operating the company. Additionally, there

might not be a mechanism in place to allow Anna to buy her siblings out or enough money if the mechanism existed. What can Owen do to make an equitable distribution of his estate among the children?

A creative approach to distribution

First, Owen may decide that equitable may not mean equal. The company succeeded in no small part due to Anna's efforts with her father. The overall value of Owen's estate is much bigger due to Anna's work, so it may be fair to decide to give Anna a controlling interest in the business — giving her 52% and leaving Brian and Catherine 24% each. Owen may be comfortable with the fact that this means Anna receives a much larger inheritance than the others. If not, he may look to other strategies to equalize value.

One option for Owen is to acquire additional life insurance to provide more liquid assets to pass to Brian and Catherine. They can be the beneficiaries of a larger share—or all—of the insurance, leaving them more cash, which is probably what they prefer anyway. The earlier Owen decides on this strategy, the better, as the cost of insurance may become prohibitive—or Owen may no longer be insurable for health reasons by the time he is nearing retirement age.

Determining ownership and influence

If insurance is not a practical option, Owen could amend the

operating agreement for the company to divide his interest into voting and non-voting units. He can transfer the voting units in large part, or exclusively, to Anna and then transfer non-voting units to Brian and Catherine. This gives Anna unfettered control to keep the business running along successfully, but it ties up much of Brian and Catherine's inheritance in an illiquid asset and leaves them second-guessing Anna about when and how she determines distributions to the owners versus retaining funds in the company for working capital.

Suppose Owen, like many manufacturing company owners, has created a separate legal entity that owns the building in which the company operates, so he is really the owner of two entities. Owen could consider leaving the operating company to Anna and the real estate holding company to Brian and Catherine.

First, Owen would need to think about whether the math is close enough to provide equitable value to all children. Then, he would need to consider whether he wants the interpersonal dynamics of Brian and Catherine serving as landlords for Anna and the company. If the family relationships are strong and Brian and Catherine are reasonably business savvy, this may not be a problem. However, if there are existing frictions among them or concern that frictions may be exacerbated by Anna having received the larger share from the operating company, the

relationship could become difficult. Also, would Brian and Catherine be inclined to sell to a third party that may also be less friendly to the operating company as a landlord, providing additional drag on Anna's ability to make the business profitable?

A matter of trust

Rather than transferring units in the company directly to his children, Owen could instead retain the entire value of the company in trust to benefit all three children collectively. If Owen is fully committed to equal economic treatment for each child, he could name Anna as trustee and require that as the company makes any distributions to the trust, the trustee must immediately distribute those dollars out to the children.

Anna, as trustee, would have full legal authority to vote the shares in the company and decide on distribution amounts. That is, she could operate the company without much legal need to consult with her siblings, but under this arrangement the family is back to a place where Brian and Catherine have a valuable inheritance on paper but only enjoy cash from it if distributions are made. In this scenario, Anna could also pay herself a large salary, leaving very little distributions for the trust. Thus, the others may pressure Anna for information about the company's financials and try to find creative legal avenues to second-guess her decisions regarding compensation, cash reserves

and capital investment in the company. Further, in this trust arrangement, buying out Brian or Catherine may be more difficult than when they held a minority interest, unless the trust is well written to contemplate that process.

The issues Owen faces are not unique. There is no one right answer, and the best approach depends on the nature of the business, corporate governance currently in place, family dynamics, health and various other factors. Working with an experienced advisory team that will first listen to Owen, then help him find solutions and synthesize business and estate planning is the best way to ensure continued success for the company in the market and continued success for the family at Thanksgiving dinner.



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