On March 11, the BBJ hosted a panel discussion with a team of experts to discuss the importance of succession planning and preserving generational wealth. The expert panel included: Matthew Cohen, Business Banking Team Leader, M&TBank, Maurice Offit, Principal and Co-Founder, Offit Kurman and Steve Wolf, Partner, UHY LLP.
The discussion

What are some of the most common challenges facing family businesses?

Maurice: I think the hardest thing about having a family business is whether you should treat the business as a business or treat it as a family. You want to stay close with family members but sometimes family members are not the best fit for the business. As a result of that, there’s always conflict that potentially takes place. Should you allow a person in the family who’s not a good fit for the business to stay employed? Should you find them another position within the business? Let’s treat the business like a family. Let’s treat family members as if they weren’t family. Let’s treat the business like they’re a business. I think you’ll get to the point where you discover the roles that they should play. The hardest part is when there’s no role available for a family member to play. That’s a very difficult conversation.

Steve: Family comes with emotions. It can make it hard to be objective. Also, what we often run into is that family businesses don’t have a financial reporting system with sufficient accounting controls. They don’t place enough emphasis on controls because they trust family members, sometimes more than they should.

Maurice: I think you have to treat family members as any other employee of the company. It’s not an easy thing to do. But once you get over that hurdle, and you say let’s evaluate family members as if they weren’t family. Let’s treat the business like they’re a business. I think you’ll get to the point where you discover the roles that they should play. The hardest part is when there’s no role available for a family member to play. That’s a very difficult conversation.

How should a business start succession planning?

Maurice: It’s important for the family to communicate clearly with their banker the role of each family member and to make sure everybody’s aware of what the transition will look like, what it will feel like, how the financing will be put in place. Also, how that exit or entry into a business will occur for different family members.

Steve: It all comes down to planning. When you look at it through a banking lens, it’s important for the family to communicate clearly with their banker the role of each family member and to make sure everybody’s aware of what the transition will look like, what it will feel like, how the financing will be put in place. Also, how that exit or entry into a business will occur for different family members.

How do you put family members in the right roles? How do you begin to have that conversation?

Maurice: When should a business start succession planning?

Steve: Sure, time sensitivity and getting ahead of potential estate issues is definitely important. There are certain tax implications to consider in succession and estate planning. Let’s start with the value of the estate. Does the plan account for the taxes that are going to be paid upon a death of a founding member and is that going to be something that may ultimately prevent the continuation of the business because its assets need to be liquidated to cover the tax? We can’t plan for unforeseen events and it’s one of the things that people put off all the time. They’re afraid of some of these family challenges and who’s going to be affected.

Talk about the importance of governing documents and what should be included?

Maurice: Traditionally a family business would have a buy/sell agreement. It would indicate what happens to the senior generation at the time that the senior generation member would either die or become disabled or decide to retire and the
issues that come into play. Would the senior generation member be bought out? Or would the senior generation member decide to give its interest in the company to the next generation? If it decides to give the interest in the next generation and there’s children that are outside of the business, from an estate planning perspective, how do you provide for those children?

STEVE: As Maurice said, there can be challenges when the business itself is the majority of the senior generations assets. In the case of a death, there needs to be a means of providing for heirs that are not going to stay in the business, for example life insurance. Most businesses do not have the liquidity to “cash out” the non-active beneficiaries. And that’s where I think, in estate planning, life insurance is a big piece of the puzzle.

MATTHEW: Similarly, you need to look at the funding of buy/sell agreements. Obviously, the bank has the ability to provide services that help plan for that. Also, you need to consider key employees that might help continue running the business if it becomes a future generation. As mentioned earlier, the largest asset is the company itself. As one generation begins to exit, there needs to be a conversation around diversification of funds.

Talk to me about the planning for the next generation to take over a company.

MATTHEW: I have advised many family-owned businesses on not just what to do with the money, but how to transition that money in an efficient way. It is important to work with attorneys and accountants to make sure that a family secure their wealth for generations to come. As a business transitions from generation to generation, preservation of wealth along with what the impact to each family members plays a big role.

STEVE: You have to make sure that the next generation has been properly educated and trained to take over the reins, number one. And you have to make sure that you’re not making an emotional decision and that they really want to be involved. I would say in a lot of cases generation A thinks that generation B wants to continue on. Generation B doesn’t want to let down generation A, so they kind of agree to do it but their heart is not in it, and that could have a negative effect. To the extent that you can, you need to communicate and really make sure all parties are on the same page.

MATTHEW: We spend a lot of time with our clients when the conversation of a transition begins. There’s two different types. You have the financial transition of a company and you have the management transition of a company. It might not happen at the same time. I think as you start planning out transitions, some of the most successful ones include members of the family that have worked to the company for a long time. They’ve done a lot of the jobs. The best transitions are when people have put in their time. They might have outside experience bringing different ideas and different technologies as you transition to a more technological world. Maurice said it earlier, you have to treat the family like a business. You would not put in a CEO that’s never worked in the company or potentially doesn’t understand the industry well enough. I think the same goes for a family business.

From a financial perspective, you want to transition but a company might not, or family might not be able to afford it. They don’t have the balance sheet within a company, or the balance sheet personally to be able to afford it. That causes some tough times for families to make decisions.

Often times a family business may have to bring in outside talent. Talk to me about how you make it an equitable environment when an employee in a leadership role comes from outside of the family. Would that person become a shareholder?

MAURICE: It takes time in order to determine if you bring an outsider into your business - whether that outsider’s the proper fit for your organization. I do think that if you bring in an outsider that either you have to have a compensation plan that motivates an outsider give their best effort to making the company successful. Many outsiders would say they want to have equity in the company, So, then you get into different types of equity. Should you have ownership in the company now? Should you have the option to acquire ownership in the future? Should you have something called phantom stock, which means that you receive a benefit if certain events take place? For instance, when the company’s sold. You’re not a stockholder today but you’ll share in the proceeds of sale when the company’s sold tomorrow. So, lots of ways to incentivize outsiders to give their best and to run the business properly.

How should contingencies such as death, disability, divorce, retirement, resignation or termination be addressed?

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– STEVE WOLF
It’s getting financing for it or it’s having the capital available to you, to go through a type of transition can drastically impact the future growth of that company. I think it’s something to be considered as you go through your planning process as early as possible.

Are you having those conversations at the beginning when you’re working with your clients?

MATTHEW: Over the years banking, has continued to evolve. For a very long time we have sat at the advisory table with the accountant, the attorney, and their insurance provider to make sure that we understand how family businesses are planning for the future. With that said, that is what has differentiated M&T in the market for a long time. We’ve had a presence in our market, with our clients, for a long time. Then with that, we engage in conversations that are beyond today’s needs and help them project forward. We encourage them to involve their team of advisors to get to that next generation.

We’ve mentioned buy/sell agreements several times. How do you know when a buy/sell agreement is well prepared?

MAURICE: Traditionally buy/sell agreements have three basic parts to them. Part one, what triggers a potential buy-out - usually death, disability, retirement, termination of employment. Things along that line. The second thing is if one of those events is triggered. Is there an obligation to buy or an option to buy? If it’s a purchase that’s going to be taking place, how is the purchase price to be established? Is it done by appraisal? Has there been an agreement among the shareholders as to a formula that should be used to evaluate the company? And, finally, how will the price be paid? Is it paid as a lump sum? Often companies can’t afford to purchase somebody else with lump sum.

If not, is it financed by an outside lender? Or is it financed by the seller? Sometimes sellers have the role to play of not only being seller but being lender. And then sometimes it’s easier to negotiate what the terms of sale are, than the terms of repayment. All that’s set forth in the buy/sell agreement.

MATTHEW: Building off those three when you begin to look at those triggers it’s also beginning to understand what the impact is to the financial statements of the company. So as these different events happen, whether it’s death, or whether it’s disability, what other types of events would happen through those times. When you look at a buy/sell agreement, you can outline specifically what roles other people will play. When you look at it through the bank’s lens understanding what role, each management person plays and then having a plan in place for succession is important. Understanding who will step in if something happens.

MATTHEW: In a lot of instances, you can have a buy/sell agreement that gets old. If you haven’t had correct valuation done and it’s not up to date or funded properly you land in that next place, which is payment. Where the bank plays a role is being able to fund the buy/sell through insurance products and/or family planning, but also through financing. A lot of missteps happen when there is internal financing that doesn’t exactly meet with the growth objectives of the company. A bank can help with that.

What is an Employee Stock Ownership Plan (ESOP) and what benefits can it offer a family business?

STEVE: An ESOP is an employee-owned company - either in part or total. The employees are the owners of the company; they will ultimately receive the benefit of any growth of that company. Or potentially could suffer if the company doesn’t do well. It’s a retirement vehicle. The other big benefit is that it can be a good way for the owners to get out with cash in hand or over a set period, without the need to find an outside buyer.

Additionally an S-Corporation, which is the structure of many family-owned businesses, has an added benefit to an ESOP. There is a significant tax advantage because the ESOP - the portion of the profits that flow through the ESOP - are not taxed federally. And most states actually do follow the federal structure and do not tax those profits. There are also a number of other tax benefits. I mean we’ve seen cases with some huge tax savings.

MATTHEW: Funding for ESOP’s can be challenging but they can also be very beneficial. And a lot of that goes back to the strength of the company’s balance sheet. Within an ESOP, during each tranche payout depending on the strength of the company and the management team, there are typical lending standards which dictate how the bank will view and structure financing. So, the longer a company’s management team that’s taking over has been in place, the more lenient we may be. Most ESOP loans are cash flow loans. Traditionally, banks look for a great blend of cash flow and collateral. But what I will say is that the earlier a bank is involved in that option, the better planning you can do around it.

What are some of the key pieces of information or nuggets you would say every family business needs to keep in mind?

MATTHEW: The planning. Definitely start with planning. Having that buy/sell agreement in place. Making sure that it’s funded. I would say that’s number one. Number two is making sure that family estate planning is taking place and then number three, make sure that your bank or banker is brought into the process as management begins to transition so that the new managers that will eventually take over the company, are known to the bank.

Making sure they retain a similar relationship that the previous owners and previous leadership team had is extremely important through that transition from one generation to the next.

MAURICE: Businesses need outside advice. People that are specialized in certain fields and that you call those specialists to help you out. And to protect you from events which could occur.

I think that every business should have a budget for professional fees but assuming that it’s a budget that they can live within, I think professional fees should earn their keep. I try to have those call from a client saying, “We have a problem.” That’s the main advice. The other thing is to see it all the way through. Again, there’s a lot of emotion involved. I understand that. There are a number of war stories in which people will do all the legwork, get the agreements and then don’t sign them for whatever reason. You have to get across the finish line.

MAURICE: Every company really should have a vision for the future, saying “Where am I today? “Where do I want to be five years from now? 10 years from now? And I think that if you have that vision and you try to proceed forward with it, you’ll have a much better chance of getting to the finish line.