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Passing the Torch — Transferring a Family Business to the Next Generation

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Introduction — When Planning and Expectation Face Reality

Consider the following situation: A young man,[1] by himself or with one or more siblings, starts or takes over or buys a small business and grows it into a strong successful enterprise. He and perhaps his siblings have children who work in the business in the summer and after school, and he has given them a stake in the company with nonvoting stock or other equity. One day many years later, with the business thriving, the founder and owner decides that the time has come for him to cash in on the product of his hard work and take the value of his equity in the business and retire. The children decide that the time has come for them to stop being simply employees and to take over their perceived rightful place as owners and management. In other words, the time has come to pass the business to the next generation. Now what?

Everyone in the family has probably assumed for a long time that the founders would one day retire, and that the children would take over. Those involved may have done some preparation for the transition by estate planning, transfers of nonvoting or at least noncontrolling equity and placing children in some board or management positions. Most likely, however, the founders and the children have not fully considered some of the more difficult issues and problems in moving a business to the next generation, including:

- How do children, whose only income and source of funds is the business, find enough money to pay the likely very substantial amount needed to buy ownership and to cash out the founders without crippling the business?
- Can the person or people who created and built and grew the business and who consider it their personal domain or "baby" turn over real control to children without hovering over and second guessing, making a smooth transition and proper management and authority impossible?
- What happens if the children to whom the business is to be transferred cannot agree among themselves on significant management or operating issues? What if they simply do not like one another and do not get along?
- What about serious disputes during transition, between the founders and the children or the children among themselves? If principal parties cannot resolve their disputes, can the transition proceed and the business continue?

To repeat, now what?

I. Money — Buying in Without Breaking the Bank

With few exceptions, children who have grown up in a family supported by a family business have few if any resources of any substance outside of the business. If they are in line to take over as the next generation, they most likely have worked at the business and earned from it a salary and benefits, but they probably have needed most or all of those earnings for daily living expenses and support. As the heirs apparent, they may have been given or earned stock or other equity in the business entity, but the equity interests are most likely nonvoting or at least far below control, and shareholders or partnership or operating agreements almost certainly prohibit them from selling the equity or using it as collateral for a loan.

The founder or founders and first generation of a family business ready to retire and pass the business on to the next generation usually have reached a stage at which they want, and consider themselves entitled to, the equity they have built over the years and therefore expect a good deal more from the transition to their children than a continuation of salary or even distributions and a share of profits. If the founder has worked for years to create a business that he could sell to a third party for a very large amount, he most likely does not want to give up a material portion of that value by selling to his children.

Thus arises the common problem and conflicting interests of financing the transition of a family business to the next generation when, as often happens, the children are not independently wealthy and there is no reasonably available outside source for meaningful financing. How do children purchase their parents' business, when the business itself is the only source of funding, without draining the resources of the business? The simple answer is that they cannot, and

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1. In order to avoid constantly repeating "he or she" or "him or her," this presentation uses the common gender technique of referring to parties with masculine pronouns. Apologies to anyone for whom apologies are appropriate.

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that they and the founders must devise a mechanism to arrange for such funding that accommodates the needs and interests of all the parties.

One relatively simple mechanism to provide for funding involves agreements that assure that the business will consider potential fundamental transactions, such as mergers, sales of substantial assets or equity placements, with a view to the obligations to the founders and will use as much of the proceeds of such transactions as is reasonably practicable to pay those obligations.

As discussed below, until the founders have been paid in full or for some other agreed reasonable time, the selling founding generation should have a level of control and even a veto over proposed or potential fundamental transactions. This initially serves the possibly important objective of preventing younger and less experienced owners from making ill advised major decisions and stifles the impulse of new owners to try to sell everything the founders have built and run off to Tahiti. It also provides the founder with a mechanism to assure to the extent reasonably possible to his satisfaction that fundamental transactions are chosen and entered into with a view to the obligations arising from the sale to the next generation and that the terms of such transactions permit the use of proceeds to pay the obligations to the founders to the extent practicable without seriously harming the business.

Fundamental transactions that arise while payment obligations to the founders remain outstanding provide a very effective way to deal with the problem of using the assets and equity of the business to pay the price to purchase it, but those types of transactions do not happen on a regular basis and likely will not be available to help many or most buyers of the transferee generation. Assuming no windfall from a fundamental transaction, the funding for the purchase of equity from founders by the next generation will almost certainly require that the buyers use the assets and equity of the business beyond the ordinary course of the business. Given the problems inherent in any such arrangement, the parties must recognize that payments on time all the time may not be reasonably possible, and that late, and occasionally even very late, payments should not blow up the deal. There will likely be a need for payment grace periods well beyond the traditional 30 or 60 days that recognize payment obligations but acknowledge the potential difficulty that buyers may have in making timely payments, even when acting in the utmost good faith.

For example, assume a purchase price by children of a founder's equity for $10 million payable in annual installments of $1 million each, plus reasonable interest, with equity pledged to the founder as security. If the buyers rely on the business to produce the money for the payments and the business cannot provide the needed funds one year, a standard grace period of 30 or even 90 days will be of no help, and it will be necessary for the parties to extend the payments schedule on an ad hoc basis, come up with some forbearance arrangement or pull the plug on the deal.

It makes more sense to plan for such a situation in advance. As one alternative, a buying child might be given the option to extend by written notice payment dates for periods of three or six months or more with limits on the number of consecutive and total extensions, either without changing the other payment dates or with comparable extensions and perhaps additional interest during an extension. If the problem and the lack of available funds continue for long enough without resolution, it will of course eventually become necessary to confront the issue that the deal as originally agreed does not work. On the other hand, if such an optional extension beyond a regular grace period will help the situation and allow enough time for proper funding, the deal will be able to proceed without the problems and disruption that inevitably arise in the event of a comprehensive renegotiation and preparation of new agreements.[2]

II. Management and Control — Letting the Baby Go

An entrepreneur who started a family business and over many years grew it to a serious, stable and thriving operation probably likes to be in control of the business and will not easily give up control, even to his children and even for a great deal of money. At the same time, children who have worked hard in a family business for many years for only a salary based on the expectation of finally taking over the business do not easily agree to pay a great deal of money for it and not take control. As a result, the passing of control can present a very difficult and sensitive conflict that is not easily resolved.

In most instances, the best solution to the conflict over control will involve some form of gradual transition

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2. Any payment arrangement or agreement for an extension of or adjustment to a payment schedule will likely have tax consequences. While this presentation does not address tax issues, parties to a transaction for transfer of a business to the next generation should consult a qualified tax advisor.

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in which a founder recognizes that he cannot take the money for the purchase of his interest and keep control, and the children understand that they cannot take over complete control until they have paid most or all of the price for the equity that gives them control. A system of progressively lessening controls by a founder over governance and major transactions can work well with just a reasonable amount of understanding from both sides.

A common concern of founders in connection with their relinquishment of control is that young and inexperienced new owners may try to make their mark in the business world or simply to get rich with an ill conceived major transaction like a sale or merger that may dissipate the value of the company. For example, the prospect of a sale of all or a significant part of a business in exchange for a stake in a large enterprise, potentially primed to go public, can charm a new young owner without his understanding that a noncontrolling minority interest in a large business is illiquid and may not ultimately be worth very much.

As noted above, a reasonable mechanism to deal with this kind of issue involves providing the founder with special approval rights for certain designated fundamental transactions until the founder is paid, with the rights slowly phasing out. For some period after a sale, the founder may be given a veto over certain defined transactions. For a time after that, the founder can continue to have a veto but only if one other owner or perhaps director agrees with him. Thereafter, the founder may not have a veto but must be heard on the proposed transaction and have the capacity to delay action for some period of perhaps 30 or 60 days for "cooling off."

Similarly, a founder may wish to guard against children moving quickly to take the business in a direction he opposes or has previously resisted. Again, phasing out of authority can be helpful and effective. A founder can remain a member of a board or other governing body with a veto right for some period, with the authority reduced to simply a vote and eventually the capacity to give advice.

These types of mechanisms for gradual adjustment to and change of control and "letting the baby go" work very well if there is a genuine recognition of all interests and good faith on all sides. A selling founder must understand that he cannot transfer a business and take the money for the sale while keeping control over the business and its operations. At some point, almost certainly by the time he is paid in full, a founder needs to acknowledge that he must cede control to his children. At the same time, buying children need to understand that they cannot take a full control the day they sign a purchase agreement when they have not yet paid most of the price and may need to delay the payment for a number of years. Even after the completion of the transfer of control, providing a place at the table for the person who built the business generally makes for good feelings, eases transition and helps everyone.

III. Battling the Owners — Who Is in Charge Here?

The passing of a business from one generation to the next generally does not involve a simple sale from one founder to one child. More commonly, the transfer includes a new generation of two or more individuals, often siblings but possibly also cousins or more distant relations. Although there are exceptions, founders tend to try to pass a business to the members of the next generation equally, particularly if the transferees are the founder's children. Not wanting to favor, or to be accused of favoring, one child or nephew or niece over another, a founder will often pass on the business through equal ownership, voting rights, management and control. The arrangements for transition of a business on that basis work, assuming that the transferees get along, can work together and agree with one another with respect to management. That often is not a good assumption.

Although usually established with the best of intentions, very few things cause as much trouble for closely held, and particularly family owned, businesses as ownership or transfer of ownership in equal percentages, with equal voting rights but no reasonable mechanism to deal with a deadlock. Perhaps because founders of successful businesses assume that the next generation will follow their lead or because parents assume that their children will work together in harmony, many very smart people fail to recognize the most basic rules of simple arithmetic. When 50 percent votes against 50 percent, the result is always a tie with no winner, and when one-third and one-third vote against another third, the combined two-thirds always wins. The effects of that truth can be very serious. In a recent case in the Northeast, two sibling owners of a distribution business came to a difficult parting of the ways. The sibling in charge of operations considered that the other had stopped working hard, and the other thought that his sibling was unjustly pushing him out. The business operated through a corporation and a number of related partnerships and limited liability companies, and the siblings owned all the compa-

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nies and held all the board and other positions of authority equally. A serious dispute arose and one sibling offered to buy out the other who refused and filed suit. After two years of litigation and many millions of dollars in attorneys' fees, the parties finally settled for a sale of all of the businesses to the sibling who had run the operation on substantially the same basis as the original offer, but with terms that imposed a real burden on the continuation of the business. While extreme, the matter provides an instructive example, particularly considering that the entire dispute and litigation could have been avoided with a reasonable advance agreement on how to deal with a deadlock.

A less dramatic, but still difficult and disruptive, situation arises when more than two children or others expected to continue to run the family business in harmony with one another have equal ownership and voting rights and control. Siblings or cousins who worked well together as employees often surprise founders when they do not continue to do so as owners and when some do not share, or care about, a founder's vision of harmony. In such situations, two out of three (or three out of four and so on) can and often do outvote and push out a minority in a manner that the founder never intended or expected.

As previously noted, one mechanism to deal with such a problem is for the founder to retain for some time approval or veto rights that can calm or settle disputes among the next generation and provide for a phased slower transition. If that does not work, and the issues continue beyond the capacity of a founder to intervene, there are a number of potential mechanisms to deal with the problem of a majority of two or more members of the transferee generation ganging up on a minority. Governing agreements or bylaws can require super majority or even unanimous approvals for certain fundamental matters or can mandate a purchase of a minority's interest at a fair price in the event of a dispute that cannot otherwise be resolved, and there can be recourse to the dispute resolution processes discussed below.

A true deadlock, however, as when 50 percent owners take opposite sides of a significant issue, presents a much more difficult problem. That kind of deadlock can stymie a business and prevent needed decisions and operations, and as noted in the above example, can lead to crippling and exceptionally costly litigation. While there are mechanisms to deal with such deadlocks, they are often disruptive and even extreme. There could, for example, be provisions in the operative agreements for the appointment of a temporary additional director or a type of arbitrator to break the deadlock or for a so called "Chinese auction"[3] or even the dissolution of the business. In some instances simply the availability of a draconian remedy of a forced sale or dissolution may give the new generation pause and an incentive to resolve issues. Whatever happens, it is almost always best if it happens by design, not by default. Neither founders nor the next generation to whom the business is passing should consider and proceed as if the new generation of family owners will always agree and always be able to resolve its differences. Particularly founders, but also members of the generation taking over, should confront the issue of possible disagreements and deadlock and decide in advance how to proceed.

IV. Disputes — When Planning Does Not Go as Planned

In his 1785 poem "To a mouse on Turning up in Her nest with the Plough," Scottish poet Robert Burns wrote:

> The best laid schemes o' Mice an' Men
> Gang aft agly
> An' lea'e us nought but grief an' pain
> for promised joy![4]

During the past 225 years, that unassailable truth has been recited, quoted and restated innumerable times for innumerable purposes. It regularly finds its way into modern culture, as with the updated version in John Lennon's lyric in the 1980 "Beautiful Boy" that "Life is what happens while you're busy making other plans." However stated, the message is the same. Things rarely go as exactly as planned. For families passing the family business to a new generation, the message is to think about and prepare for the likely time when life happens or when schemes go agly and when family members do not agree and it becomes necessary to deal with a serious dispute.

When considering a method for resolving disputes among business principals, thoughts generally turn first to some form of arbitration, and arbitration does have some appeal.

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3. In its simplest terms, a "Chinese auction" involves the party invoking the procedure making an offer to the other party to buy the other's share of the business for a certain amount and on certain stated terms. The party receiving the offer has the option to accept the offer and sell or to reverse it and buy the other party's interest at the same price and on the same terms.

4. The Scottish phrase "gang aft agly" is commonly translated "oft go awry."

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It can be, but is not always, quicker than proceeding in court and can be cheaper than litigation with less discovery and fewer formal proceedings and rules. It provides final, nonappealable results and prevents endless proceedings in multiple courts. Perhaps most important, arbitration is very flexible. It can apply to all disputes or to as many or as few as the parties desire with the arbitrator having as much or as little authority as everyone agrees from complete discretion to so called “baseball” style arbitration in which an arbitrator can only choose the position of one of the parties without change.

In the context of family businesses and the disputes likely to arise in connection with the process of transition to a new generation, arbitration also has its drawbacks. While perhaps faster than traditional litigation, arbitration generally is not quick, and any process in which a family business must operate with a serious dispute pending can be very troublesome. Also, the finality of arbitration often leaves no recourse to respond to or correct mistakes or ill advised decisions, and that can be more harmful than beneficial to the continued operations of a going business. Perhaps most significant, however, like court proceedings but probably more so, arbitration leaves to an outsider decisions as to the business, operations and proper activities and future of a family business and rights and obligations of family members. Even in the midst of the most strident and nastiest disputes, few family business owners want a third party deciding the fate of their businesses and thus of their families.

A potentially better solution that is starting to gain support involves acknowledging that, if after a genuine serious good faith effort, family members cannot resolve core disputes on issues not fully covered in their agreements, they may have reached an impasse which no dispute resolution process can or should solve. As a result, the best approach for dealing with disputes may be to try to compel a serious effort at resolution, perhaps by a mandatory period of negotiation requiring a stated number of meetings and thereafter mandatory mediation for some reasonable time with an agreed mechanism for selecting a mediator. If that does not succeed, it may well be that nothing will succeed, and that the parties are best left to whatever remedies are available to them as a matter of law or to dissolve the business or to litigate, or both.

Conclusion

In the ideal world of the thriving family business providing steady jobs and income to an extended family — perhaps the 21st century equivalent to Thomas Jefferson’s ideal of the family yeomen farmers — the patriarch of the family begins and grows the business and grooms his children to take over when he is ready to retire. Those children continue to run the business without missing a beat and prepare to pass it on to their children and so on for successive generations. As Robert Burns and John Lennon reminded us, however, nothing is that ideal, and the transition of a business to the next generation requires a good deal more then the magic wand or pixie dust of an ideal world. Founders who build a business want to be paid for the equity they created, and the children obligated to pay must use that equity to fund the payments. Founders who devoted their lives to creating a business do not readily turn over control, but the children who succeed them do not want to wait to take charge. The first generation expects its children to follow its lead and policies and to work together in harmony to do so, but the second and successive generations often do not get along with either the founding generation or with one another. Founders do not usually expect serious disputes among their successors, but fundamental disputes do happen can cripple or even destroy a business.

No agreements or arrangements for the passing of a business from one generation to the next can predict or provide for everything that may happen in connection with or after transition. On the other hand, most things that may happen have happened before to others, and the first and next generations can consider and try to provide for many of the likely issues and problems, and they should make a serious effort to do so. While implementation may be complicated and even difficult, the basic concept is very simple. As the Boy Scouts say — be prepared. ◆

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