OWNERSHIP AND LEADERSHIP SUCCESSION – A STRATEGIC ISSUE

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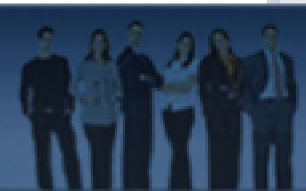


I. A Strategic Issue

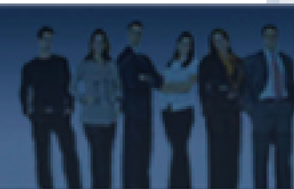
Whether a closely-held business or a "publicly-held" business

II. Succession is not just about the CEO

- It is about management, leadership, and ownership progression at all levels

III. Succession on the Micro Level

- "Two deep" with respect to each material function
- Discussion/Planning "Back-up" on material functions should be part of periodic one-to-one reviews
- Should always be an area of review in preparation of periodic strategic plan
- Deal from a proactive posture vs. a reactive posture

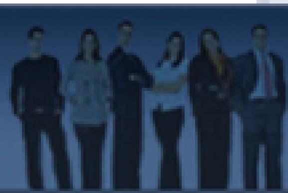


IV. Two Types of Succession

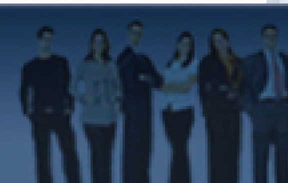
- Unplanned – “The proverbial beer truck scenario”
- Planned

V. Unplanned Succession

- Adequate working capital/liquidity/key man life insurance to fund the interim process
- The alternative – forced to sell
- Planning for such crisis and sale

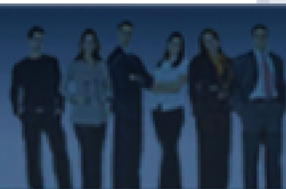


VI. Planned Succession for the Closely-Held/Family Businesses



➢ Options to consider

- ✓Retain family ownership and management control
- ✓Retain ownership but hire outside management
- ✓Sell to an outsider or employee
- ✓Close the doors



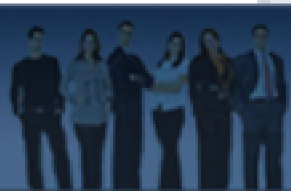
The answers to these questions become more critical and complicated when involving a family-owned business.

- Why do family firms fail to transfer the business successfully from generation to generation?

  - ✓ Lack of viability of the business
  - ✓ Lack of planning
  - ✓ Little desire on the owner’s part to transfer the company
  - ✓ Reluctance of offspring to join the company

➢Uniqueness of a family-owned business

- ✓Majority of the ownership or control lies within a family – two or more family members directly involved
- ✓Duel system consisting of the “family” and “business” – different roles, different expectations
- ✓Conflicts arise when the roles assumed in one system intrude on the roles in the other

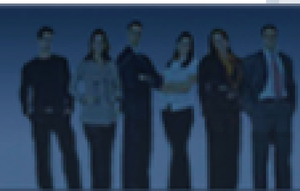


➢Issues in the family business

- ✓Participation
- ✓Leadership and ownership
- ✓Letting go
- ✓Liquidity for estate taxes
- ✓Attracting and retaining non-family executives

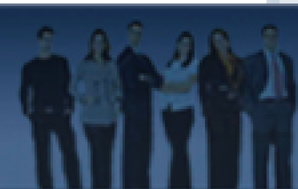
➢Issues in the family business

- ✓Compensation of family members – equality vs. merit
- ✓Successors – who chooses and how to choose among multiple successors
- ✓Strengthening family harmony

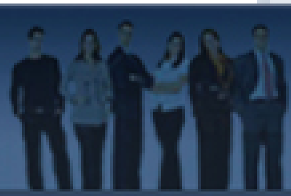


Different relationships

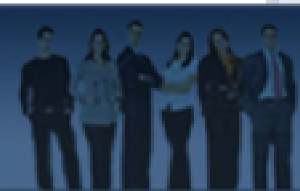
- ✓Family members – neither an employee nor an owner
- ✓Family members – an employee but not an owner
- ✓Family members – an employee and an owner
- ✓Family members – not an employee but an owner
- ✓Non-family member – employee but not an owner
- ✓Non-family member – employee and an owner



- Strategic planning for the family-owned business
  - ✓ What are the long-term personal and professional goals of family members
  - ✓ What is the family mission
  - ✓ Is the family committed to establishing and operating a business



- Strategic planning for the family-owned business
  - ✓How do you envision the business in the future
  - ✓Will family members be “active” in the management or will they be “passive”
  - ✓How will issues, such as compensation, benefits and performance evaluations, be determined



➢ The family retreat

- ✓Family creed or mission statement
- ✓Management succession
- ✓Estate planning
- ✓Strategic business planning
- ✓The reward system

➢ The family retreat

- ✓Performance evaluation
- ✓Communication within the family
- ✓Preparing adult children to enter the business
- ✓Transition timing
- ✓Entrance and exit policies

➢ Succession issues for the founder

- ✓Fear of death
- ✓Reluctance to let go of power and control
- ✓Personal loss of identity
- ✓Fear of losing work activity
- ✓Feelings of jealousy and rivalry towards successor

➢ Succession issues for family

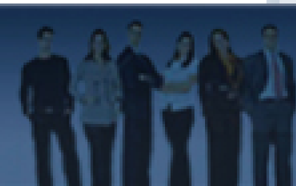
- ✓Founder's spouse's reluctance to let go of role in firm
- ✓Norms against discussing family's futures beyond lifetime of parents
- ✓Norms against favoring siblings
- ✓Fear of parents' death

➢ Succession issues for employees

- ✓Reluctance to let go of personal relationships with founder
- ✓Fears of differentiating among key managers
- ✓Reluctance to establish formal controls
- ✓Fear of change

Environmental succession issues

- ✓ Founder, colleagues and friends continue to work
- ✓ Dependence of clients on founder
- ✓ Cultural values that discourage succession planning



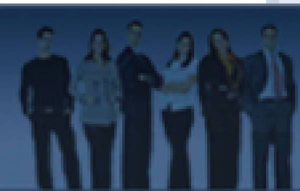
Planned Succession – Within the Family or Outside the Family

- Ownership succession may be different from leadership succession

- Separate passive investment from active management and leadership

- Fair vs. equal treatment of second and third generations working actively in the business and those not working actively in the business

- Transition from entrepreneurial stage to “administrative” stage:
  - ✓ Separation of investment from management function
  - ✓ Use of board of directors/board of advisors
  - ✓ Use of tiebreaking vote



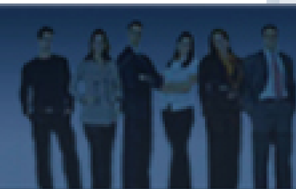
- Should we sell – when and who are the best prospects (family, employees, competition)

  - ✓ Want to sell before any “downward spiral”

- Succession Planning and Capital Planning go hand-in-hand

  - ✓ If selling to family – “bargain-sale”
    - How will they pay for it – security and controls for seller

  - ✓ If transfer on death – may be too late – sufficient liquidity in estate so that taxes do not devour business



➢ Some techniques for transferring family-owned businesses:

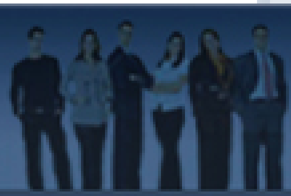
✓Methods to freeze value:
- •Recapitalization to freeze value (difficult in sub-S's)
- •Family Limited Partnerships

✓Gifting of ownership interests (annual valuation issue)

✓Redemption

- Some techniques for transferring family-owned businesses:

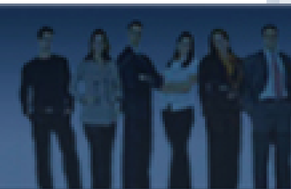
  - ✓Charitable Remainder Trusts
  - ✓“Bargain-Sale”
  - ✓ESOP’s
  - ✓Buy-Sell Agreement



VIII. BUY SELL AGREEMENTS

What is a Buy-Sell Agreement?

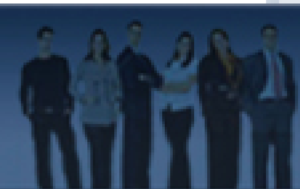
- ❑ Written Document
- ❑ Essential Provisions:
  - ➢ Ownership
  - ➢ Triggering events
  - ➢ Valuation
  - ➢ Funding



Buy-Sell Agreement

Advantages

- Help Establish Business Value with the IRS
- Create a Market for the Business
- Create Liquidity if Funded
- Provide Support for the Family if Funded
- Provide Protection for non-Family Member Owners
- Provide Protection for Minority Owners
- Help Minimize Conflict Among Owners



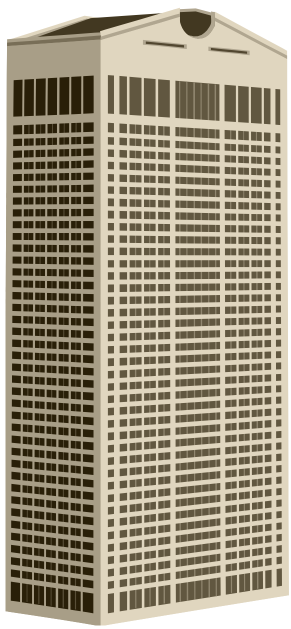
Buy-Sell Agreement

Disadvantages

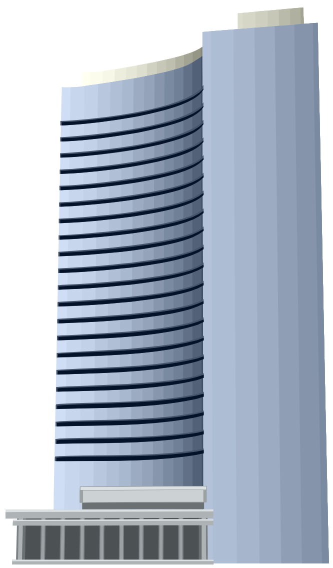
- Cost
- Time

Types of Buy-Sell Agreement

Entity Purchase

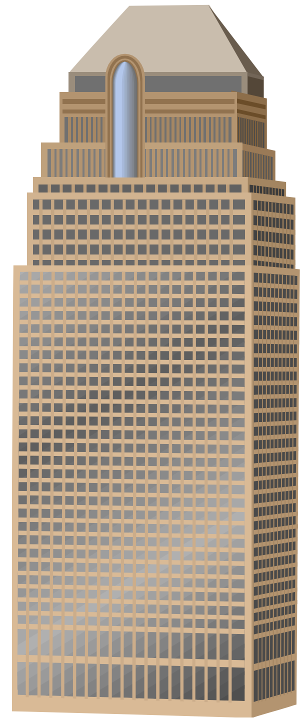


Cross Purchase



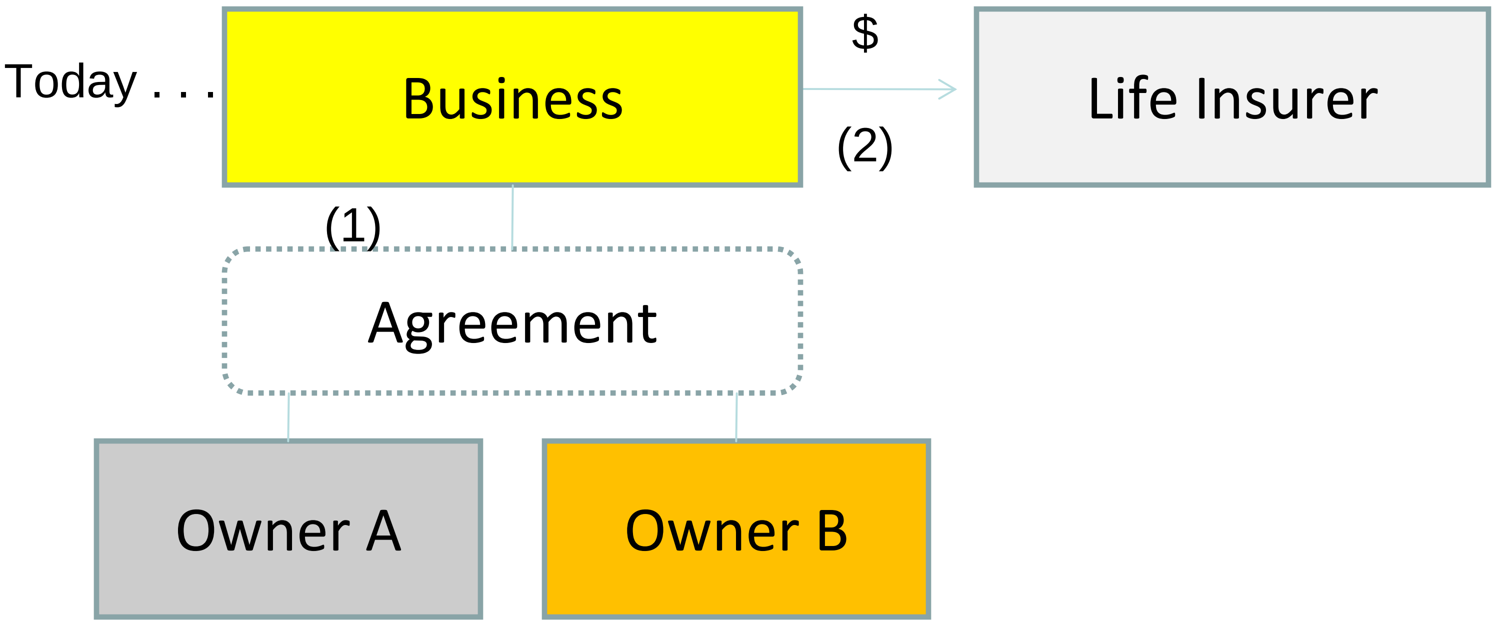
Wait and See

Trusteed



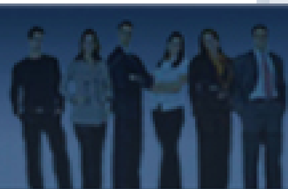
Entity Purchase Buy-Sell Agreement

(Stock Redemption)



How the Agreement Works:

1. The Business agrees to purchase the interest of the deceased owner.
2. Business pays premium on each owner's policy.



Entity Purchase Buy-Sell Agreement

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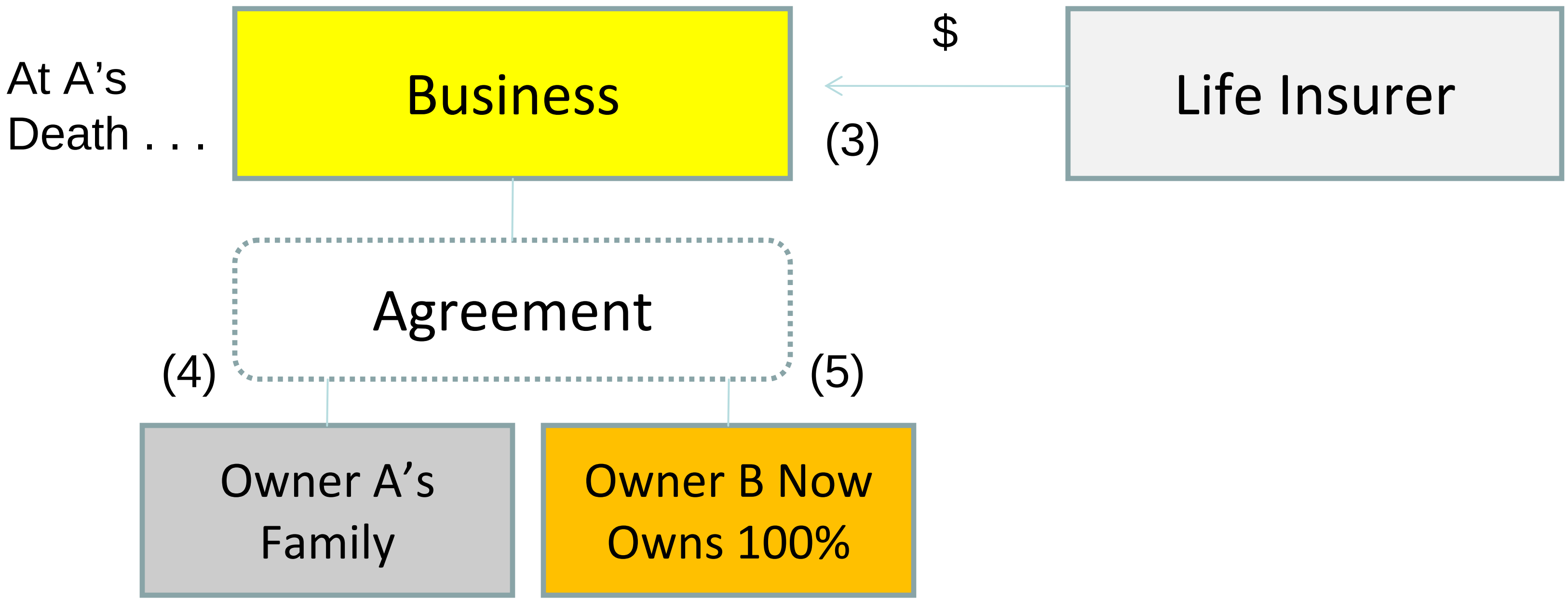
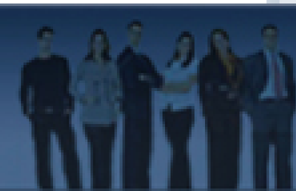


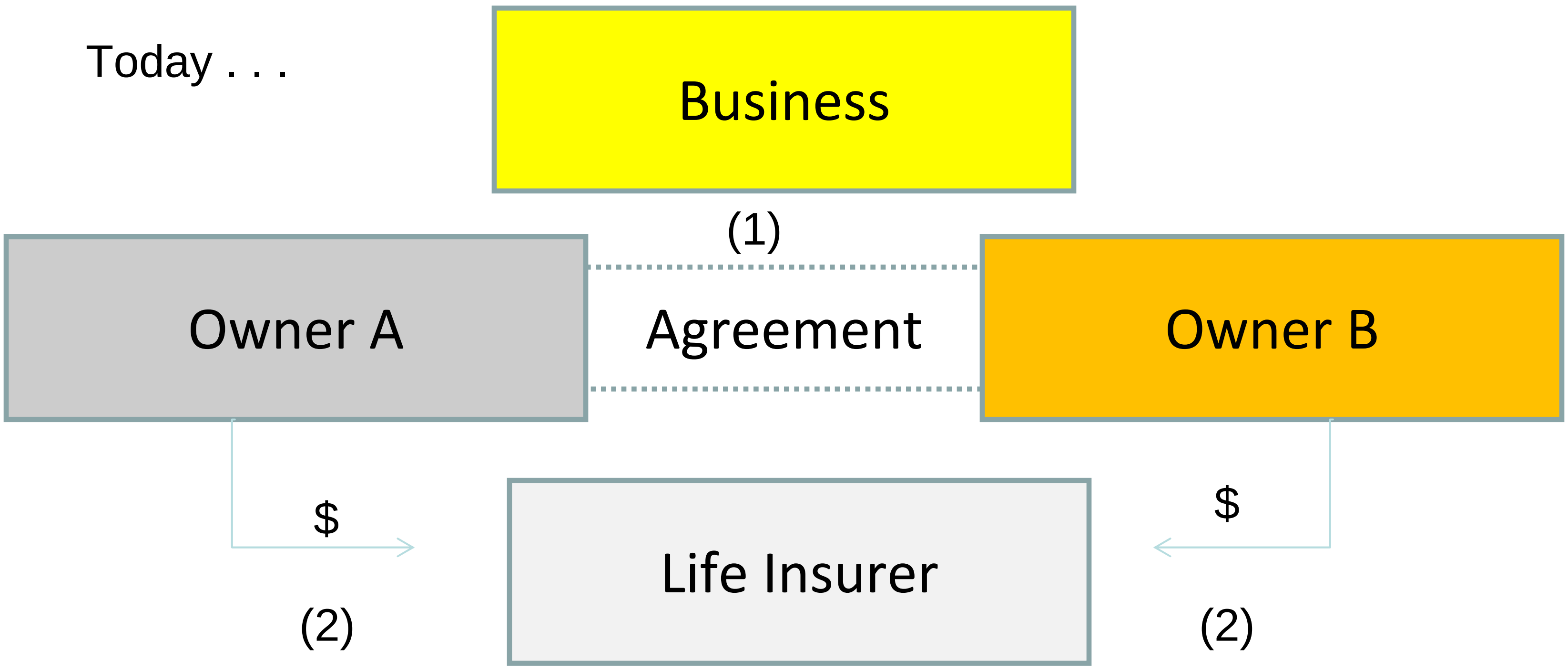
How the Agreement Works:

3. Business receives generally income tax-free insurance proceeds.
4. Business uses cash to purchase owner A's business interest.
5. Surviving owner B now owns 100% of the business.



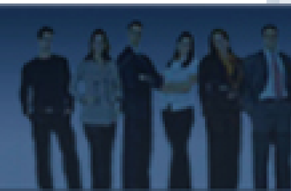
Cross-Purchase Agreement

Today . . .



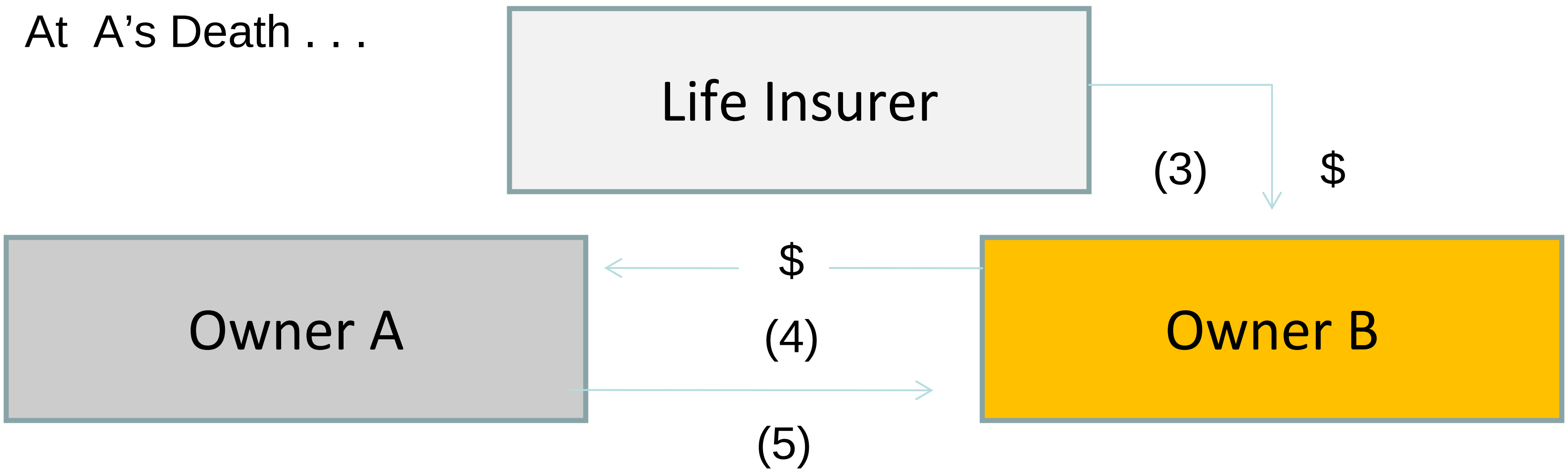
How the Agreement Works:

1. The surviving business owner agrees to purchase the interest of the deceased owner.
2. Each business owner individually purchases insurance on the other business owner's life.



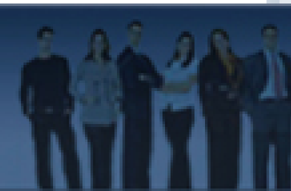
Cross-Purchase Agreement

At A's Death . . .

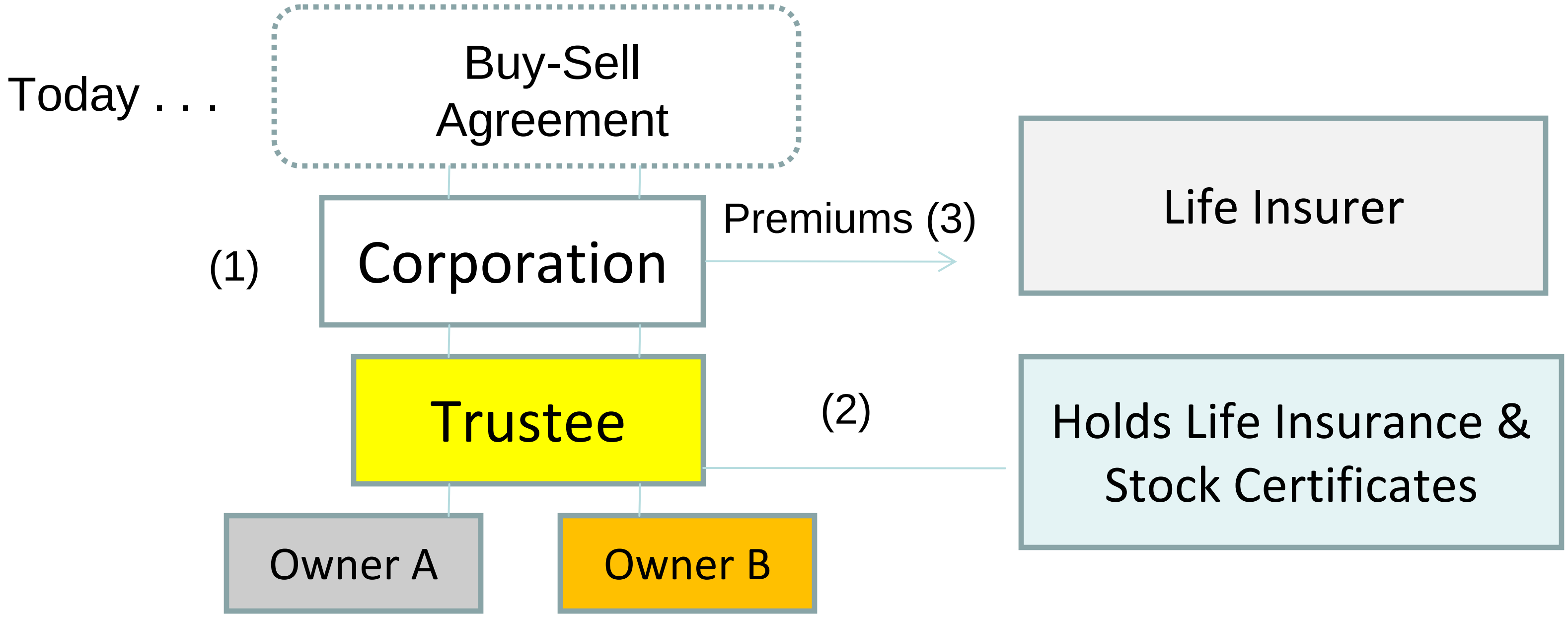


How the Agreement Works:

3.The surviving owner B receives generally income tax-free insurance proceeds.
4.The surviving owner B uses the policy proceeds to purchase owner A's business.
5.The surviving owner B now owns 100% of the business.



Trusteed Cross-Redemption Agreement

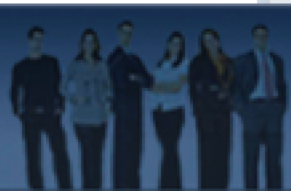


How the Agreement Works:

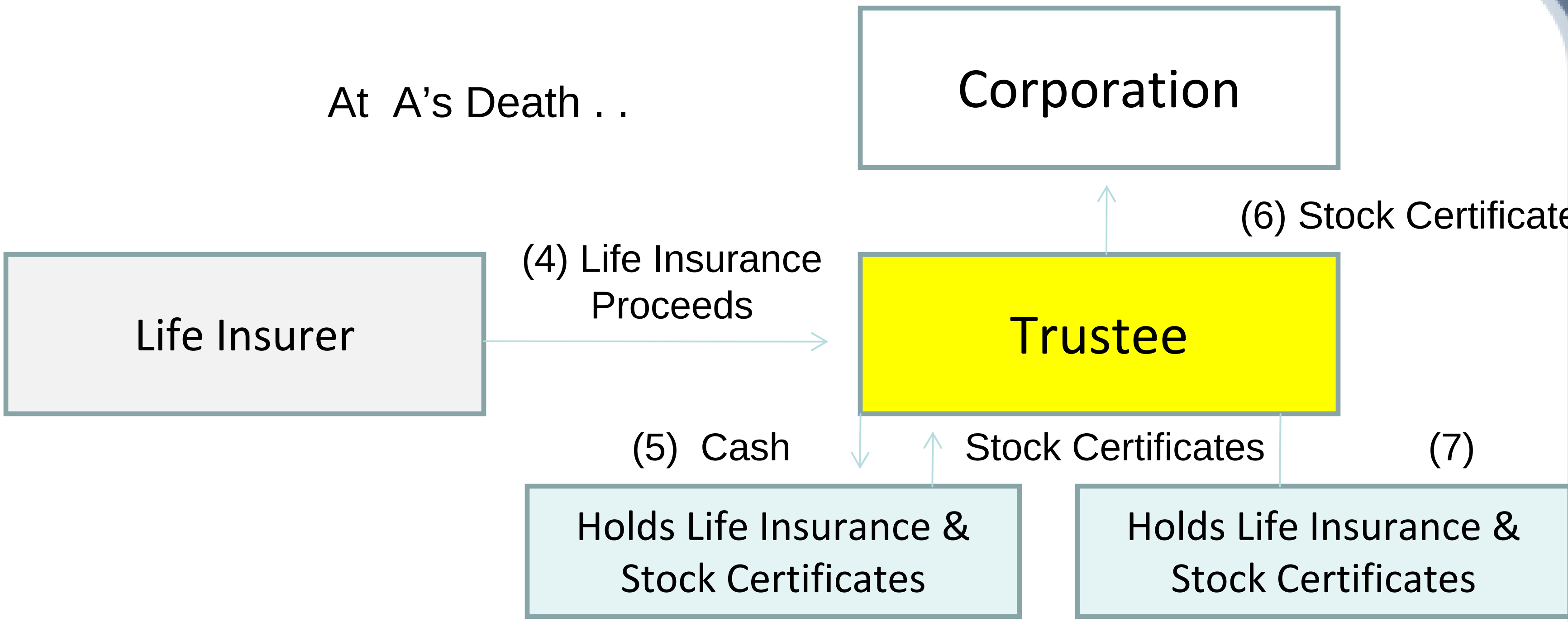
1.Owners agree that upon the death of an owner, the Corporation will redeem his/her entire stock interest. They adopt a Trusteed Cross-Redemption Plan.

2.The Corporation purchases life insurance on the life of each owner to fund the redemption with the Trustee named as owner and beneficiary. The Trustee receives stock certificates and holds them in trust.

3.Premiums are paid to Life Insurer – by the Corporation.

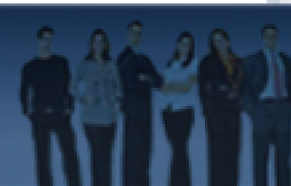


Trusteed Cross-Redemption Agreement

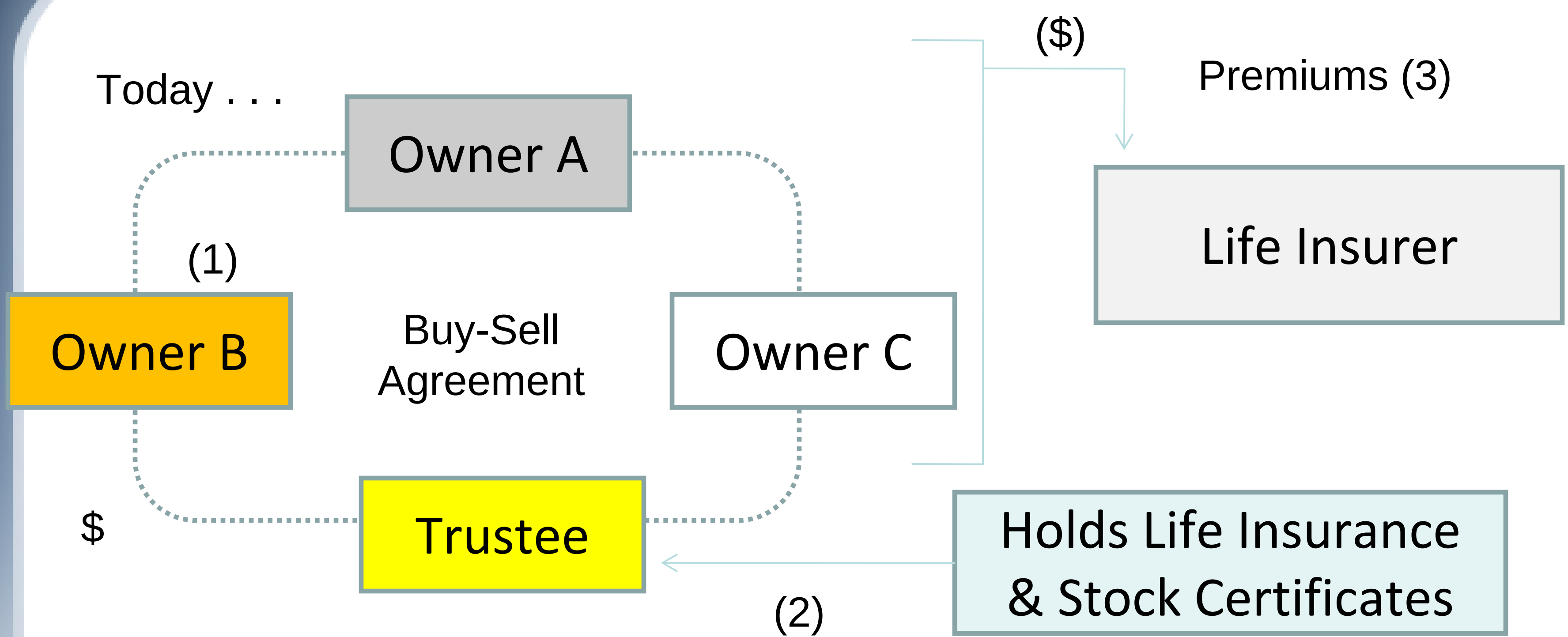


How the Agreement Works:

4.Upon the death of Owner A, Trustee receives the proceeds of the policy.*
5.Trustee uses the proceeds to purchase the stock certificates from owner A's estate.
6.Trustee releases A's stock to the Corporation in accordance with the terms of the agreement.
7.B now owns 100% of the outstanding stock.



Trusteed Cross-Purchase Agreement

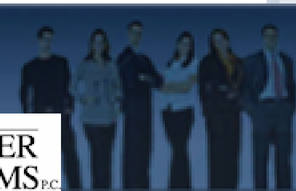


How the Agreement Works:

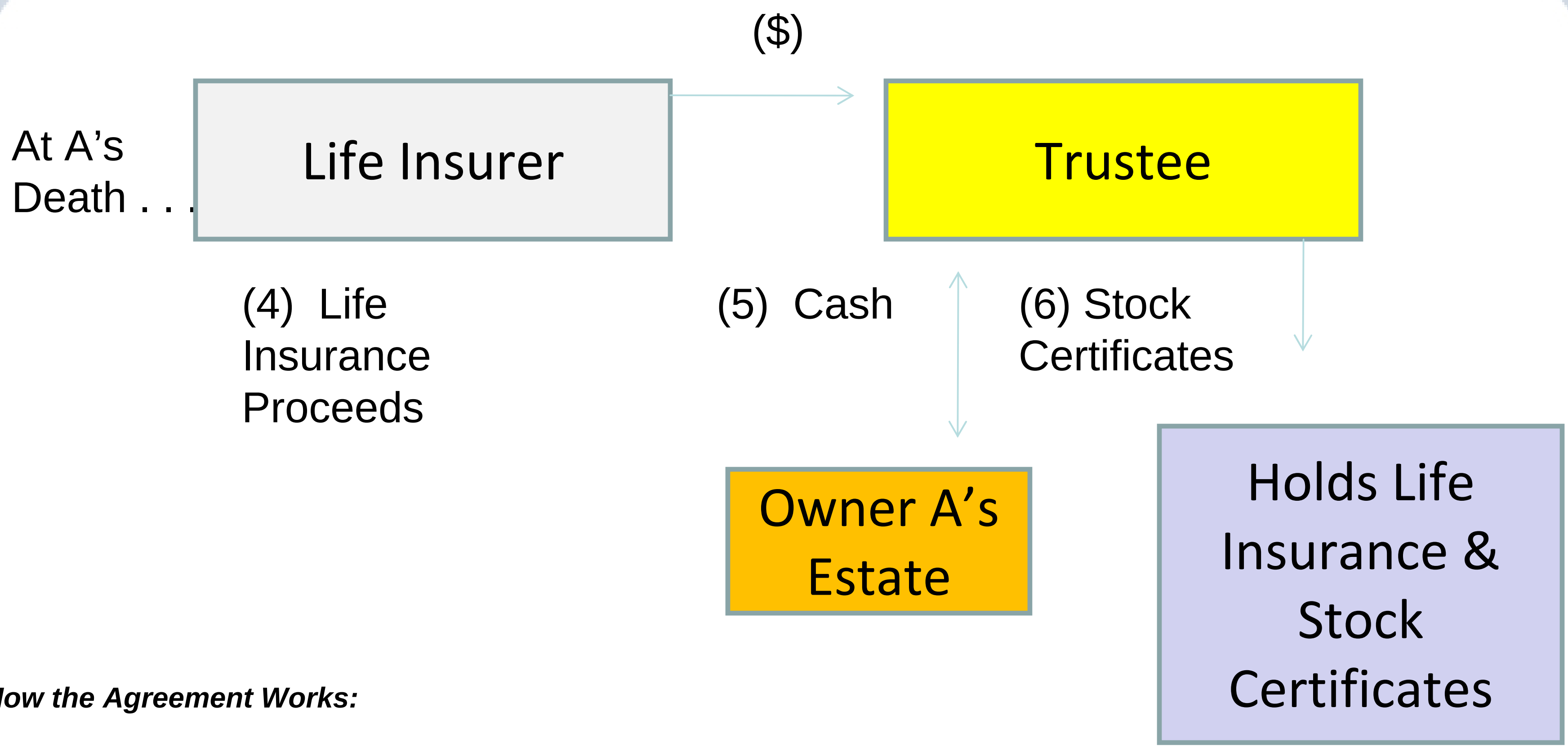
1.Owners agree that upon the death of an owner, the survivors will purchase his/her entire stock interest. They adopt a Trusteed Cross-Purchase Plan.

2.Life insurance is purchased on the life of each owner to fund the agreement and certificates and holds them in trust.

3.Premiums are paid to Life Insurer – either by the owners or through a Split-Dollar Plan.*

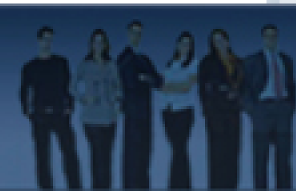


Trusteed Cross-Purchase Agreement



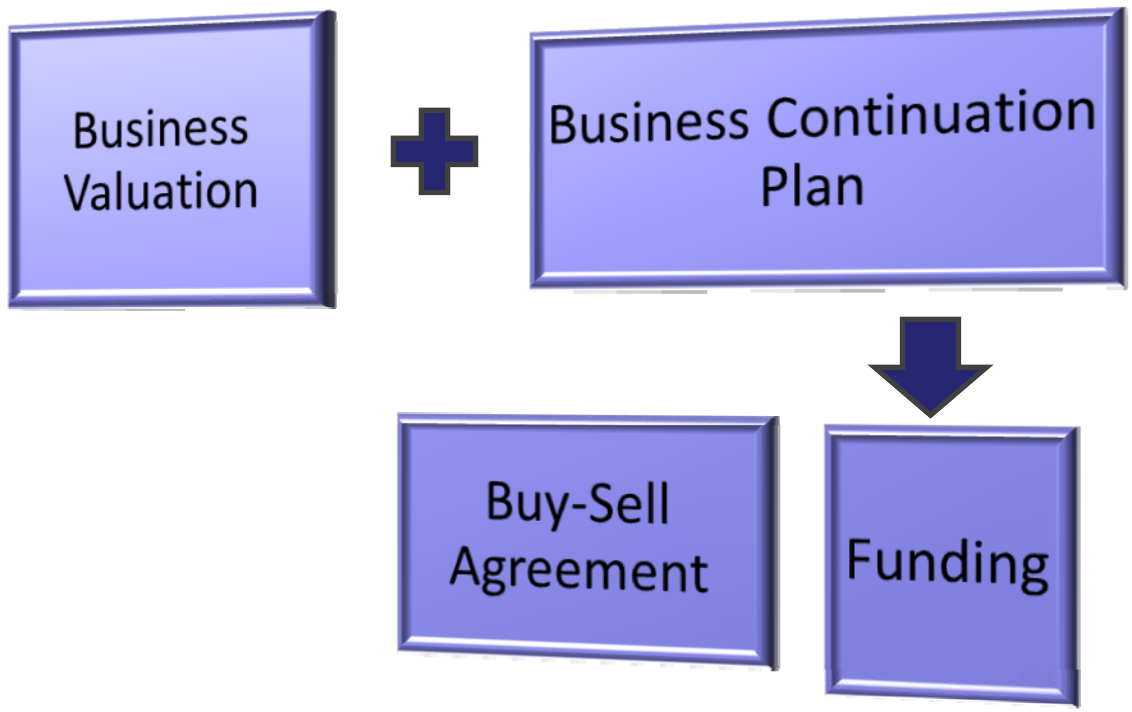
How the Agreement Works:

4.Upon the death of owner A, trustee receives the generally income tax free proceeds of the policy. *
5.Trustee uses the proceeds to purchase the stock certificates form owner A's estate.
6.Trustee releases owner A's stock to B and C in accordance with the terms of the agreement.



Business Succession Planning Fundamentals:

Traditional Plan



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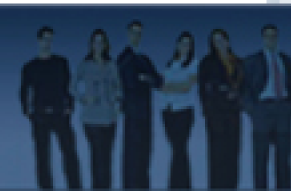
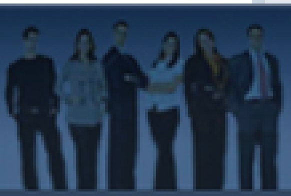


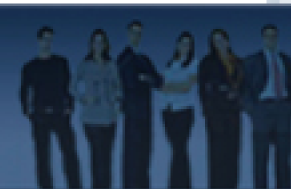
Funding Techniques

- Cash
- Sinking Fund/Reserve
- Borrowing
- Installment Sale
- ESOP
- Insurance



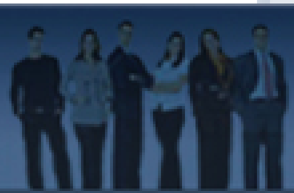
Insurance Payment Strategies

- Cash
- Financed
- Split Dollar
- Profit Sharing Plan



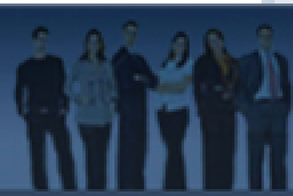
Funding Technique: Cash

- **Cash (Terminal Funding)**
- Advantages
  - Simple
  - No Immediate Outlay
- Disadvantages
  - Cost – Full value of business as determined in buy-sell agreement
  - Cash may not be available when needed
  - Adverse affect on cash flow may be harmful to business operations.



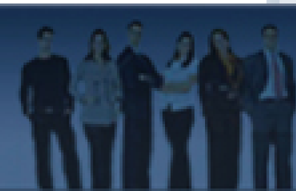
Funding Technique: Sinking Fund/ Reserve

- **Reserve (Sinking Fund)**
- Advantages
  - Simple
  - No Immediate Outlay
- Disadvantages
  - Cost – Full value of business as determined in buy-sell agreement although interest may be earned on the reserve, which reduces the cost of this alternative
  - Death may occur before sufficient funds are accumulated
  - Business may not make annual contributions to sinking fund because of other expenses



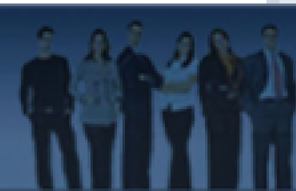
Funding Technique: Borrowing

- **Borrowing (Bank Loan)**
- Advantages
  - Simple
  - No Immediate Outlay
- Disadvantages
  - Cost-Full value of business as determined in buy-sell agreement plus cost of interest payments on borrowed money.
  - Credit may not be available after death of an owner.
  - Surviving business owner may have to borrow at a time of high interest rates.
  - Indebtedness may impair business growth by decreasing cash flow which could otherwise be used for expansion.



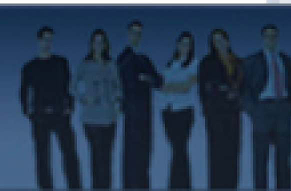
Funding Technique: Installment Sale

- **Installment Sale**
- Advantages
  - No Outflow Until Sale
  - Outflow Reduced
  - Recipients Receive Interest on Unpaid Balance
  - Spread Gain Over Several Years
  - Estate Tax Value Frozen
- Disadvantages
  - Cost-Full value of business as determined in buy-sell agreement plus interest.
  - Heirs may not receive all of payments if business encounters financial difficulties.
  - Business growth may be inhibited by decreased cash flow.
  - Credit, which is needed to finance other business needs, may be impaired.
  - Owner who survives cannot fully realize the benefit from increased profits until installment obligation paid off.



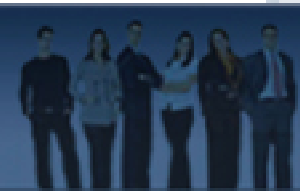
Funding Technique: ESOP

- Overview of ESOP (Employee Stock Ownership Plan)
  - ESOP can be written as a stand-alone plan or can be combined with a 401(k) plan
  - C and S corporations are allowed 25% deductions of eligible payroll for contributions
  - C corporations can deduct dividends if funds are used to retire debt or pay participants
  - Typically, the ESOP purchases between 25% and 75% of the total company's stock.
  - Upon purchase of stock, the ESOP is a single tax-exempt shareholder.



Funding Technique: Life Insurance

- **Life Insurance**
- Advantages
  - Agreement Funded When Policies are Issued
  - Death Proceeds Generally Received Income Tax Free
  - Most Economical Financing Method
  - Credit Position Strengthened
  - Cash Value Can Be Used for Buy-Out Due to Retirement or Disability
- Disadvantages
  - Possible Lack of Insurability
  - Other methods can be used for uninsurable owner
  - Installment Sale
  - Sinking Fund
  - Premium Payments



Suggested Financing Strategy

Hybrid Approach

Insurance

Installment Sale

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NFIB Resources on Selling a Business

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