TABLE of EXPERTS

FAMILY-OWNED BUSINESSES

CREATING A FUTURE FOR YOUR FAMILY — AND YOUR COMPANY

MODERATOR

Sara Freetly-Grubb

Executive Vice President + Partner, candid marketing + communications

Sara discovered her passion for integrated marketing communications while earning a B.S. in public relations at the University of Central Missouri. Having always worked at advertising and PR firms, it was only natural for her to join candid marketing + communications, the firm her sister founded in 2005. Sara provides oversight, strategic direction and marketing communications support for candid clients Logistics Park Kansas City, KCP&L / LocationOne Information System, Likarda, CBC Real Estate Group, McCarthy Building Companies and several area economic development organizations.

PANELISTS

Cameron Bishop

Partner, The Capitus Group

Mr. Bishop's business experience covers a variety business scenarios involving start-ups, product line extensions, organic growth, international business, mergers, acquisitions and deal integration. The majority of his career in management was spent executing leveraged roll-ups for private equity firms. He has extensive M&A and deal integration experience involving nearly 60 buy and sell-side transactions. His work with Capitus Group now emphasizes helping business owners prepare their companies for exit or transition.

Daniel Blegen

Shareholder, Rouse Hendricks German May PC

Daniel Blegen has an active civil litigation practice in Missouri and throughout the country. Mr. Blegen's practice includes a broad array of business litigation, ranging from breaches of contract and business torts, to trade secret theft and unfair competition, to governmental investigations and enforcement actions. Mr. Blegen represents corporations and individuals, both as plaintiffs and defendants. As litigation increasingly involves questions of data integrity and destruction of evidence, the unique experience and expertise Mr. Blegen offers in the area of computer forensic investigations provides an added benefit to his clients.

Lori Dean

President, Lori Dean Consulting, LLC

As President of Lori Dean Consulting, LLC, Lori assists private & family owned businesses in defining a shared vision plan for future generations. She spent over 25 years in her own large family business and served as a 2nd generation Chairperson and CEO. She understands first-hand the emotional and tactical challenges that businesses face with transitions. Lori is also an Advisory Director to The Bank of Kansas City and The Rehabilitation Institute of Kansas City.

Ann Swarts

Director, CBIZ and Mayer Hoffman McCann P.C.

Ann provides a variety of tax and consulting services for estates and trusts, closely-held businesses, family-owned businesses, individuals, partnerships, and real estate clients. Ann specializes in estate and income tax planning for family groups, often acting as the family group's CFO. Ann joined the organization in January 1988.

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Nobody likes to face his or her mortality. And many business owners have an equally hard time picturing anyone, even their children, running their companies. But most financial, legal and business experts would tell you that a succession plan is almost as important as a business plan.

Recently, Sara Freetly-Grubb, who owns Candid Marketing + Communications with her sister, led a discussion for the Kansas City Business Journal *about how business owners can best tackle this difficult task. Area experts offer tips specifically tailored to the needs of owners of family businesses about how to plan for succession and maximize their companies' value while creating the most options for family members.*

Sara Freetly-Grubb: How do you get clients to start planning for the succession of a family business?

Ann Swarts: Oftentimes, they're forced into it due to health issues or because a third party is courting them for a possible sale. I think it's better if you can show them there's a very slim chance a family business will stay in the family unless they start planning now. It's generally accepted that only 30 percent of family-owned businesses are passed to the second generation and that only 10 percent make it to the third generation.

When talking with owners, I also like to ask whether they would like their grandchildren to be a part of this business and/or to be able to help their grandchildren out financially. It's often clear that the owners are more motivated to follow through with their planning process for the benefit of their grandchildren than for their children.

Lori Dean: Company founders often have a hard time beginning that dialogue with family members. One approach that can help is creating a shared family vision. When you start talking about that you bring up issues that sometimes even the founders might not have considered previously. Oftentimes, founders are concerned with one version of the Golden Rule: He who holds the gold rules. As long as the money passes down then the assumption is everything's okay and they don't want to, don't know how, don't know where to start or are afraid of dealing with the emotional side of the family business. So sometimes just beginning that shared-vision dialogue can go a long way.

Freetly-Grubb: To that point, if keeping the business in the family is important to the founders or to the family members, what obstacles have you seen standing in the way of that?

Dean: One is not having the right documents in place. You may have identified the person or persons who you want moving forward in terms of management but if you get hit by a train and you don't have the documents in place then what you want may not occur.

Lack of appropriate planning for the estate tax liability can get you off the track pretty easily, too. Uncle Sam wants his share at any given point in time. If you do the right planning then you don't have to worry about selling the business to cover the estate tax debt.

Family relationships can be the biggest obstacle. As a founder, you may believe that one or two people will be really qualified to run the business. However, that may not seem fair to other family members. How are you going to deal with those internal family relationships? "Not all families are driven by equal vs. equitable. A better solution often lies in equitable vs. equal," says an advisor I work with at Auctoris. Those can be very difficult conversations to have.

Cameron Bishop: Lori's right that opportunities to transition the business to the next generation can arise. But statistics show that option is diminishing for baby boomer company owners because their millennial generation children have no interest in moving into mom and dad's company. So the alternatives then are to either establish some kind of an ESOP or management team buyout or a direct exit.

Dean: Another option that's okay, but challenging for some people, is passive ownership. You can put professional managers in place and trust the business stays within the family under that ownership group.

Bishop: I agree 100 percent. The biggest challenge we see there is that these company owners often own all the client relationships, and it's one of the greatest impacts on value creation. They own all the business process knowledge. And they've been unwilling to delegate or invest in any kind of transition management staff to come in so that they can have that passive ownership.

Dean: When my dad was in his early 50s, he started thinking about his children and the future of his company. He put the guts of a financial plan in place. But the management plan was a struggle because we were in our teens and 20's and not ready or equipped to lead the business. So he brought in a professional manager. Part of the manager's contract was to bring along and teach family members to give them the opportunity to grow and see if they wanted to come into the business.

Freetly-Grubb: What do you think is the biggest mistake that family business owners make regarding their business?

Bishop: As I said, the broad answer to that question is that they simply don't plan for a family transition, management transition or an outright sale. But even when they do, they often miss two subcategories. Number one is the technical aspect of planning, such as making sure their accounting structure is right and assessing whether there are impediments to either selling or transitioning the business—having no management successor in place, for example.

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The other factor is that they often aren't emotionally prepared. They have not developed a plan for life after running the business. I have spent a good part of my career doing leverage roll-ups for private equity firms. Many business owners we bought companies from would see a pot of gold at the end of the rainbow and a life without the stress of running a company. But the day after that check hit the bank account, some of these people would crash and burn because they had no life plan.

It becomes even more complicated if they're selling the business outright or even if they're transitioning to younger generation. Usually, a buyer of a business wants that manager to stay on board for a period of time, usually a year to two. That allows the buyer to mitigate risk and have complete knowledge and customer relationship transfer. That change in dynamic can be even more difficult for business owners, because they are used to calling all the shots.

So in our practice, we spend about half of our time in a technical role, helping them to establish and structure the business operationally and the other half is sort of a Dr. Phil role, to help them think through their life plan post company ownership.

Freetly-Grubb: So Dan, Cameron just mentioned emotions. And I would assume that in your line of work, especially when we're talking about family-owned businesses, that sometimes emotions are what get people into potential litigation. What do you think are the best methods to prevent disputes that lead to potential litigation within family-owned businesses?

Daniel Blegen: With family-owned businesses, disputes are often much more personal. I counsel my clients who are the generation who started family-owned businesses to remember how emotional business decisions can become. Obviously, many people have a strong desire to leave something for their children. They want their children to take over the business. They have this grand vision of this being a 100-year-old company with multiple generations of the family involved in the business.

But you have to factor in your family's dynamics. Can the family dynamic handle the transition of ownership for this company? Is there a situation in which the siblings all can work together? Do they get along well enough? Do they currently work together in the business? Is there one child who is directly engaged in the business and wants to run it? Will the other children be willing to just be passive owners? You have to consider all of that.

And if you don't think your children can handle the co-ownership aspects of that succession, then, despite your dreams, I think it's important to really take a serious look at whether that is the right answer. Your well-meaning intentions to pass on the business may create family conflict for generations after that. I've seen many family-owned businesses in the second or third generation end up in legal fights that cause the company to be sold to a third party because it's unsustainable because of the money being spent on lawyers and the loss of value of the company from the fighting, and that's not how you want to transition.

I strongly encourage clients to consider what is best for the next generation. Which would be better for their children and grandchildren—passing the business to them or selling the business and passing along stock ownership or the estate-based proceeds from the sale of the business to them?

Freetly-Grubb: Let's dig into what common techniques are being used to transfer family businesses.

Swarts: I advise small family-owned businesses—the $2- to $30-million businesses—about the annual exclusion gifting and the use of the lifetime federal exemption. The annual exclusion gifting is where you can gift up to $14,000 a year to each individual and pay no gift tax without using any of your lifetime federal exemption. The federal exemption is currently at $5,430,000 per individual, which would be over $10 million for a married couple filing jointly. So you can use that $10 million and gift the family business during your lifetime or you can do it at death. Whatever you haven't used during your lifetime, you can use at death.

You can do this by transferring assets to intentionally defective grantor trusts (IDGT). An intentionally defective grantor trust is an irrevocable trust designed so that contributions to the trust are considered completed gifts for gift-tax purposes even though the trust is considered a grantor trust per income tax purposes. So that's where the defect comes into play, and that's a good defect. We like that. Selling your business to an IDGT rather than to your beneficiaries outright allows you to retain control over the business during the trust term while still enjoying the significant tax benefits.

You can simply give your business to an IDGT, but an installment sale to the trust offers a couple of key advantages. Selling the business avoids gift taxes. You create an installment note. Once the note is paid off, the remaining trust assets pass to your beneficiaries tax-free. And the regular installment payments provide the owner with a tax-free income stream.

I also want to point out that with the current low-interest-rate environment, selling to the IDGT is a very attractive estate-free strategy. If assets associated with the installment sale appreciate more than the interest rate, the increase in value will benefit the IDGT. A sale to the IDGT freezes that value of the property sold for the value of the note received and the future appreciation and the value of the family business is transferred to the next generation. The value of the notes is

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included in the grantor's estate. If the grantor fails to survive the term of the note, no sale is recognized. Therefore, there's no capital gain tax because the grantor and the trust are considered to be the same taxpayer.

Freetly-Grubb: What elements need to be in place for a successful succession plan?

Dean: The first two most people think of are ownership and management. And it sounds odd but those are probably the easiest two. The other elements are more challenging. Who has the authority? Who's looking at the relationships among the family? Who is managing the relationships with the vendors? How are you going to transfer the founder's knowledge to successors? How do you get a family member exposed to that knowledge? And probably the single biggest thing is the values of the family.

As I said earlier, creating a family-vision statement forces you to identify what's important to the family. That dialogue may reduce some of the litigation risk because now you're starting to include others in your thinking as a founder and creating something bigger with the vision statement for everyone to rally around.

Blegen: I agree and think a lot of those issues could be headed off by having that kind of conversation and defining the expectations and the roles of the siblings and second- and third-generation members. And as mentioned earlier, capturing the knowledge of the founder is important. Family-owned businesses tend to be a little less formal in their business practices. Investing in some formalization of business processes and rights can help the transition to a subsequent generation because it's all documented and everything's ready to go.

Freetly-Grubb: When should family-owned business owners start thinking about bringing in an outside expert to help with that transition?

Bishop: That depends on the situation. If you have a really young generation coming in, you may need five to 10 years. If I were advising an owner, I would have that young generation start right at the bottom and learn the business and grow through the different areas or disciplines in the business. That seldom occurs. The second option is for younger family members to work outside of the family business first to be exposed to different ways of doing things.

Dean: I think working outside of the family business offers two main benefits: It gives the family member a higher level of self-confidence, and it gives that family member credibility with other employees in the business.

Bishop: One issue that doesn't get discussed enough is the sudden death of a business owner who ran the business, managed the primary customer relationships and possessed either all or most of the business process knowledge. It often destroys the company because they have no succession plan and they have no one who can step in and sustain the business. It's massively disruptive on an economic level and on an emotional level for the remaining family members.

The family often ends up walking away with simply liquidation value for the business, essentially inventory on hand or maybe real estate, so there's no retained value for that family for the lifetime of that owner's work in the business. That's especially the case in service-oriented businesses.

Freetly-Grubb: What tools do you need to start this process and when in the company's life should you do this?

Dean: If you own a family business then I think you have a fiduciary responsibility to that business to plan for succession. Even if you only have one employee, you have a fiduciary responsibility to that employee to ensure the success of that business at any given point in time. So you have to start planning now, regardless of the size of your business.

When you start planning you begin the dialogue with yourself: What is your long-term vision? Is it an exit strategy? Are you building this to build value and sell? Are you building the value to pass along to your family? Each one of those answers takes you on a very different path.

Bishop: Our process really begins with a pretty deep conversation about what they want out of life. After we've established what it is that they want personally, then we'll evaluate the business and then build a proposed plan. Every plan that we create with a client is relatively unique based on their personal goals and timetable. We try to help them achieve that goal.

Part of that plan is not only growth and value creation options but also risk mitigation. Then we have a final exit execution, again, whether it's a transition or a sale or an ESOP.

Blegen: Every step of the way you're planning for that sudden change. It's making sure that you have an appropriate will. It's dealing with correct documentation of the various things your company does and that includes rights. It's dealing with what you want your children to know about how you run this business in the event they have to step in.

Planning also protects your customers. If the owner dies, what happens to your customers that relied upon your business that has your family name on it? What do you want those customers to remember? Family businesses tend to be, if nothing else, a bit of a memorial to the hard work of the family member, and you don't want that hard work to be undone because of poor planning.

Freetly-Grubb: That's a great point. So, after the plan is made, is the family done? Can they sit tight until the next generation's ready or should they keep continually working on their plans?

Swarts: They have to keep working on their plans. The plans have to be modified continuously. Some of the techniques are rather complicated, and there are issues that need to be monitored yearly to determine the appropriate treatment. The intentionally defective grantor trusts I referred to earlier, for example, need to be monitored regularly. There's a lot of planning involving cash flow, income taxes and estate taxes. Somebody needs to be functioning as the family's CFO to monitor all of this.

Freetly-Grubb: Sometimes, trust issues come up within the family. How do you recommend dealing with those kinds of things throughout this process?

Dean: Trust has many facets to it. Sometimes, it has to do with honesty and that is pretty straightforward. Is that person lying? Is that person stealing? If the family member is not an honest person then you have to deal with it instantaneously. You lose credibility and the business suffers if you put that kind of a person in the business at that point in time.

Trust issues can also involve competence, professional and personal. Does that person have the skills to do what you're asking them to do? If not then you're faced with another question which is - do you have time to build that skill and knowledge level and the personal characteristics for the younger generation to succeed?

Do they have the commitment? The generation that's coming up is changing careers every seven years. So re-evaluating the generational differences comes into a commitment conversation within a family today. What if the family member is running another business? Are they going to fully commit their time and energy to this business?

If you're looking at bringing a person into your family business, can they create the vision? Can they create the leadership team? Can they guide that business where it needs to go? Do they have courage? Do you trust their ability to have those hard conversations?

At the end of the day, as I said earlier, there is a fiduciary responsibility to the business. When you're in a family business, the way I look at it, balancing the needs of the family with the needs of the business is an art not a science. And sometimes you have to have those hard conversations with your family. Those conversations are much easier if there is a shared-vision plan.

Bishop: One element that many family companies don't understand is that it really takes a village to help them through this process and to execute it at an optimum level for them. I'm a believer in, "Know what you know and do it; know what you don't know and find an expert to do it." So we often coordinate a team of these specialized experts that have skills and knowledge in areas where we aren't experts, like complex tax structures, for example.

The advisers have to talk to each other, and they all have to understand what's going on. Many times, a company owner isn't in a position to do that because they're busy running the day-to-day business. And in both transition and exit situations, it's a highly emotional process. Sometimes owners need someone to help them to stay on track and stay rational as they work through the process.

Freetly-Grubb: How can family-owned businesses prepare for potential litigation?

Blegen: A big step for family-owned businesses is to be more formal in their processes, have their documentation in place and have their rights preserved. Smaller businesses often do not have the appropriate insurance either. It may be they don't have enough. It may be they don't have the right policies. It may be they haven't thought about their exposure. For example, a director's officer policy exposes the siblings that run the business to personal financial liability that they may not have had to face if they were insured.

That's not something you think about when you start a business and it's just you. But that's an area you can plan for and can help prevent a dispute from becoming a company-ending dispute.

To follow up on what Lori said on the trust issue, transparency can prevent unnecessary disputes. As the parent and founder, make sure everyone understands what's going on and instill that in your kids. So when one of the kids takes over the management of the company and the other kids are just owners who sit on the board, have the board meetings, explain to the family members what's going on and make sure they understand the direction of the company. Make sure they know why you're making the decisions you're making and make sure they don't feel like you're not telling them something.

A lot of the disputes that I see arise from a sibling who's a passive owner feeling that the active owner was taking advantage of the company or is taking too big a salary or is benefiting themselves on a related investment that they didn't bring to the family business as an opportunity. So the transparency of that management prevents a lot of disputes from arising and that's just an important step and that's something that a parent can teach the children as they're teaching them about the company—that they need to make sure everyone is up to speed on what's happening at least on a macro level.

Freetly-Grubb: Is there anything else you'd each like to add?

Swarts: There are different techniques you can use when trying to be equitable with the family members who are in the business and those who are not. You can have voting and non-voting interest. They can all be involved and all come to the table in some manner, but the family members who are in the business have the voting interest.

You can also purchase life insurance for the family members that aren't in the business. And you can segregate the business owners' assets between business assets and the non-business assets and allocate the non-business assets to the non-business family members.

Bishop: Whether the company's moving forward via an exit or through a transition, it's a very complex process that's fraught with emotion in the best of circumstances. And it begs the need for outside, independent advisory help and support. It almost always pays off in significant return on investment, whether it's just being able to sleep at night or increasing value in the business.

Dean: I agree. The family-shared vision can align the cadre of advisers you have: These are our values. This is what we are trying to achieve. Mr. or Ms. Tax Person, how can we make this vision happen? Mr. or Ms. Lawyer, how do we make this vision happen? It guides and informs conflict resolution. This is a huge key piece that informs the actual creation of the documents.

There is the right time, the right method and the right place for this conversation. And oftentimes it does require an outside facilitator to make sure it goes down a productive path.

Blegen: There is a strong pull for entrepreneurial people who have established a company to leave a legacy for their kids and for their community. But as much as they may believe that that is doing something good for their children, they need to do a serious assessment as to whether it is better for their family to leave the children the inheritance from the business rather than the business itself.