

Succession and Planning In Family Businesses: The options and Pitfalls

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1 - Introduction

About the Author

I have grown up alongside a family business and became professionally involved in advising family businesses over 15 years ago early in my legal career. I have acted for and advised a variety of family businesses and families in business dealing with both the business affairs of the income producing asset (the family business) and the succession issues affecting the family itself (the family inside and outside the business).

About this Book

This book aims to review the use, and in some cases misuse, of different vehicles and structures at a professional's disposal when dealing with succession issues around a family in business. It considers the options available to family business owners and seeks to demonstrate that, through understanding the options and potential pitfalls, a family business owner can make informed choices that enhance the chances of a successful transition. Later in the book I liken the family business to the Goose that lays the golden egg in Aesop's fable. Succession planning is the balance of caring for the Goose through multiple generations (where the Goose could be likened to the family business or family harmony) and utilising the golden egg - the income and wealth generated by the goose.

Whatever challenges you are facing, my team at MLP and I can help by using our strong understanding of family businesses and our experience in dealing with a whole range of issues.

The commentary in this book is for general use only and should not be relied upon as legal advice in any particular case. Always seek advice relevant to all individual circumstances. Although based on UK law at the time of writing, I believe that the commercial and common-sense points made in this book could and should apply to families in business wherever they are based. Legal advice must always be sought in the local jurisdiction.

Stephen Attree

2 - Background & Problem

Family businesses are enjoying greater recognition as major contributors to the UK and international economy.

Professional advisers can often fall into the trap of treating them as 'just another SME'. A different level of skill and understanding is required to advise family businesses and choosing the right advisers is critical to helping ensure successful transitions for current and future generations.

Research suggests that around only 30% of family owned and run businesses make it through to the second generation and less than 10% make it through to the third staying within the same family ownership.

Succession planning is the single biggest concern for family business owners. How to effectively and successfully pass the business on and simultaneously achieve financial independence from the business are significant weak points in an owner's preparation.

Tax and Succession

Too often advisers focus on their own ability to solve a problem (that is what they perceive they are paid for). Not so, in my view. The transfer of a family business requires detailed, careful and usually lengthy planning. Tax and financial efficiency is just one factor of many. The business, managerial, strategic, emotional and family needs all play a part and need balancing. The competing needs weigh heavily on the incumbent owner(s) and their decisions. An adviser who approaches the issue solely from a limited range of experience does the family, the founder's legacy and themselves a disservice.

Generally, succession follows one of the following patterns (or a selection of the following):

- The oldest heir
- A selected group of heirs
- Separate classes of shares (e.g voting for those working in the business and non voting for those outside the business)
- To family members in the business
- To all heirs
- To a family trust(s)

Key questions, that should be addressed many years in advance of a transition, include:-

- Who should own the business in the future
- How to reconcile the interests of family members in the business and those who pursue other interests (including home making and children)
- What do the next generation think of ownership (and leadership)
- Is a leader readily identifiable (naturally or with training)

Charter

As the next Chapter (Chapter 3) sets out in more detail, a Family Charter or Constitution is an expression of the key principles and motivations of the family. A Charter should be used as a framework for the conduct of the family in their dealings with the business. There are many different definitions, but setting down the key principles is a crucial first step in the family's journey to a lasting legacy and a meaningful transition.

The process of its creation is as important, if not more important, than the document itself. The Charter should be the reference point for the creation of all other binding (or non-binding) arrangements, such as: governance structures, Family Councils, Assemblies, Executive Boards (or committees), shareholder / partnership agreements and trusts.

The problem

We still see too many advisers that do not understand the complexities of a family business. In some cases they may appreciate some of the issues but choose to ignore them in a rush for a quick fix within their own, limited sphere of expertise. The result is a plan that will not or certainly has less chance of succeeding.

Ignoring these crucial first steps, failing to ask the right questions at the outset, and proceeding with complex strategies that optimise the estate planning or tax efficiency of the incumbent generation (trusts) leads to misunderstandings, misalignments and unmet expectations. A plan and structure that ignores the needs of the business and / or the next generation will not stand the test of time nor secure the incumbent generation's legacy.

Trusts are a common and useful tool in the planner's toolkit. Trusts created on death by a Will are tax efficient, but this requires the ownership to still vest in the deceased at date of death. The next generation want to succeed and get on with it. If any child has the capacity to run a successful business are they likely to patiently wait for the incumbent to abdicate or die? Trusts can be created during the lifetime of the owner (current owner) but there may be fewer benefits and there are alternatives that need to be considered: the Family Investment company or partnership.

Changes in regulation a number of years ago made Trusts a less attractive lifetime planning option. They are still widely used and can be very effective in the right circumstances. Chapter 4 will explain further that Trusts can be seen as an attractive option to incumbent owners, but their use must be weighed against the disadvantages:-

- Separating ownership from control
- Binding on successor generations : will your grand children thank you when the trustees take a risk averse approach to every proposed business decision in a rapidly changing market and economy?

Are Trusts fit for use in Family businesses, are they over used and what are the alternatives?

3 - Family Constitutions / Charters

The family business - the goose that lays the golden egg.

I liken the family business and the enterprise of the family around the business to the Goose that lays the golden egg in Aesop's fable. If you fail to look after the goose - the love understanding and compassion of the coherent family (albeit the family itself can be large and unwieldy) - it is likely, if not a certainty, that the golden eggs (the wealth derived from the family business that sustains the family) will dry up / be lost. Family governance then, at its fundamental level, is the balance between caring for and protecting the Goose and implementing the framework for sharing keeping spending the golden egg, family harmony, it produces. Focus too much on one at the peril of damaging the other.

I am sure if you, as the reader, are a family business you will benefit from thinking for a moment on the analogy. How much time and effort do you spend on caring for the goose, the succession plan and the legacy? How much time do you spend on planning the investment and placement of the assets and capital generated? Are the two in balance?

The same effort should be put into succession management (of the family in business) as to employee development and management succession in the business.

A structure of governance for a family succession plan is essential. Whilst an individual family will require a solution as unique as its own circumstances, there are common themes to each family plan.

When embarking upon the process it is critical that the founding or incumbent owners see the preservation of the family legacy and the protection of wealth through multiple generations as key objectives. Only then is it likely that the time and effort to create a meaningful and lasting charter will be sustained to ensure a successful succession plan. By that I mean a plan that is implemented, observed and used for the benefit of the family and future generations.

Mission and Values

The process would establish the key mission and values of the family that are then shared with the family. Family "Buy in" is essential and the process of collaborating with and involving the family at each stage of the process is an important ingredient for a successful charter.

Formal bodies

Through the advisory process different structures will be recommended and implemented. They may or may not include titles such as: Family Council and / or Assemblies, Executive Committees or Family boards, Junior leader meetings (future leaders). Whatever combinations and titles are used it is the framework and rules embedded within the structure that is the most important aspect of the process. Each family is unique - the sum of the individual family members make up the sum of the whole.

Codes of conduct (non binding) and privacy agreements (binding) can be employed where necessary by the family direct or through the family office (depending on family size) and can be a useful mechanism to involve the wider family. The process should place emphasis on enhancing understanding, aligning expectations and eliminating uncertainty for all family members (and spouses current and future). A robust process and governance will also address the requirement to educate future generation(s) (from central funds) on the principles of family business, the burden of ownership and the benefits to be gained, and used to identify and develop future family leaders. Collective good should never limit the ability of individual members defining and exploring their own individual goals.

Family office

Many large successful family will engage the use of a family office. Where a family office is used to manage the collective affairs of the family, jointly owned assets, it is important to appreciate those areas that are within the remit of the family office (such as planning meetings, promoting values, creating mission statements, family policies, education shared charitable giving) and those that are commonly not within their remit (such as managing the production capability of the family and its wealth generating assets - this is usually delegated to a board or executive committee of family and non family members). The Executive Committee or Board will make investment and management decisions affecting the capital assets of the family.

Size matters

As with any family the growth through generations is exponential and the business may struggle to cope (unless it is already of a sufficiently large size) with managing the demands of each branch of the family. With 2 founders based on 3 off spring each, by the third generation a family office may be handling up to 26 different family sets (and at least 6 very different branches of the family)!

Binding or non Binding

Opinion is divided on whether Charter's could or should be binding. I believe there should be binding and non binding parts to each Charter. Securing the legacy each founder wishes to leave for future generations requires it. The key is flexibility. This book explains that different structures have the flexibility to be binding and adaptable to future circumstances. Careless use of Trusts can lead to a serious disconnect between ownership, responsibility and beneficial entitlement. This makes Trusts, in the hands of the inexperienced adviser, less beneficial (and even dangerous) when considering the Family's objective of successfully implementing a succession plan, securing a meaningful legacy and protecting wealth for the collective good of future generations of the family.

You will see in the case study (Section 7 below) that in that case a mix of binding and non binding arrangements were used and the binding arrangements had a mechanism by which they could be varied. The choices for decision making are virtually limitless. The family circumstances can drive how to settle on thresholds for collective decision making. Unanimous (100%), simple majority (50 plus 1%), two thirds or 90%, one A voter and any one of 3 B voters, the Golden or casting vote. The list could go on.

Good legal, financial and tax advice can ensure these mechanisms are fully in line with family, company and trust law.

4 - Trusts

There are very many different types and uses for Trusts. It is not intended in this book to consider the variety of uses and the detailed advice required around their use. Specialist advice is always recommended. My studies suggest that the main benefits of trusts can be summarised as:

On death

- Tax efficient (Business Property Relief or 'BPR' generally gives a 100% relief against inheritance tax for the business assets that qualify), but family owner needs to hold on to shares until death. Next generation are wanting to take control (and ownership) sooner.
- Can stagger the succession issues and provide income and security for a surviving spouse (before the ownership stake is passed on to the children / next generation). Often business owners considering succession do need (and want) to ensure their spouse is financially secure in the event of their death. Consequently, the Will cannot simply transfer or gift the shares to the children entirely.
- If the children / future successors to the business are not old enough, trusts can be a useful mechanism to hold the shares until the intended beneficiary is old enough to inherit.

The disadvantages (during lifetime or on death):

- Business transfer via a trust is often no substitute for long term succession
- Family owner needs to hold the shares until death = uncertainty. Next generation (and even the one below that) want to take control now. Can destabilise the workforce especially the top non-family performers. If taking advantage of BPR then the business needs to consider how the ownership succession plan will be communicated to the key employees and how they will be motivated and retained (if part or full ownership is now or never on the cards).
- As the owner gets older, capacity (mental and physical) issues come to the fore. Powers of attorney have their limitations and separating ownership and management responsibility can create problems if left for too long.
- Trusts can create ownership without meaningful responsibility or involvement. If used as an estate planning exercise during the settlor's (current owner's) lifetime, the settlor, as the senior person, may remain involved in the business (and a dominant force within it) with key employees and worse, external stakeholders, banks, suppliers, etc., still viewing the senior person as still being in charge. This is unlikely to achieve the long term aims of successful family succession.
- Can give the beneficiaries an interest in the egg without responsibility or any interest in the goose.

Trusts should not be discounted and form a very important aspect of planning, especially when dealing with minors, vulnerable people or financially dependent spouses. That said, the following pages explore the alternative options and set out some general advice to help make sure any structure, once properly implemented remains fit for purpose through successive generations.

5 - Family Investment Companies and Family Limited Partnerships

What is a Family Investment Company (FIC) or Family Limited Partnership (FLP)?

Whilst an FIC and FLP have some structural differences for the purposes of this note the benefits vs a Trust are similar if not the same. The benefits of FIC Vs FLP generally involve a detailed consideration of effective tax rates and individual circumstances. Generally speaking due to the treatment of an FLP as a collective Investment Scheme (CIS) requiring FAS regulated administration they are generally used for high investable pots (e.g. £2m plus) .

In both cases you will have a separate legal entity (the FIC or FLP) that holds family investments. Through use of different ownership classes (Share classes and directorships for FIC and General Partner and member classes for FLP) you can phase and vary ownership and control between different various classes of owner.

For instance, Dad and Mum may retain a controlling vote between two siblings, whilst mum and dad also retain a capital interest in the entity. Siblings 1 and 2 may have all the income rights and general capital rights once mum and dad have been repaid.

These arrangements can have all the benefits of a Trust and can also connect ownership to control of and responsibility for the capital producing assets (the goose).

Benefits:

Very flexible and can be structured to suit individual requirements. Not a one size fits all. Control and responsibility are (can be) aligned.

Disadvantages: BPR benefits may be lost or diminished key benefit of trust, but outweighed in my view in most cases by the commercial need of the business and succeeding generation to 'get on with it'.

6 - Conclusions

Family Charters and Structures : get the right advisers on board early to advise on how to approach the consultation process and achieve a workable solution. The right structures and arrangements properly implemented can, and more often than not will, endure the test of time.

Be wary of trusts: they may be the answer. They may not be. Trusts can be tax efficient and have their uses. They have many disadvantages commercially: lack of certainty, control, authority and responsibility can be detached. Wherever possible in a family business the managers and owners need to have control or at least an element of control.

Trusts with control divorced from management and the family nucleus are not to be encouraged. They are not sustainable in the long term. The well being and care of the goose is not aligned with the class of people who benefit from the egg.

Family Investment Companies / Family Limited Partnerships - Despite the benefits the take up has been relatively small. Largely down to advisor awareness and costs to implement. Estates worth more than say £1m should ask their advisers to seriously consider FICs / FLPs when considering family succession and inheritance. Further, advisers working solely on Wills and Inheritance need to be more aware of the alternatives and the unique demands of planning succession when a family business (or any business asset) is involved and where no clear succession and legacy plan is in place.

Take advice

7. Case Study

A recent case I have dealt with, and want to share with you, highlights several issues/points explored in this book.

Background

Company D, a manufacturing business, was owned 50% each by 2 brothers, Andrew and Brian. Andrew has 3 Daughters and Brian has 3 Sons. Each owner has one child working in the business. The business had been trading for over 30 years.

Objectives

Both brothers wished to transfer their shareholding in the company during their lifetime to the next generation and start planning and implementing their wishes. I had worked with the company for several years on different matters and was therefore involved in this process, from the outset, discussing the best structure and key objectives for both brothers, and the business itself.

Andrew wanted his 50% to go into a Trust for the benefit of all 3 of his daughters. Brian wanted the Son who worked in the company to receive a 25% share.

Solution

After meeting and discussing options and risks with both brothers, the off-spring and wider family, the following arrangements and structures were put in place, including the drawing up of a detailed and clear Family Charter:

- 1.** A trust was set up for the benefit of the 3 daughters. Decisions in the Trust were to be made by a majority vote (2 of 3) provided that the daughter who worked in the business voted in favour. This rewarded the daughter working in the business with more control and responsibility – she had a veto over decisions affecting the business but had to get the agreement of at least one of her sisters for any decision.
- 2.** Brian placed 25% directly with his son working in the business and the remaining 25% in a Family investment Company (with some additional assets accumulated outside of the family business). The FIC was for his and his wife's benefit during their lives and for their 3 sons, who were given separate classes of shares. Voting control: Brian had a veto whilst he was alive. Any decision, once made, allowed Brian's son in the business to exercise the family's block of 50%.
- 3.** In the event of deadlock in the Company (i.e. Andrew and his daughters disagree with Brian and his sons), an extensive dispute resolution procedure was agreed and set out. The solution agreed upon ultimately ended with 3 of the family's trusted advisers being involved and able to vote. This made a total of 5 votes, each block of the family being entitled to a vote as well (with no abstentions allowed).

In addition to the more formal structures in place, a Family Assembly and Executive Board were set up, providing informal guidelines on education, social gatherings and use of wealth generated by the business. Though the next generation are likely to have issues with other assets, both personal and business related, the agreed Charter, at this stage, has created a clearer understanding of the wishes of all parties and the objectives for the business going forward and sets out an informal process for agreeing details later.

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