

ENTERPRISE
Family Business

What to do when “all in the family” stops working

Mike Cohn

Family business succession planning sometimes becomes “stuck” until a less-than-productive family member can be bought out.

Too often, the inability of family members to successfully negotiate through this delicate minefield results in businesses being sold rather than staying in the family.

When parents transfer stock in the family business to active and inactive children, without discussion or preparation, they often transfer future governance problems. For example, what if an inactive shareholder later wants a voice in business strategy or wants to sell some shares back to the business, after mom or dad have passed away?

Without a good shareholder's agreement and a realistic understanding of the business' value, these issues may become full-blown conflicts.

Here is where the adage applies: “No good deed goes unpunished.” Generosity in early years with compensation, bonuses and dividends to less-than-productive family members comes back to haunt everyone.

Example: A 62-year-old sister/aunt who owns 35 percent of a company and hasn't worked in the business, counts on her S-corporation distributions while the next generation wants to cut dividends and fund business growth. Or, a 70-year-old uncle who comes in once a week but



still demands his full compensation and benefits.

Where do families get stuck? The problems and

solutions are in several areas:

1. Don't tiptoe around hard issues. Andy Grove built Intel on a philosophy of “creative confrontation.” That means it's better to get in shouting matches and solve problems quickly than let issues fester for fear of offending someone.

2. Have a family reading of the old buy-sell agreement. If your agreement doesn't provide options to buy or sell during lifetime, then consider amending it. No one wants an elder family member, or sibling, to have to negotiate with family who may not share the same compassion as their parents did.

A “put” or “call” option, which can be included in the buy-sell agreement, is not an automatic trigger, but means that if either side wants to buy or sell the provisions are in place without further negotiation.

3. Use a realistic valuation methodology and keep it updated. Establishing a price, based on a fair market value formula, or an appraisal of a 1 percent interest, can help curb unreasonable expectations about the value of shares, especially for inactive shareholders.

If there is no binding buy-sell agreement, then some negotiations are in order.

In one case, the 72-year-old uncle and the 38-year-old nephew each hired their own appraisers and the conclusions were significantly different. Our firm was hired to help them agree on price and terms. Agreeing on one appraiser, or methodology, ahead of time can save time and money later.

4. Communicate operating results and how they impact share value. Valuations typically are based on three- to five-year rolling results, weighted so the most recent period carries greater impact. Future, projected cash flows may be significantly different than recent history, so educate shareholders on how operating trends and business decisions may impact share value.

5. Separate the family dividend from compensation. The urge to deduct family distributions may backfire later. Too often, the thinking is, if you're going to pay family, you should deduct (for income tax purposes) as much as you can.

This can create unrealistic future expectations while ignoring personal performance. Compensation should be based on individual contribution and level of responsibility, while S distributions (non-deductible) are paid pro-rata to all shareholders.

Letting the income tax impact drive family income decisions causes later problems since family members may come to expect the business "owes" them an ongoing income.

6. Add a crawl-back provision to your buy-sell agreement. Sometimes elders or siblings hold on to their shares since they think the business may get sold to a third party for far more than family members think their interest is worth.

They may be reluctant to sign a buy-sell agreement since it may not give them their best price. A crawl-back says that if an internal, family sale occurs, and the business is later sold to a third party for far more than the seller received in the family sale, then the seller participates financially in the third-party transaction.

The term of the participation is usually for five to 10 years, and the percentage usually declines over time.

A cautious and respectful process may take a real commitment but can result in a workable agreement that both sides view as fair.

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