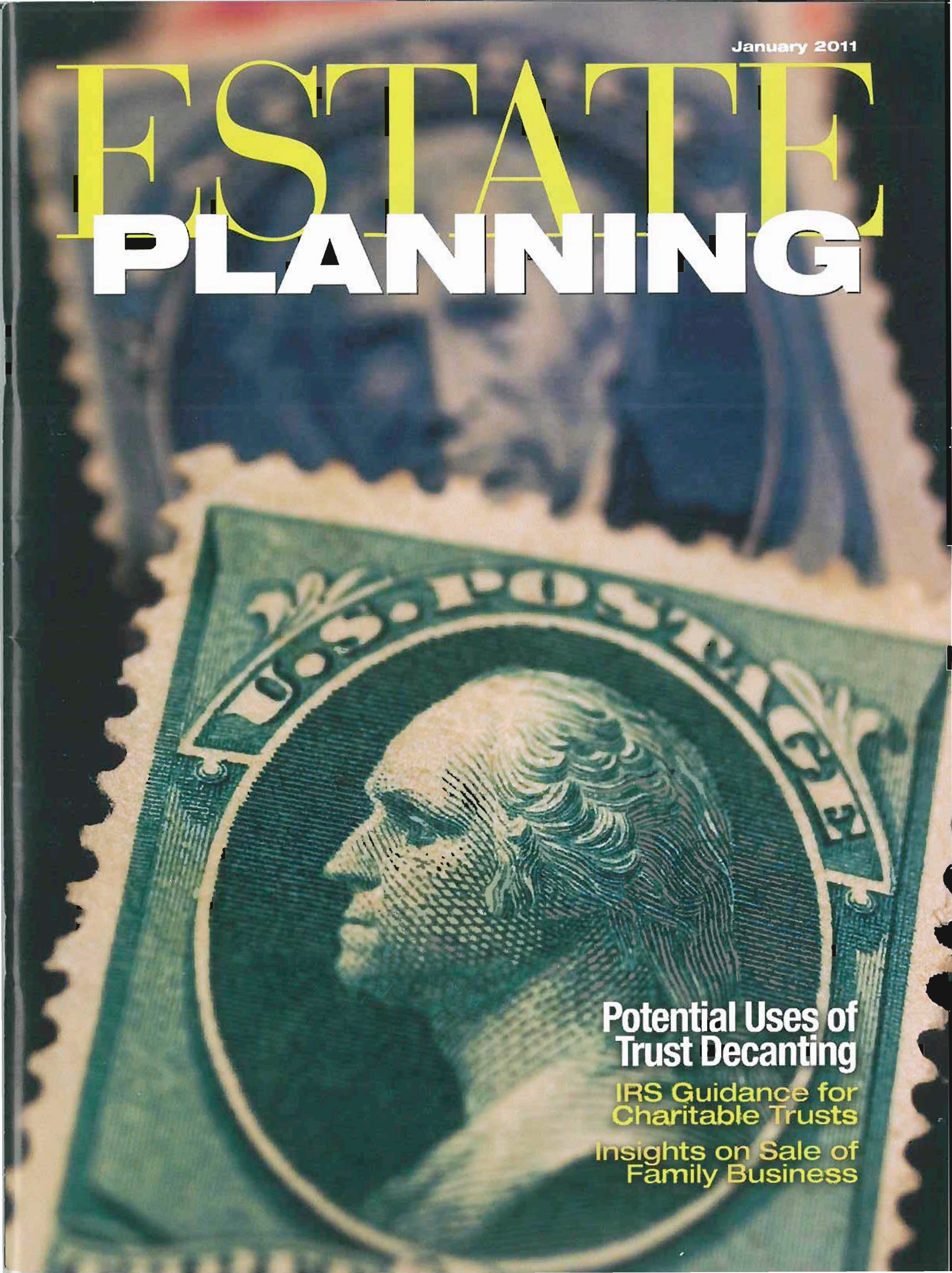
January 2011

ESTATE PLANNING



Potential Uses of Trust Decanting

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Insights on Sale of Family Business

Insights and Lessons for Surviving the Sale of a Family Business

A liquidity event can be a major life-changing occasion that requires planning and decision-making, as a younger-generation former owner of a family business relates.

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Clients engaged in the sale of a multi-generation family-owned business are undergoing a life-changing experience, for which their professional advisors can offer guidance with respect to more than the legal and tax aspects of the sale. In this article, Lauren Wolven interviews Bruce Werner, who had been a director and officer at his family's ladder manufacturing business at the time of its sale. They discuss certain life transitions that business sellers wrestle with as a result of the liquidity event and relevant topics that clients and their advisors should consider in connection with structuring the sale of the business. The article presents a true story reflecting many of the concepts discussed in an article in the August 2009 issue of ESTATE PLANNING, on the challenges of planning for family wealth succession.[1]

Werner Co.

A member of the third generation of the Werner family, Bruce spent most of his life dreaming about growing the family business and passing it along to the fourth generation. Started in 1922, Werner Co. was a way of life to his family. The founder, R. D. Werner, was the second oldest son of 12 fatherless siblings. After serving in World War I, he began distributing needles and threads for carpets and other flooring products. This led to metal trim products, such as sink frames, which led to larger metal products, and eventually to ladders in the 1950s.

After 75 years, however, facing a changed world, the family decided in 1997 to sell control of the business. Bruce's father and the other three members of that generation worked until their planned retirement dates, and Bruce and the other five sons in the third generation, all between 30 and 40 years of age at the time the business was sold, sought their own paths.

Having served as the Vice President of Sales & Service at the Extruded Products Division of Werner Holding Co., Bruce found himself in the position of needing to figure out what to do with the rest of his life once the plan he had since childhood was no longer available. Faced with a different financial position due to the liquidity event and with the opportunity to reinvent himself in the business world, Bruce learned several lessons about the impact of selling the family business; some of them were learned the hard way.

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Selling the family business for Bruce's father's generation had a very different meaning than it did for Bruce. Bruce was not near retirement age and is not the type of person who one would ever imagine to be content sitting still. His experiences, therefore, are likely to be more apropos to that "next generation" waiting in the wings to take over the full operation of the family business. For those individuals, he summarizes the eight key points learned from his personal experience as follows:

1. Be honest about priorities and values.
2. Develop a personal strategic plan.
3. Invest in friendships.
4. Understand that wealth works in step functions.
5. Realize how the family business experience situates oneself in the job market.
6. If early retirement is chosen, consider the impact on family members.
7. Get used to everyday inconveniences.
8. Enjoy the ride.

The dialogue that follows expands on the points noted above.

Wolven: Before we dive into your eight points, talk a little about the deal and some of the broad family issues surrounding the decision to sell the business. With four dads and six sons in the board room, and 110 shareholders, how did you address the key issues of deal structure, tax planning, and use of proceeds?

Werner: Our decision process evolved over approximately three years. While we were private, in many ways we ran the business as if it were a public company. We delivered an annual report that was comparable to a Fortune 500, maintained a dividend policy, and used outside consultants to tie our compensation programs to market norms. Our investment bank analyzed a dozen different scenarios to inform the Board about the tradeoffs between valuation, liquidity, tax efficiency, control, and future growth potential.

As the Board considered the needs of the shareholders at large, our priorities became clear and we quickly determined that a change of control transaction was in the best interest of the shareholders. We had a large and diverse shareholder base, which actually simplified the decision process because we could not focus on the tax or liquidity issues of just a few insiders. The Board's responsibility was to maximize value for the shareholders, which drove us to the deal we consummated.

Most of the shareholders had received stock as a gift from the family patriarch. He made numerous gifts over many years as part of his estate plan. Each family unit had its own circumstances to deal with, and each chose a different path to deal with its own tax and estate issues. Some shareholders formed family limited partnerships, either before or after the transaction, to deal with their own estate issues and to address their investment needs more effectively. Other family members formed private foundations to pursue their charitable objectives. Because the original gifts were valued at a low cost basis, the transaction created a onetime opportunity for the current generation to advance its estate planning. While we were certainly pleased with the transaction, ten years later I can clearly see the benefits of taking early action on my estate plan.

Wolven: After the sale, eight of the ten insiders continued working at the company. How were your employment contracts structured? Where there any unusual issues?

Werner: Part of the sale process included performing diligence on our future partner. We spoke to the CEOs of several companies that our future partner had purchased previously, and post-sale employment was one of our key questions. We also did our own research, and were prepared to address issues unique to our situation. Because it was a change-of-control transaction, we were concerned with diminishment of duties and forced relocations. We did not want family members to be treated unfairly, or to be forced to relocate during the initial contract period. These points later proved to be quite important to individual family members. While it is easy to focus on the amount of sale proceeds, I advise sellers to think carefully about terms and conditions. Negotiating representations and warranties, and issues like employment, are more likely to determine satisfaction with the deal.

Wolven: In a family business, it is not uncommon for the family to enjoy compensation or benefits that would not be allowed in a public company. In most transactions, the family loses its perks after the sale. Did this cause a problem for the family members?

Werner: All of the sons were required to work elsewhere before coming into the family business, so we were always aware of the benefits of family ownership. We had family discussions about what would change after the sale, and we openly discussed that "change of control" meant we would give up the family perks to maximize the sale value. As part of our prepa-

1 Wolven and Clemons, "Educating Younger Generations Through the Estate Plan," 36 ETPL 29 (August 2009)

rations for the sale process, we analyzed the likely buyer adjustments for family expenses, on a line-item basis. By the time we were in negotiations, these issues were well behind us.

As I continue to speak and work with family and private business owners, I have come to appreciate the rigor which our fathers imposed on us, and how we benefited from their discipline. Our compensation, titles, duties, and performance appraisals were within the company's policy guidelines. Everyone generally understood what was earned as an employee, versus a privilege bestowed due to being a family insider. Had the fathers not been as focused on the success of the business, and the need to be fair to outside shareholders, we may have had the types of problems (e.g. compensation, fairness between siblings, etc.) that I hear about in other businesses.

Wolven: I would like to talk about your personal transition process. You mentioned eight points that summarize your transition process, so let us start with the first one. When you say that it is important to be honest about your priorities and values, what do you mean?

Werner: Everyone has different priorities and values. It is important that you are honest with yourself and your family about choosing priorities that are consistent with your values. There are trade-offs to be made in the pursuit of happiness, family harmony, money, or prestige, and you should not be confused about your motivations. While this lesson is universal, leaving the family business may present the opportunity to revisit this important issue.

Wolven: Why is a personal strategic plan important?

Werner: Businesses require strategic plans to be successful, and so do people. Especially if there is a liquidity event, you need to understand the implications of your new financial circumstances and how they affect your options in life. Your personal strategic plan should integrate your life goals, commercial interests and legacy issues. Do you really want to run another business? Or would you rather pursue your favorite hobby or charity? If you are young, early retirement may not be as fulfilling as you originally thought. Without a plan, it is easy to drift through life.

Shifting from the theoretical to the practical, a friend of mine sold his family business around the same time we sold our business. He bought a large house, invested in start-up companies, and played a lot of golf. I know he has not worked since selling the business 10-12 years ago, and he is well under 50 years old. He did not invest in himself, however; nor did he develop a personal strategic plan. Just this week I learned that the bank foreclosed on his house. While this story saddens me, it reinforces the need to have a thoughtful personal strategic plan.

Wolven: At what point did you develop a personal strategic plan?

Werner: We sold the business in 1997, and I left in 2000 after fulfilling my employment contract. During my last year in the business, it became clear that I needed time to assess the future without the pressure or bias caused by maintaining my professional obligations. It was during my sabbatical that I was able to review my personal and professional goals, and realized that I needed an integrated plan for the future. This plan needed to consider decades, not calendar quarters and fiscal years.

Wolven: Do you find that your personal strategic plan is static? If not, how often do you revisit it and make adjustments?

Werner: The plan is based on my core values, which do not change. The plan needs to be monitored and adjusted to be consistent with the changing realities of life. For example, when we sold the business in 1997, the structure of the deal suggested that there would be a second liquidity event when our private equity partners exited the deal. The additional liquidity would have enabled us to reach for stretch goals in our plan. Unfortunately, the company was bankrupted in 2006, so we adjusted our plan based on this new fact. On a happier note, in a few years our youngest child will be off to college. We are starting to talk about possible changes, which, only a few years ago, we would not have considered. These new opportunities cause us to reassess the interplay between life goals, commercial interests and legacy issues. Understanding the trade-offs now allows me to take advantage of certain opportunities which I may have previously ruled out.

Wolven: One of your key points is to invest in friendships. Why is that such an important item?

Werner: Leaving the family business is the start of a journey. You will need friends to help guide you, provide reassurance and redirect you if you get lost along the way. The transition process can be lonely at times, and it helps to have trustworthy friends you can talk to. Building your friendships outside of work may help fill the void you may find due to lost workplace relationships.

Wolven: Along the lines of lifestyle changes, did you have difficulty adjusting to your newfound liquid wealth?

Werner: The initial step-up in lifestyle (bigger house, new car, exotic vacations) is easy to do, but it does not take long to realize that this change is a singular event. Hopefully you can maintain this new lifestyle, but you cannot take another big step-up without creating new wealth. When we were deciding whether to sell the business, we often said, "We will only sell the business once." Afterwards, when our new circumstances became better understood, I started repeating this phrase again, but for different reasons. Managing expectations quickly becomes important, especially if you decide not to go back to work. Be sure to secure good professional advice on how to manage your financial assets.

Wolven: You mention the importance of finding good professional advice regarding financial management. How did you find that personally, and what tips can you offer to help others find the right advisors?

Werner: Within our enterprise, we owned a captive insurance company, and I had spent some time working on the Investment Committee. This, along with my MBA, provided me with a good frame of reference. During my sabbatical, I spent significant time studying the markets, assessing my risk tolerance, and talking to numerous professionals so I could make informed judgments. I focused on educating myself first, and always relying on common sense when dealing with something unfamiliar. Frequently, I would ask the same question to different professionals and interpolate between their responses to make my own decisions. So my best advice is to ask questions, gather diverse opinions, beware of conflicts of interest, and be truthful about your risk tolerance.

Wolven: After you left Werner Co., you did not immediately move into new employment. Do you believe that a sabbatical is something others in your position should emulate?

Werner: As I mentioned previously, one of the best decisions I made was to allow myself the time to plan for my future. I was fortunate to have this luxury. I recommend that you take time off if you are able to do so. But I would also caution that part of your exit plan from the family business needs to consider how long a job search may require, and assuring that you have the financial wherewithal to support your family during an extended period without income.

Wolven: How did you find the search for a new position? Was your family business experience an advantage or disadvantage?

Werner: My family business experience was a real advantage in a few situations, but a distinct disadvantage in other situations. Some hiring managers will shy away from former business owners due to a bias that former owners will be too independent, difficult to manage, or lack motivation because of their financial security. If you have unique industry expertise (e.g., in sales), you are more valuable than if you have a functional skill (e.g., in accounting). This effect will be more pronounced if you change industries. To put yourself in the best position to succeed professionally, you must understand how the market views you. Traditional search methods were not productive for me, so I adapted my search techniques to take advantage of my skills and experience. You should expect to invest in yourself by expanding or retuning your skill set to the current market needs and conditions.

Wolven: Did you use a career counselor? Is that something you think might be helpful to others going through a transition like the one you faced?

Werner: After I left business school, I worked for a venture start-up, and then started a business when I was 25. So, I had not written a resume or had a job interview in almost 15 years. Once I understood the magnitude of the change, I did engage a career counselor to coach me on the process of transitioning from the family business world to the larger business community. This is where I came to understand how my background made me a nontraditional candidate in the workforce. The counselor helped me to understand my professional capabilities within the context of the marketplace and successfully adapt to my new reality. It is worth considering a career counselor so long as the counselor is skilled at dealing with the specifics of your transition issues.

Wolven: Did you ever contemplate staying home rather than going back into the workforce?

Werner: Absolutely not! Like many business owners, I have a natural drive to be productive and engaged. As my wife would say, if I am not busy, I am not happy. Second, it was important to me that my children understood the importance of work and the need to be productive. Even during my sabbatical, I had an office outside the house and came and went as if it were a regular job. My children were in grade school at the time, so to them it looked as if Daddy was working as he always did.

Wolven: What affected your decision to continue working?

Werner: As I contemplated my next move, I thought about what makes me happy. Being productive, creating positive change, and having a material impact on my surroundings are big motivators for me. I liked being part of an organization. This was true in the business world and the nonprofit world. If I were an artist or a musician, I might have chosen differently, but I like business. From my work with investments, I knew that lifestyle, taxes, inflation, and surprises would deplete our liquidity over time, and working was the best way to protect my children and grandchildren. So, there was never a doubt that I would go back to work, it was just a matter of when and where.

Wolven: In your key points, you mention "everyday inconveniences." What does that encompass?

Werner: If you no longer have an executive assistant, life's little issues—travel reservations, calendar management, and errand running—are now your responsibility. While not difficult, they do take time, and may be small inconveniences in what is otherwise a better situation. A concierge or part-time bookkeeper may improve your quality of life.

Because the original gifts were valued at a low cost basis, the transaction created a one-time opportunity for the current generation to advance its estate planning.

Wolven: Did you find that these "inconveniences" caused stress at home?

Werner: Before we sold the business, my wife and I had discussions about what would change, and what would remain the same. My family was used to me being away all week, so when I stopped traveling it was a big change in the daily rhythm of the household. We needed to adjust roles and responsibilities to avoid stress. By managing the changes proactively, these inconveniences soon faded away.

Wolven: If you could go back to 1997 and give yourself advice on how to think about the sale of Werner Holding Co., what would you tell yourself?

Werner: The key issue is to develop a good perspective of your likely future, anticipate your future wants and needs, get good advice, and be honest with yourself. I had worked both internally (engineering, manufacturing) and externally (sales), but had spent most of my career thinking about only the Werner Co. Afterwards, I had to learn new skills to manage the transition process and to develop judgment to make good decisions in unfamiliar circumstances. I found that speaking to numerous people across diverse situations was the best way to develop this critical understanding.

Additionally, it is critical that you involve the key people in your life when you plan your new future, because they will be a part of this journey with you. Be prepared for uncertainty and surprises. Hopefully, you will be able to leverage these lessons to achieve your ideal vision of how you wish your future to unfold.

Analyzing the liquidity options

As Bruce noted in the interview, it is important for the family to perform its due diligence prior to embarking on a liquidity transaction. One of the most difficult hurdles, and one that often leads to litigation, is the inability or unwillingness of the family business insiders to contemplate the needs and interests of the entire shareholder base as opposed to focusing on the personal and financial desires of the insiders. In family businesses, it can be easy for the insiders to forget that they have a fiduciary duty to the shareholders.

It is advisable for the insiders to stop and ask themselves from time to time "Is the business being run for the best interests of the insiders or the best interests of the whole family?" Sometimes, the interests will be aligned. If there is a large group of shareholders, as there was with Werner Co. and as is often the case when a family business is on the third or fourth generation, and if the answer to the preceding question is "best interests of the family," then the insiders may need to put their personal goals second to the best interests of the family to reduce the potential for litigation.

The situation is ripe for litigation when the insiders want to keep their perks and jobs, but the broader shareholder base of cousins want to sell. In a situation that one of the authors observed, the insiders had rejected a purchase offer for nearly $100 million over the objection of the broader family shareholder base, and with the decline of the economy, those shareholders watched the company plummet in value to a point where the stock had minimal value and the company had almost no cash flow.

Key questions. In considering whether it is time to pursue a liquidity event, a family might ask itself the following questions to help analyze the pros and cons:

1. Is there an adequate transition plan to the next generation of managers that is open to all capable family members, or is control becoming centered with an elite group of insiders who are not necessarily close with their cousins and other relatives who are shareholders?
2. Are funds available (either in the company or through borrowing) to buy out the interests of the nonemployee shareholders who may want to monetize their interests so that ownership can be concentrated with the employee group to align business and family interests?
3. Does the family have a diversified portfolio of assets, or is the family business a concentrated position for most shareholders?
4. What are the short-term and long-term prospects for the business? Are the business risks and competition increasing or decreasing?
5. Has the business increased in value to the point where it is time to take all or some of the chips off the table to ensure financial stability for future generations?
6. What are the liquidity options available, and do they meet the overall family and business needs and goals (or most of those goals)?

Some hiring managers will shy away from former business owners due to a bias that former owners will be too independent or difficult to manage.

Categories of liquidity events. One of the key financial considerations when a family business is contemplating a liquidity event is the structure of that event. Liquidity opportunities generally can be grouped into three categories: sale, financing, and partnering.

The sale is fairly straightforward and can involve the sale of the entire business to an outside purchaser or a single family member or family group; or the company may have a particular division, product, or service that can be separated out through a restructuring and sold to provide partial liquidity. Selling only a portion of the business may be an opportunity to create liquidity to allow certain family branches to be bought out and to permit active employee family members to continue in their chosen profession with the family business.

Financing opportunities may include bank loans to finance growth or permit a buy-out of family-member shareholders wishing to unhitch their financial future from their employee cousins. These opportunities can also include recapitalizations or ESOPs.

The last option group, partnering, encompasses bringing in outside capital through private equity or a strategic alliance, but also includes IPOs. Partnering generally anticipates significant growth of the company. The trade-off, however, generally is the loss of control by the family members over the management of the company. With partnering comes outside pressures of parties less interested in family dynamics and personal family goals than in financial profit. Partnering can be lucrative and positive for the company and family. As noted in the interview, however, the insiders need to be prepared to lose control over the running of the family business.

Because it can be difficult for the family group to separate the emotion of a multi-generation family business from the financial opportunities, it is advisable for the family to employ outside advisors to help analyze the options. These advisors can also assist in setting up communication mechanisms with the shareholders so all parties are informed regarding the investigative and decision-making processes of selling the business.

Tax planning in anticipation of a liquidity event

The process of contemplating a liquidity event generally takes at least a year, and sometimes spans several years. If a family has not contemplated tax planning prior to the liquidity exploration process, such planning should be one of the first items on the checklist of things to accomplish. Once a company has been taken to market or an offer has been received, valuation is fairly clear. Before the external market has been explored, however, valuation may be less certain and leveraging opportunities may be greater.

Installment sales to grantor trusts, GRATs, the use of lifetime gift exclusion, and the generation-skipping transfer (GST) tax exemption are all options that should be considered prior to or at the front end of the liquidity event process. Although GRATs, gifts, and the GST are all up in the air in 2010, it is hoped that we will have some resolution on these issues soon. Family limited partnerships and limited liability companies are also effective planning tools for transferring some of the business interests downstream, with the ability to use them limited somewhat depending on the corporate structure of the family business itself.

One other planning item to consider when a liquidity event may be in the nearer future is ownership by younger generations. Trusts are often set up for grandchildren of the principal-owner generation before a family business spikes in value and without contemplation of a liquidity event. The trust may own only 5% of the business interests, but if the business is sold for $50 million and the trust provides for mandatory income distributions to the beneficiary starting at age 21, there may be a problem. Dealing with inappropriate or inflexible trusts is a topic for its own article. For purposes of monetizing a family business, however, it is important to address these issues before the liquidity event.

Personal impact of a liquidity event

How much money is being placed in the hands of younger generations through pre-existing estate planning structures is just one of the many personal aspects of a liquidity event that should be considered. For all family members, the impact of the new wealth can be significant. While the family may always have been wealthy on paper, having liquid wealth is a very different thing than owning valuable business interests.

It is important for family members to find financial advisors who can help them budget properly and develop a good understanding of realistic spending capabilities with the new wealth. As mentioned during the interview, the liquidity created from a business sale is not endless, and if not properly managed, can lead to foreclosures and other financial difficulties. Good investment firms can help the owners define their financial goals, model their investment portfolio, and set an appropriate budget for new purchases (like a bigger home) and long-term spending. For the family members of retirement age, the ones who probably spent the better part of their lives working in and building the family business, adjusting to their new "business" of investing can be difficult—particularly in recent years. Finding financial advisors who are willing to go slowly, to educate the client, and to assist the client in acclimating to a different, and usually more passive, role is important.

For employees of the family business, there are other considerations as well. Evidenced by Bruce's experience is the fact that time spent working in a family business is not considered a positive by all prospective employers, and the skill set of each family employee may not translate well to other business opportunities. Those employed in the family business need to consider what they will do with their lives after the liquidity event. As in Bruce's situation, there may be an employment contract that requires one to stay with the company during a transition period. The family may want to consider hiring career counselors to help family employees (and other employees) analyze their skills, interests, opportunities, and additional education.

Depending on the size of the deal and the needs of the family, establishing a family foundation can provide a second career for some family members. For those who are younger but find themselves in a situation where they do not need to work, the lack of purpose resulting from the loss of a job at the family business can be a tremendous challenge to a relationship with one's spouse or partner, with children, and in other aspects of their personal lives. Many of these individuals have found a new and satisfying purpose by taking some of their wealth and devoting themselves and this wealth to charitable causes that motivate them.

Conclusion

Many outsiders look at those who receive money from the sale of a family business as "lucky" and "living on easy street." While there is an advantage to having financial security, there is also a lot of emotional adjustment and financial education that must take place with a liquidity event.

Litigation, aimless heirs, and financial ruin are only a few of the pitfalls that must be avoided when contemplating a family business liquidity event. With proper planning and good advice, however, most shareholders and family business insiders can make a successful transition to the post-sale phase of their lives. ■