

That Ain't No Fairy Tale: The Grimm Facts behind Business Succession Disputes

By Gale Allison and Vale Gonzalez

© 2018

All Rights Reserved

I. The Story of the Brothers Grimm, Hiding a Tale of Business Succession Advice

The Grimm Brothers, Jacob and Wilhelm Grimm, are two of the most famous folklore collectors and German scholars known for the collection of traditional and oral tales. Some of the best-known stories are Rumpelstiltskin, Snow White, Sleeping Beauty, and Cinderella. These collections of stories are found in *Children's and Household Tales*, published in two volumes back in the 1800s. Although their stories have become mainstream titles for children's movies, there is a lot that adults have learned through the centuries and still can learn from their stories, including for business succession! Most of these stories are riddled with lessons of caution, mistrust, and deceit. With proper planning and preparation, many of these unfortunate endings might have been avoided.

II. Pitfalls and Folly Don't have to be Your Fairytale Ending

Planning has always been hailed as the remedy for avoiding accidents and misfortune. As business owners, we take initiative in the now to maintain a constant state of balance. Whether it be increasing workflow or ensuring quality service, having a plan to get to a goal is a crucial step for business founders. Although business owners have the experience and knowledge to withstand and plan for problems, preparing a plan to pass on the business has not been a common act.

In the United States, the majority of businesses are considered 'closely held' and account for over 75% of all new jobs.¹ Family businesses make up a staggering 80% to 90% of all businesses in the nation and account for 50% of our gross domestic product², an important indicator in our

¹ Louis A. Mezzullo, *Business Succession Planning*, SX007 ALI-CLE 445 (2015).

² Doug Bailey, *More Than 8 Out of 10 Family Businesses Have No Succession Plans*, Talking Business Advice Series (Feb. 9, 2016), <http://sponsored.bostonglobe.com/rocklandtrust/more-than-8-out-of-10-family-businesses-have-no-succession-plans/>.

economy. It is clear that our nation runs on, and is supported by small businesses. With such an important legacy among our citizens, ensuring the continuing prosperity of our nation and the people who continue to work in these businesses is crisis critical. Unfortunately, the daunting statistics on business succession are best described as grim. Like the tales of misfortune, statistics conducted by The Family Firm Institute show that only 30% of family businesses survive to the second generation.³ Even more alarming, just 12% make it into the third generation and a mere 3% to the fourth and beyond.⁴

With such a high rate of failure, preparation for the next generations is key. A survey conducted by Wilmington Trust found that the majority (58%) of business owners do not have a succession plan even though they recognized the dangers of financial risk associated with lack of planning.⁵ Further, 42% of business owners felt excused from planning because of being too busy running their businesses.⁶ Prioritizing business success is a key skill that business owners have developed throughout their careers. However, proactive planning is also important to protect the business, owners and employees when the unforeseeable happens. This proactive approach is not common in older generations. To many surveyors' surprise, the Boomer generation was twice as likely not to have an established business succession plan compared to Millennials (74% vs 37%).⁷

³ Brett Ryder, *Family Companies – To Have and To Hold*, The Economist (Apr. 18, 2015), <https://www.economist.com/special-report/2015/04/18/to-have-and-to-hold>.

⁴ *Id.*

⁵ Katie Kuehner-Hebert, *Business Owners Need to Focus more Time on Transition Planning*, Survey Says, Chief Executive (Sept. 25, 2017), <https://chiefexecutive.net/business-owners-need-focus-time-transition-planning-survey-says/?platform+hootsuite>.

⁶ Rex Hammock, *Only 40% of Owners Have a Business Succession Plan*, Small Business (Feb. 7, 2017), <https://smallbusiness.com/legal/owners-need-succession-plan/>.

⁷ *Id.*

III. Mediating in Business Succession: Hansel and Gretel Hatch a Plan

Like the mischievous and well-prepared siblings, planning is only a single part of the process to meet a goal. Many are quick to say planning is essential and the best remedy to prevent or stop an unfortunate situation. The problem is this: unlike the hungry witch in the tale of Hansel and Gretel, the disaster that befalls businesses is not presented right then and there. It typically emerges one or two years after the founders or prior leadership begin to retire. How can a person or persons prepare for an issue that nobody knows is there? There are several steps to creating a business succession plan, including implementation and execution.

A. Horror Stories of Yore—Faulty Business Succession Planning

Not being prepared for the inevitable is unwise. Whether it be retirement or death, the transfer of the company without instructions will lead to chaos and possibly litigation. However, having a faulty business plan is equally dangerous. Many lawsuits have as their root cause a poorly drafted buy-sell agreement. The necessary elements of a buy-sell agreement include who the buyers are, the value of the company, how the agreement is funded, and what the triggering event is. In the following stories, faulty plans led to unfortunate and expensive outcomes.

1. Estee Lauder Conundrum: Valuation Issue

Joseph H. Lauder died in 1982 having prepared a buy-sell agreement that included valuation of his shares.⁸ The buy-sell agreement provided a formula for finding the valuation of the company's shares at the time of death of Joseph H. Lauder. The Commissioner of Internal Revenue found a deficiency of more than \$42 million in the federal estate tax that was due from

⁸ *Estate of Lauder v. Commissioner*, Docket No. 21525-87, 1994 Tax Ct. Memo LEXIS 535 (T.C. Oct. 19, 1994).

Mr. Lauder's estate, which used the valuation in his buy-sell agreement. The estate appealed the decision. It took 10 years for the matter to settle in tax court at a cost of hundreds of thousands of dollars. Since there was an undervaluation of the shares and the terms/reasons of the formula provided within the buy-sell agreement did not hold sufficient justification, litigation ensued. At the end, the litigation led to a payment of \$20 million from the estate.

2. Tata Group Leadership Crumbles: Successor Pushed Out

The Tata Group is a multibillion-dollar company composed of a mostly family-managed business. Established in India, its total assets are an outstanding \$126 billion.⁹ Ratan Tata was a board member in 2005 with a set date of retirement at 75, thus ensuring his retirement to occur in 2012. Once he retired, he passed on his leadership to Cyrus Mistry, an Irish businessman. Due to strains of core values and other issues (since he was an outsider of the company), Mistry was removed from his board position 4 years later.¹⁰ The retired Ratan Tata replaced him once more. Without the necessary establishment of a business plan to guide the new leaders in their succession, the effectiveness and qualification of successors most always crumbles, as it did in this case.

3. The Divorcing Spouse or Widow Suddenly Owns Your Business

Running a business with co-owners requires trust, confidence and respect. How would you deal with an individual walking into your business, with no prior experience or permission, demanding business changes and respect? This daunting scenario happens to many business owners every year when a co-owner divorces or passes away. With no agreement controlling the

⁹ http://www.tata.com/htm/Group_Investor_GroupFinancials.htm.

¹⁰ Press Trust of India, *Cyrus Mistry sacked by Tata Sons as chairman; Ratan Tata returns*, India News (Oct. 24, 2016), <http://www.india.com/news/india/cyrus-mistry-sacked-by-tata-sons-as-chairman-ratan-tata-returns-1613031/>.

ownership of the company, suddenly substantial portions of it can be owned by ex-spouses or other strangers to the business. If a deceased co-owner did not have a buy-sell agreement, the shares would be distributed to the surviving spouse or other family members what were not involved in the business. Preparing a buy-sell agreement and mediating the terms of the agreement places the parties in the best position to protect the business and each stakeholder's financial outcome.

B. Mediating Between the Seven Dwarves is Easier Said than Done

To create a viable business plan, you need to customize one for your specific situation. No two businesses are alike. Focusing on the parties involved in your business is part of the process. Those parties may include partners, family members (whether or not they are active in the business), and other key employees. At the end of the day, all people involved will have their work and lives affected. Building consensus at the get-go is often difficult, and resistance is common with change. Pushing past the line of comfort and meeting your 'ever after' goal can be achieved with a skilled business mediator.

Mediation can get all the characters in your tale on the same page. Mediation is the process of bringing the parties together to settle a dispute. Luckily, there are several tools available for mediators to use to get the parties in line. Facilitative, evaluative, and transformative mediation styles are all effective and may overlap. Humans are innately emotional and business issues can become incredibly visceral. Having a mediator well versed in business transition tools like buy-sell agreements, tax vehicles, asset protection, and life insurance policies can provide parties with options to satisfy their mutual goals.

C. Elements of Your Happily Ever After

Good stories are made up of five essential elements: the characters, the setting, the plot, the conflict, and the resolution. A business plan requires many of the same components. The characters in a business include the shareholders and their families, active management, and employees. The setting includes the specific type of business, its historical and projected growth, and future needs. The conflicts of the business are the events and relationships that are likely to arise. In the case of transition tales, sibling rivalries and animosity between shareholders are important factors in designing a business succession plan. A solid plot looks at your business values and principles before considering implementation of the business plan. Ultimately, the resolution in a business setting is the successful transition of the business to the next generation. A skilled business succession mediator can pinpoint all of the elements and tools to develop a strategy to 1) realize the goals of the founding parties and stakeholders, and 2) create a mutually agreeable resolution.

IV. Shiny Pieces of Your Business Succession Plan: Ownership and Governance

Rumpelstiltskin loved his shiny, shiny gold! Succession plans are mostly about ensuring the smooth transfer of ownership interests and continuing some type of governance by the new owners of the company. The issue is most often that people will disagree on what will be paid, how the company will be valued, what circumstances will trigger the transfer, who will be in charge and so on. With the business lawyer at a loss as to how to keep the various factions moving forward to some 'draftable' agreement, things tend to lag and take a back seat to things that can be more easily agreed upon. A mediator can be important to introducing these ideas as neutral, emotionless concepts and helping all parties understand that the best interest of the company is a core concern. Through mediation, a plan can be created with the input of the parties to reduce future calamity and guide the parties to a mutually agreeable plan.

Ownership transfer is completely different from transferring daily operational management. Looking at who will succeed the ownership interests of a deceased or retiring party is important. Many owners are devoted to their non-family business partners who helped them grow the company to its success. On the other hand, an owner might want to transfer his ownership interests to his family. A knowledgeable business succession mediator not only helps resolve issues between the parties, but also provides an open setting to aid their discussion of options for how to meet their family and business planning goals. Structuring your ownership transfer is another part of this section. For example, formulating a voting/nonvoting interest, debt/equity interests, and separating assets from the business to create a trust are all viable options to separate an interest amongst different members of your family or business. Additionally, the timing and mechanics of the transfer must be considered:

1. When will the transfer be made?
2. What is the triggering event? divorce, bankruptcy, disability, retirement, death are the top concerns
3. Will it be a sale or gift?
4. Is it going to a trust or some other type of entity where noninvolved relatives will benefit from the income?
5. Will a buy-sell agreement be used and is the purchase funded by having a life insurance policy on the owner(s) who pass away?

There are also dozens of transfer vehicles available to customize your goals and your business's needs. A qualified mediator with knowledge in estate planning techniques can serve as a valuable resource to meet your needs.

V. Buy-Sell Agreements: Beware of Disguises, Spells, and With Whom You Do Business

Buy-sell agreements are contracts that allow you to formulate a method of transferring assets once a specific event occurs in exchange for money. In other words, the agreement defines how the shareholders will react and defines the buyout terms of the departing shareholder. Not all buy-sell agreements are made equal. The designs of buy-sell agreements are endless but common ones are (1) corporate redemption agreements (2) cross-purchase agreements, and (3) hybrid agreements.¹¹ Within these different kinds of agreements, you can further customize who is allowed to purchase shares, whether the sale is mandatory or merely an option to purchase, and buy-sell triggers. Although buy-sell agreements provide an infinite number of variations far beyond what is written in this article, the general purpose and protections these agreements are relatively universal. Using a buy-sell agreement allows all parties to maintain a thorough understanding on how assets are treated when a trigger (such as death, retirement, or termination of employment) occurs. You certainly do not want to buy or sell Jack's magic beans.

Funding the agreement allows certainty on how the parties to the agreement will buy shares. To fund a buy-sell agreement, the purchasing party must have adequate means to ensure purchase of shares when the trigger occurs, but the business itself often assists in providing the funding. Life insurance policies, sinking funds, borrowed funds or installment notes, or cash are options.¹² Insurance is the most popular method to fund the purchase price of a shareholder agreement when the triggering event is death or disability.¹³ A sinking fund is essentially a savings account set aside to purchase the shares when available after a trigger occurs. However, this may be disadvantageous if the event happens too soon for sufficient funds to be built up.

¹¹ Steve R. Akers, *Family Business Succession Planning and Planning Considerations for Buy-Sell Agreements*, SFA2 ALI-ABA 679, 717 (2001).

¹² *Id.* at 695.

¹³ Nancy Schmidt Rouse, et al., *ACTEC Shareholders Agreements for Closely-Held Corporations Outline*, SY010 ALI-ABA 1367.

Borrowed funds from a bank are a possible funding method, but there may be credit difficulties when a co-owner is deceased, retired, or disabled. Lastly, having cash freely available as a funding source may not be possible regardless of who the purchaser is (shareholders or corporation). Alas, there is so no Rumpelstiltskin to spin straw into gold.

With such an array of different agreements, shareholders are likely to have conflicting opinions on what is the best instrument for their situation. One shareholder might prefer to have the corporation purchase the shares of the departing shareholder while another would prefer to purchase directly due to the tax benefits. A mediator involved in business succession planning and buy-sell agreements could provide alternative protections in the agreements to satisfy all parties' core concerns. In the Grimm tales, most of the really good mediators are hiding in the forest (or they are the forest). They are much easier to find today.

A. Corporate Redemption Agreements

A corporate redemption agreement mandates the corporation repurchase shareholder's shares. Since the corporation is funding the agreement, if there will be an insurance policy to fund the plan, this is purchased by the corporation. In comparison, a cross-purchase agreement would require the shareholders to have an insurance policy on the other shareholders as well as themselves. For example, a cross-purchase agreement between three shareholders may require six life insurance policies. A corporate redemption would only need three policies since the corporation is buying the shares, not the shareholders amongst themselves.¹⁴ Since the corporation redeems the shares, each shareholder will gain a proportionate share. This protects

¹⁴ *Id.*

less affluent parties from being unable to purchase since the corporation is tasked with funding, rather than the individual shareholders.

B. Cross-Purchase Agreements

A cross-purchase agreement is an agreement between shareholders to purchase shares of the departing shareholder.¹⁵ Although there is a need for additional insurance policies since the purchasers have one for each co-owner, there are distinct advantages in this type of agreement. With a cross-purchase, each buying shareholder attains an increased cost basis in the shares bought. A corporate redemption agreement does not increase the cost basis of the shareholders.¹⁶ Having an increase in basis is important if the company may be sold. It is not important if the shareholders will hold their shares until their deaths.¹⁷ Reviewing how many shareholders own the business, how equity is held by the business and the financial condition of the owners will help determine if a cross purchase agreement is best for the business, the deceased or selling owner's estate, the retired or disabled owner, and the remaining owners.

C. Hybrid Agreement

Combining elements of both, a hybrid agreement 1) formulates a scheme to allow the corporation to have either an option or duty to buy the shares of the departing, retiring or deceased owner, and 2) allows the existing owners to have the additional option to buy the shares under certain conditions.¹⁸ This type of agreement can further require existing owners to purchase all shares not purchased by the corporation or vice versa due to "legal restrictions, lack

¹⁵ *Id.*

¹⁶ Akers, *supra* note 11, at 719.

¹⁷ *Id.*

¹⁸ Roush, *supra* note 13.

of sufficient funds, or other reasons.”¹⁹ This is particularly useful in a C corporation when the shares are obligated to be purchased by the corporation.²⁰ Giving the corporation the first opportunity to purchase the shares removes the tax consequences of the shareholders receiving dividends subject to ordinary income.²¹

There are complicated tax consequences that must be weighed so reviewing which buy-sell agreement works best is essential. A careful review of your business story and all the characters involved helps evaluate the options available. Like managing a project of sorts, getting several owners and potential owners on the same page and weighing competing interests is difficult when done alone. As they say, ‘you have to kiss a lot of frogs to find your prince’ of an agreement.

VI. Valuation

Like any fairytale, there needs to be a value to it. To determine the value of a story, readers look at the theme and lesson the story provides. The same type of analysis is required of a business. Valuing a business in a buy-sell agreement is known as one of the most important and challenging features to determine the purchase price of shares. A professional appraisal, done by a professional business appraiser is required.²² However, other valuation methods are available. It is a fact that appraising a business is extremely expensive, and shareholders many times want to have several different valuations. Some businesses decide to use the valuation of formula used in the appraising of the business to value shares. Commonly use purchase price methods are the

¹⁹ Louis A. Mezzullo, *An Estate Planner’s Guide to Buy-Sell Agreements for the Closely Held Business* 15 (3rd ed. 2017).

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 23.

fixed price method or the book value and adjusted book value. Other methods that are less common include the Dutch auction, using the estate tax value of a deceased owner's interest, or price "based on a percentage of gross receipts or some other objective factor or related to the sales of interests of comparable companies."²³ Additionally, a blend of the above can be used. Valuation can be an extremely contested topic since departing shareholders would prefer a higher valuation method while the purchasing shareholders would prefer a lower price. However, at the end of the day fair market value is essential for both sides.

VII. Conclusion

Business succession is a combination of ownership agreements, estate planning, and succession planning. Taking steps to ensure your business continues to function is at the heart of business succession planning. Instructions to integrate new leaders to your team, preparing a leadership plan when there is retiring or deceased shareholders, and creating a buy-sell agreement allow comfort so you can continue to do what you love—run a successful business for yourself and successive generations.

ABOUT THE AUTHORS

Gale Allison has four decades of estate, trust and tax experience as an estate, trust, business succession lawyer and consultant on tax aspects of divorce. An AEP®-designated and Martindale-Hubbell AV-rated Preeminent attorney, her mediation certifications include family and divorce from the Mediation Institute, as well as litigated cases and elder care from Pepperdine University. A former litigator for the federal government and estate tax attorney for

²³ *Id.* at 25.

the IRS, in private practice for most of her career, she mediates exclusively through Dispute Resolution Consultants in Tulsa.

Vale Gonzalez is a third-year law student at the Tulsa University College of Law, with a BA in criminology from the University of Texas at Dallas. Fluent in Spanish and English, he has worked in estate and trust law, federal and state criminal defense, and pro-bono immigration cases.