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TAX AND WEALTH ADVISOR ALERT: THE OBJECTIVES OF GOOD SUCCESSION PLANNING

This the 4th of 11 articles based on our firm's book *The Art, Science and Law of Business Succession Planning*.
In the last article we discussed the five essential objectives a good succession plan needs to address. In this article we will discuss the first objective in more detail–maximizing the value of the business.

Number 1: Maximize and Protect the Value of the Business

Every business– no matter how large, small, or financially sound– becomes vulnerable to losing value during a change of leadership. Thus, your first goal with succession planning should be to enact a strategy that enables the company to preserve its value and continue to grow after the transfer is complete.

For our discussion, we will assume you've already built a profitable family business that remains on a growth trajectory. The guiding principles that have built your success won't change; the primary variable is the transfer itself. Thus, your best strategy for maximizing company value is to protect its value during the transition. For that reason, this article focuses mainly on protection strategies.

Developing and Retaining a Trusted Management Team

Your best defense against losing company value is to assemble a strong management team well in advance. This team may consist of family members or key associates or managers you trust.

For any key management people who are non-family, it is wise to incentivize them by giving them some financial stake in the company's operation. Consider the following examples.

Minority Stock Ownership

One of the more common methods of sharing a financial stake with key management personnel is to grant them a minority interest in the company through stock ownership. Though if you do so, bear in mind that, by taking this action, you're giving these managers more than just a vested interest–you're also granting them specified rights and legal access to the company as minority stockholders. Let’s address some of these in turn.

Right of Inspection

At any time, stockholders have the right to inspect and make copies of some corporate documents, including the list of stockholders, the stock ledger and some financial records. To view or copy these documents, the stockholder must make a written demand stating a “proper purpose” for doing so. In Wisconsin, state law defines “proper purpose” as “a purpose reasonably related to such person’s interest as a stockholder.”

In plain English, the law requires you to make these records available to minority stockholders if the stockholder provides a specific reason why it’s pertinent to their investment. This does not mean you have to automatically open all of your books for every request. If a stockholder requests to see the corporation’s books and records, the burden of proof is on the stockholder to demonstrate why this information is needed.

On the other hand, stock ledgers and stockholder lists are more in the stockholder’s domain, and the burden of proof would be on you to show why that member does not have a “proper purpose.”

Right to Bring a Derivative Suit

If a minority stockholder believes it necessary, he may have the legal right to file a “derivative lawsuit”—that is, to sue a third party on behalf of the institution in which he owns stock. These suits don’t happen often, but you need to know they can happen.

Derivative suits are intended to let a stockholder to protect his investment in the corporation in the event that the firm’s leadership fails to do so.

Thus a third party defendant may be any entity who poses a perceived threat to the company’s well-being. That includes its executive officers and directors. In an extreme application, if you make a key employee a stockholder while you remain in an executive position, that employee could subsequently sue you on behalf of the company, if he believes you breached your duties in some way (such as by using corporate property for personal gain).

In most cases, the stockholder can only bring a derivative claim if the following conditions are met:

• The stockholder must meet the minimum standing requirements as a stockholder, based on applicable laws. (For example, he must own a specified number of shares or be a stockholder at the time of the alleged offense.)
• The stockholder must have already made a written demand to the board of directors to

take action, and the board either refused or failed to act.

Because the derivative claim is filed on company's behalf (rather than the individual stockholder's), if he wins the case, any financial award goes to the corporation, and not directly to the stockholder.

Right to Protection Against Shareholder Oppression

This provision protects minority stockholders against financially oppressive or harmful actions by stockholders with a controlling share in the corporation. Examples include:
• Controlling shareholders buy more shares below fair market value
• Forcing minority shareholders to sell their shares below market value
• Taking actions that cause minority shares to drop in value significantly

If a minority stockholder believes controlling stockholders are committing shareholder oppression, he may file a direct suit against the corporation itself, as opposed to a derivative suit.

When you maintain good relations with key employees, and when your company conducts business in an upright manner (even in your absence), chances of a minority stockholder invoking these rights are greatly reduced. But because you grant these rights to anyone who has stock ownership, choose your stockholders wisely.

Deferred Compensation/Bonuses

If you don't want to face the complexities involved with minority stock ownership, deferred compensation can also be an excellent way to give a financial stake to non-family members of your management team.

Deferred compensation is additional income paid out over time, based on profits or other identifiable goals. This gives your key employees a great incentive to stay with your company post-succession. You can implement deferred compensation in a variety of ways; we generally review four of the most common types below.

Deferred Bonus Plans

Bonus plans provide excellent incentives to work hard and grow the company, because the workers receive a share of the additional profits. When bonuses are deferred, they can incentivize staff to remain with the company as long as possible. For example, if you calculate bonuses annually, an employee could receive 50 percent up front, 25 percent in year two and 25 percent in year three, with additional annual bonuses adding to the amount each year. With this in place, employees know they will forfeit a portion of their bonus if they leave the organization.

Non-Qualified Retirement Plans

Unlike the standard plans defined by the Employee Retirement Income Security Act (ERISA), a non-qualified retirement plan is a tax-deferred instrument designed for the specific retirement needs of key employees.

Under this structure, an institution agrees to pay specified additional compensation to the employee upon retirement, and this amount is calculated according to a vesting schedule. Thus, the longer the employee stays with your company, the larger this retirement bonus will be, up to a fixed amount.

Stock Appreciation Rights (SARs)

With stock appreciation rights (SARs), your key employees receive additional deferred compensation tied directly to firm growth. As your business increases in value, your employee's financial stake grows proportionately in the form of ownership shares, based also upon the employee's tenure with the company. These shares are given to the employee upon one or more "triggering events," such as when the employee retires, or if the business is sold.

Phantom Stock Plans

Phantom stocks are similar in nature to SARs, with the main exception that they aren't actual stock, but instead stock "units" that parallel the value of real stocks. Upon a triggering event as described above, the non-family employee receives a dividend or cash bonus for her phantom stocks, proportionate to the increased value of the actual stock.

Non-Compete Agreements

When a key employee leaves, your company's value may become vulnerable. This is especially true if that employee has knowledge of your client base or trade secrets. To preserve your business interests, you'd be wise to have these employees sign a non-compete agreement of some sort. These agreements occur in two basic forms:
• *Non-compete Clause (or, Restrictive Covenant)*: Under this agreement, the employee promises that if she leaves the organization, she will not perform similar work that might compete with your business within a defined geographic range, for a set period of time.
• *Nonsolicitation Agreemen*t: This agreement specifies that an employee leaving the company will not attempt to solicit your clientele away from you.

Non-compete agreements are validated by some sort of valuable consideration— that is, an added value to the employee as an incentive to sign. For an employee just coming on board, the valuable consideration may be the job offer in itself; however, if you ask existing key personnel to sign a non-compete, you'll need to include additional incentives, such as a bonus, a raise or increased benefits.

It is important to note that in Wisconsin, the validity of non-compete agreements is determined on a case-by-case basis, so it’s critical to consult with an employment lawyer regarding the specifics of these contracts.

As the owner of your business, you’ve already developed habits that encourage company growth. By utilizing tools such as those we’ve described here, you’re building a trusted, motivated management team and laying important groundwork for continued growth of your business after you leave it.