Session 609

Counseling the Family-Owned Business

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COUNSELING THE FAMILY OWNED BUSINESS

ESTABLISHING THE ROLE OF GENERAL COUNSEL/IN-HOUSE LEGAL DEPARTMENT

Good morning and welcome. I am Joan Albright; General Counsel for a group of companies called Overseas Military Sales Group. We are in the car business. Just in case you haven't heard car dealers are ranked slightly above lawyers at the bottom of the corporate food chain…so you see I struggle to overcome poor public opinion every day. Seriously I suggested this subject, which I felt would strike a familiar chord. I hope that what Joann and I discuss will stimulate open discussion among you. One of the benefits of these events is exchanging ideas and concepts that we can take back home to ponder and perhaps use to solve a problem or initiate a solution. These sessions are not always about substantive law but about developing good lawyering and management skills.

I am going to speak about what I know best. Establishing an effective and professional legal department in a small privately held company owned and operated by family members. I will outline briefly my experiences and then summarize each segment with a rule that I live by. JoAnne Hagen, my partner, is going to lead a discussion involving the growth and maturation of this kind of company as it grows and prospers.

When I was hired, 14 years ago, it was primarily to review and administer the company's contracts. This is the lifeblood of the company. We do not manufacturer vehicles. We only sell them. The appointment was task based. Although the company seemed professional no one had a clue what to do with me. Most had never worked anywhere else and were only familiar with attorneys that closed on their house or wrote their will. I was often told that I had the best job in the company because no one knew what that job was. I was not comforted. The first thing I did was to embark on an orientation schedule aimed at educating me on the important functions of the business. Since I worked directly for the COO he paved the way for this project. I sat and observed every facet of the business and he filled in the blanks with the important " numbers". Numbers that reflected sales commissions, costs revenues, expenses and statistical reports that tracked performance. That brings me to the first rule.

RULE 1: LEARN THE BUSINESS

As I became more conversant in the various functions supporting the business plan, I set out to educate management about the contracts and how they affected their job functions in terms they could understand. These training sessions gave me the opportunity to make a stronger connection with the people and be keyed into management's objectives. I also realized that people were not going to come to me with issues. I had to reach out to them. Therefore my second rule.

RULE 2: BE VISABLE AND ACCESSIBLE TO ALL MANAGEMENT

For the first 5 years or so I was called upon to put out fires. I was rarely invited to a meeting other than to discuss a problem already in the process of being handled. It was always an afterthought to include legal review. The problem rested with the owner of the company who basically felt lawyers got in the way of conducting business. He restricted my involvement to limited matters. Although the position was created by the COO and received his support, the owner did not have any involvement with the person or the position. I needed to accomplish a very difficult task – educate him on the function of the General Counsel. I had mistakenly thought he understood the purpose of the function. I began a series of difficult but necessary meetings with the owner regarding the future of the business. Through persistence and patience I was able to change his view of lawyers and more importantly my potential as a member of the management team. Developing this relationship was particularly challenging as I had to speak in terms the owner could understand and avoid legalese at all cost. He was able to endorse some of my initiatives and therefore encourage the employees to seek legal advice as a part of their normal everyday work load.

RULE 3: MAKE SURE THE KEY DECISION - MAKER IN THE ORGANIZATION UNDERSTANDS THE FUNCTION YOU ARE CREATING AND SUPPORTS YOUR INVOLVEMENT.

In the 14 years I have served as General Counsel I have never represented the owner or his family personally. I have always maintained that I work for the company. It is important to maintain the separation between company legal issues and the family that owns it. In keeping this distinction it promotes trust and credibility for you and your department among the organization. Although it may seem impossible rule 4 is about separation of family and business.

RULE 4: DO NOT GET INVOLVED IN THE FAMILY'S PERSONAL LEGAL ISSUES.

As the business grew so did my responsibilities. I expanded to counseling human resources and risk management. I participated in various management committees tasked with improving communication throughout the company as well as establishing formal management training. In a small company you can involve yourself with non-legal functions which can have a powerful impact on the productivity and morale of the organization. This only enhances your perceived worth to the company. This rule also provides you with the diverse environment you are hopefully seeking in working inside a corporation.

RULE 5: SAY "YES" TO NON-LEGAL ACTIVITIES THAT WILL FURTHER INTEGRATE YOU WITH MANAGEMENT.

As my role has evolved from solo practitioner into a legal department it has been necessary to publish my own policy and procedure for submitting issues for legal review. This formal procedure has been important to ensure work is completed on time for the benefit of the business project involved. I designed an intake form that is attached to all projects. It lists the work that is being requested and requires all pertinent facts be provided. The form also requires a return date. In this way we avoid the old lament that legal review is holding up action.

THAT BRINGS ME TO THE FINAL RULE6: PROVIDE MANAGEMENT WITH PROCEDURE TO OBTAIN LEGAL REVIEW.

If you follow these simple rules you will establish not only an effective legal function but also develop a rewarding career. The best part of becoming involved in this type of environment is being afforded the opportunity to expand into the business itself and develop other skills that only serve to enhance one's lawyering.

There is no doubt that creating or establishing the legal function within an organization that is intertwined with many long- standing relationships takes time and diplomacy. A family owned business reflects the personality of the owner(s) regardless of who operates the business. There is a bit of luck involved as to how receptive they will be to a new insider or stranger to their family. There is great pride felt in saying you are part of the family. However as a professional you cringe when that is said to you after many years of being considered an outsider. You also do not wish to compromise your objectivity or professionalism even if there is great personal gain promised. It is a balancing act to become close enough to the family that they will heed your advice and at the same time remain true to the mission of the corporation.

CONSIDER THESE ISSUES:

You have successfully drafted and published an employee handbook that contains company policies and procedures concerning human resource issues. One such policy involves the posting of positions. One family member wants to circumvent the policy and hire a friend's daughter at $5000.00 more than others in the same position hire. The Human Resource manager is having a problem making this person understand the impact of such action. You are contacted. What do you do? How high up the family ladder do you go?

The business is subject to audit by one of its contractors. Prior to an audit it is discovered unauthorized activity will be discovered during the process and the owner wants records destroyed. The executive in charge refuses and comes to see you about the ethical issues and his employment status. How do you advise him?

You are in the position for just 2 months and the firm is selling a large piece of real estate. You are instructed to use the owner's law firm that did his father's will. You know they are expensive and not equipped to handle the matter. Do you relinguish control and yield or take over?

Counseling the Family Owned Business
Growth and Maturity Challenges

First, let me introduce myself. I am Jo Anne Hagen, Chief Counsel of Hach Company, formerly a public corporation in which the family owned 52% of the stock. Hach Company is now part of the Danaher Corporation. My life at Hach has spanned 20 years with much of it spent learning about family ownership and the unique problems that go with it. In addressing this issue, the matter is about two often mutually exclusive terms -- family and business.

Growth, Maturity, Divestiture, Death

Growth and maturity of the family owned company may present unique problems for families. The business is often the entreprenuial concept of a single person, the founder. He or she has a particular way of viewing how the company should be run, and the entrepreneur and the family are often reluctant to share problems with outsiders such as attorneys, accountants or consultants even though wise counsel could offer them much needed assistance in crises. Such outside consultation may be considered intrusive into family matters. In many family companies, consulting an attorney is tatamount to going to a marriage counselor.

It is often difficult for you, the mere attorney, to understand what underlies the family approach to business. For example, one may be asked to solve a problem, say the dismissal of an employee. You come up with the "right" legal answer and provide your opinion, then are told that there are other considerations, perhaps the employee is an old family friend and although his or her usefulness (in a business sense) is considerably diinished, the family ties make it impossible to dismiss this person without creating a family rift. Your carefully crafted opinion is discarded, the employee is not dismissed, and you scratch your head in wonderment at the way things worked out.

Or consider the alternative problem. The employee, a valuable business asset, has had a disagreement with one or more family members running afoul of familial ties which are often tighter than that rubber band that encircles the New York Times Sunday Edition. The family may not only be seeking dismissal but vengence.

No family business is without emotion, the key difference between family and non-family businesses. A second, ans often equally important difference, is the matter of self sufficiency. Those were the original fuels of entreprenurial business: the belief and investment in oneself and abilities to succeed. Logic, self-restraint, objectivity, good business sense – none will overcome the family's emotional investment.

The family-owned business often has more "persona" than the non-family company. The business' emotional IQ is the ratio of family objectivity to family bias. And, like all of us, the business life experiences the same human experiences as personal life: birth, death, growth, infancy, juvenileness, maturity, gain, loss, success and failure.

Consider these situations: The founder is young and inexperienced. The founder is old and infirm. The founder is legally incompetent. The child of the founder cannot make it in the business environment. The brother of the founder steals from the business. The wife of the founder enjoys spending "time" inside the company and likes to sit with the telephone customer service folks. If any of these persons was not a family member, it would be an easy call wouldn't it? But when it is mom, dad, sis, brother, auntie or grandma, the situation changes drastically.

And, what, you might ask [because counsel often does] is the situation with succession? Family corporations are born, mature, grow old and die, just as do the people who found and work them Young entrepreneurs rarely have time to deal with such matters; elderly entrepreneurs may not wish to deal with it at all. In the middle lies the rest of the family, the employees, and all the others who depend upon the company for livelihood. The end game is often the divesting of the company…through merger, acquisition, or dissolution. It can be the hardest of times for the family members and the employees, and with everyone suffering in one way or another, in-house attorneys are often faced with difficult choices.

Consider these three hypotheticals:

The family-owned company is being acquired by another company. It is immediately obvious that about half the present employees are going to be let go. The patriarch is devastated by the situation and is remorseful of his decision to sell. He tells you that he has made a pact with some of the current employees that if they are laid off he will help them sue the acquirers. He wants your advice as to how to proceed? What do you tell him? What do you do next?

You are three weeks from closing on the sale of the family-owned company. The person who will be the new president and to whom you will likely report tells you that he will be asking all family members to leave as soon as the acquisition closes. You are then asked by one of the family members who is an employee/owner and who wants to stay what you think they should do to assure continued employment? What kind of ethical matters does this raise?

The Board of Directors of your family-owned business is comprised of two sisters, two brothers and two counsins. Mom is the Chairman of the Board. There is a dispute involving Dad (Mom's second husband). Dad has been working for the Company for the past four years and is nor in good standing with one brother, one sister and both cousins. They plan to discuss Dad's future at the next Board Meeting and want your advice as to what they should do about Mom (ask her to leave during the discussion, assume she will be objective, etc.). What do you advise?

TAX ISSUES AFFECTING THE FAMILY BUSINESS

By: Ira A. Rosenberg

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TAX ISSUES AFFECTING THE FAMILY BUSINESS

I..INTRODUCTION

II. CHOICE OF ENTITY

A. GENERAL CONSIDERATIONS

1. Control
2. Number of Owners
3. Nature of the Business
4. Asset Protection
5. Simplicity
6. Duration of the Business
7. Transfer of Interests
    a. Restrictions on transfers
    b. Valuation
    c. Discounts
8. Income Tax Issues
    a. Operational Tax Issues
    b. Disposition of Entity
9. Cash Flow (tax-free)

B. TYPES OF ENTITIES

1. Sole Proprietorship
    a. Overview
2. Partnership
    a. Overview
    b. General
    c. Limited
3. Limited Liability Company ("LLC")
    a. Overview
    b. Comparing Limited Partnerships with LLCs
        (1) Treatment of Liabilities
        (2) Basis in Interest
        (3) Passive Loss Rules
        (4) Distributions to a Withdrawing Partner (Member)
        (5) Passive Investment vs. Active Business
        (6) Asset Protection
4. Corporation
    a. Overview
    b. C Corporation
    c. S Corporation

d. Comparing S Corporations with C Corporations
e. Comparing S Corporations with Partnerships (incl. LLCs)
(1) Ownership Restrictions
(2) Transfers of Appreciated Property
(3) Distributions of Appreciated Property
(4) Profits Interest
(5) Basis Adjustment

III. BUSINESS SUCCESSION PLANNING

A. GENERAL CONSIDERATIONS
1. Valuation of the Business
2. Succession of Management
3. Passing on Equity Ownership
4. Retaining Voting Control
5. Liquidity to Fund Death Taxes/Other Costs
6. Adequate Retirement Income for Older Generation

B. BUY-SELL AGREEMENTS
1. Functions of Buy-Sell Agreements
a. Restrict Transfer of the Business Interest
b. Create Market for Business Interest
c. Determine Valuation
2. Types of Agreements
a. Cross Purchase
b. Redemption
c. Choosing Type of Agreement
3. Income Tax Consequences
a. C Corporations
(1) Cross-Purchase Agreements
(a) Tax Consequences to Selling Shareholder
(i) Recognition of Gain
(b) Tax Consequences to Purchasing Shareholder
(i) Purchaser's Basis in Stock
(2) Redemption Agreements
(a) Tax Consequences to Redeeming Shareholder
(i) Recognition of Gain
(aa) Distribution vs. Sale/Exchange Treatment
(b) Tax Consequences to Corporation
(i) Recognition of Gain
(ii) Effect on Earnings & Profits

(c) Tax Consequences to Other Shareholder(s)
(i) Effect on Earnings & Profits
(ii) Deemed Dividend on Hybrid Agreements

b. S Corporations
(1) Income Taxation of S Corporations
(2) Cross-Purchase Agreements
(a) Tax Consequences to Selling Shareholder
(i) Recognition of Gain
(b) Tax Consequences to Purchasing Shareholder
(i) Purchaser's Basis in Stock
(c) Tax Consequences to Corporation
(3) Redemption Agreements
(a) Tax Consequences to Redeeming Shareholder
(i) Recognition of Gain
(aa) Distribution vs. Sale/Exchange Treatment
(b) Tax Consequences to Corporation
(4) Special S Corporation Buy-Sell Issues
(a) Protecting S Election
(b) Distributions to Fund Income Taxes on Profits
c. Partnerships (incl. LLC)
(1) Cross-Purchase Agreements
(a) Tax Consequences to Selling Partner
(i) Recognition of Gain/Loss
(aa) Character of Gain/Loss
(ii) Effect on Seller's Partnership Taxable Year
(b) Tax Consequences to Partnership
(i) Constructive Termination of Partnership
(2) Entity Agreements
(a) Tax Consequences to Liquidating Partner
(i) Recognition of Gain
(aa) Payments for Partnership Property/Goodwill
(3) Family Partnership Rules
(i) Purpose/General Provisions
(ii) Effect on Buy/Sell Agreement
4. Estate and Gift Tax Consequences
a. Introduction
(1) Establish Gift/Estate Tax Value
b. Implications of Section 2703
(1) Applicability of section 2703
(a)Post -10/8/90 Agreements
(b) Pre-1980 Agreements Substantially Modified
(2) General Rule

(3) Exception to General Rule
(a) Binding Obligation to Sell
(b) Restriction on Lifetime Transfer
(c) Determinable and Reasonable Agreement Price
(d) Business Purpose
(e) Device
(f) Comparable to Third Party Agreement
(4) Effect on the Estate Tax Marital Deduction

B. RECAPITALIZATIONS
1. Overview/Structure
a. Shifting Future Appreciation
b. Retaining Control
2. Special Gift Valuation Rule (IRC Sec. 2701)
(1) Applicability of Sec. 2701
(a) Lifetime transfer of Equity Interest
(b) Transfer to Transferor's Family (same or lower generation)
(2) General Rule/Valuation of Stock
(3) Certain Transfers Escape Sec. 2701

C. PLANNING FOR S CORPORATION
1. Special Trusts or Transferring S Corp Stock
a. Qualified Subchapter S Trust ("QSST")
(1) General Provisions
(2) Requirements to Qualify
(3) QSST Election
(4) Trust Provisions
b. Electing Small Business Trust ("ESBT")
(1) Requirements to Qualify
(2) Election
(3) Trust Provisions

IV. POST DEATH ESTATE TAX ISSUES

A. DEFERRAL OF ESTATE TAX ON CLOSELY-HELD BUSINESS ASSETS (Sec.6166)
1. General Provisions
2. Qualification

a. Election
b. Deferral Period
c. Closely held business
(1) Definition
(2) Percentage of Adjusted Gross Estate (AGE)
d. Miscellaneous Rules
3. Acceleration of Deferred Tax
a. Disposition of Business Interest

B. STOCK REDEMPTIONS TO PAY ESTATE TAXES AND ADMINISTRATIVE EXPENSES (Sec. 303)
1. General Provisions
a. Limitation on Redemption Proceeds
b. Capital Gain Treatment
2. Qualification for Capital Gain Treatment
a. Qualifying Stock
b. Percentage of Adjusted Gross Estate (AGE)
c. Time Restrictions of Redemption
3. Interplay between Sec. 6166 and Sec. 303

C. FAMILY BUSINESS DEDUCTION (Sec. 2057)
1. General Provisions
a. Maximum Deduction
2. Interplay with Unified Credit
3. Qualification
a. Residency Requirement
b. Qualified Family-Owned Business Interest
c. Material Participation
d. Percentage of Adjusted Gross Estate
e. Qualified Heirs
f. Estate Tax Recapture Provisions
g. Election