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Corporate Insights: Key Legal Tips for Family Business Succession Planning

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Transferring your family business into the hands of a new generation is an exciting opportunity for growth. But with that opportunity also come legal considerations that are crucial to the ongoing success of any business. We have highlighted some of the key topics to consider during the succession process.

THE DECISION

At the beginning of the family business succession process, it's important to understand what drives your decision regarding the future of your business. It can be assumed that the key driver is the level of involvement and confidence in family members managing the business. But it's also important to discuss with advisors any other factors that affect your decision.

Business owners should also be aware of any limiting conditions or guardrails present in the business's governing documents that could pose obstacles to their intended succession plan. Particularly, you should ensure that interfamily transfers of interest are permitted, and that other transfers are permitted if not all interest holders are family members. You should also make sure that any buy/sell agreements prioritize family transfers.

OPERATIONAL CONSIDERATIONS

Often there are challenges when it comes to taking over or handing over a family business. These "growing pains" provide us with an opportunity to look at ways to make the succession process smoother. Having a working document prepared ahead of succession is always helpful. This document should act as a guideline for family members taking over the business. This document, in addition to key person insurance, will also be crucial in case the business owner is involved in an unexpected tragic event causing death or disability.

EXIT CONSIDERATIONS

In some instances, a business owner may explore exit opportunities, potentially partnering with a private equity buyer. In positioning your family business for an exit, outside of the obvious financial metrics, it's crucial to consider what cultural, organizational, and operational aspects are likely to be attractive to a buyer. When discussing terms with a buyer, defining the family's governance rights, decision-making authority, and board representation to avoid potential conflicts are key factors in arriving at a deal. Consider questions such as, will the family have one or more board seats or observer rights, and will the family's equity allow any influence on key business decisions, or will it be passive? You should also consider protective provisions, meaning certain rights like restrictions on additional debt, sale of assets, and hiring or firing of executives that might require family approval. In addition, restrictions on transferability, including lock-up periods, rights of first refusal, and tag-along/drag-along rights, should all be reviewed.

Incentive and retention programs are also things you should consider for key employees that may be essential to the business, particularly if the business is to be transferred to family. Additionally, if transfer to family is not possible, an alternative to a private equity sale is an Employee Stock Ownership Plan (ESOP), as it keeps the company from outsider sales and provides the seller with capital gains tax advantages.

