Is Employee Ownership the Answer to
Family Business Succession?

Articles by
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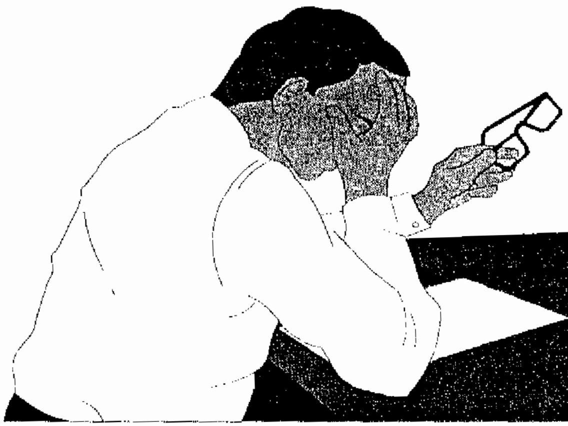

Why It's So Difficult For Family Businesses To Plan For Succession

by John Logue & Alex Teodosio

Business succession planning is one of the most important and difficult decisions facing business owners. It is a personal decision comprised of complex philosophical questions about the owner's future and his or her family. It is a decision that affects not only the owner but also the employees and the community the business helps to support.

So why do so many owners fail to plan for succession? According to a 1996 Council of Smaller Enterprises (COSE) survey, "*only 21% of Cleveland, Ohio business owners have a written plan for succession.*" Running a closely-held business often requires the owner's attention to detail in the day-to-day operations and prevents him or her from dealing with longer term issues like succession planning. This is one of the main reasons why "*70% of family-owned businesses do not make it to the second generation, and only 13% continue to the third generation.*"

Succession planning is often difficult because of emotional issues surrounding business and family relationships, life changes, and mortality concerns. Although there are a variety of "mechanical" transition tools available such as buy-sell agreements, keeping it in the family, gifting of shares, trusts, management buy-outs and selling to the employees, the owner needs to discover his or her comfort level based on personal philosophical beliefs before attempting to make one of these alternatives work.

Relationships

Ironically, the close relationships that enable a small business to grow and prosper are often the same ones that lead to its demise. This is because the personal identity of the business owner is often intimately tied to the business. Disturbing that connection often raises insecurity about the owner's personal and professional relationships. When succession planning begins, it changes these relationships. Planning can put the relationships between family members under tremendous stress and managers, employees, suppliers and customers get nervous about what the change will mean for them.

Since planning for succession may bring potential conflicts into the open, it is important to have a formal process to include everyone's opinions and concerns. If people who have a stake in the outcome of the succession plan are not aware of the process, they may build up resentment for those who are involved and will feel that they are not getting what they deserve. As a result, a good succession plan will meet the needs and goals of the business owner as well as the other major stakeholders and retain the relationships necessary for the business to succeed and the owner to be satisfied.

Life Changes

Throughout the business owner's life, he or she had an easy measuring stick for personal accomplishment - the business. Retirement often marks the end of the business owner's most productive years. Whereas the success of the business is a great source of personal affirmation and encouragement, retirement requires that those measures of success change. Business owners are used to being in control and their opinions and ideas have added weight because they are in charge. There are varying levels of comfort and insecurity for an owner giving up control. While the owner's support and professional advice may still be needed, business owners are essentially preparing themselves not to be needed any longer.

Mortality

None of us likes to think about or discuss our own mortality, but the process of succession planning is all about what will happen "*when I am gone.*" The first recommendation of many succession planners is for the business owner to find a personal counselor to help him or her deal with these complex and emotional issues involved. If the mortality issue is not explored, often the business owner and the business die on the same day.

Although relationships, life changes and mortality issues are invariably more complex when there is no clear successors, there are compelling reasons to plan for ownership and management succession.

After the owner tackles the philosophical and mechanical aspects of succession planning, he or she is ready to consider the economic ramifications of the various alternatives that are available. These financial

considerations include: taxes, risks, options, control, and value issues.

Taxes

Few business owners like the idea of paying their hard-earned dollars to the government in taxes. The business often symbolizes the greatest life accomplishment of the business owner, except perhaps his or her family. If no plan is in place at the death or disability of the business owner, the government takes much of the value of the business, leaving less benefit for his or her family. On the other hand, by planning for succession, business owners can reduce, and sometimes completely avoid, taxes and insure that the family and important employees get what they deserve, instead of what is left after taxes.

Risk

The longer a business owner waits to design and implement a succession plan, the larger the risk that the plan will not meet the goals of the business owner. The risks also increase that the business will not continue beyond his or her lifetime.

Options

The sooner a business owner starts planning for succession, the more options he or she will have to meet his or her goals. Most business owners want to provide continued income for family members, jobs for family members and colleagues and to establish a personal legacy. The number of options available to meet these goals decrease steadily as the business owner nears the end of his or her productive life.

Control

By planning for succession, the business owner retains control over the outcome. When business owners fail to plan, the government or varous attorneys involved will take control.

Value

If a business owner has not implemented a succession plan and is still involved in the day-to-day operations of the business when he or she dies or is disabled, the value of the business can drop precipitously. This means that owner's beneficiaries will not receive the full value of the business, had succession planning been done.

What can you do to begin planning for your succession?

The Ohio Employee Ownership Center at Kent State University has implemented a business succession planning program in the Cleveland area with the support of the Cleveland Foundation and the George Gund Foundation. In partnership with the Greater Cleveland Growth Association's Council of Smaller Enterprises (COSE), the OEOC coordinates these seminars to help business owners explore a wide-range of succession planning options. This program was developed to preserve jobs that would otherwise be lost from an owner's failure to plan for succession. Without a succession plan, many business owners must liquidate all or part of their business to pay estate taxes. That's bad for the business, the family, and the community.

The Business Succession Planning Program's Fall Schedule

Initial Steps In Succession Planning	*September 9th*
Legal & Tax Issues In Succession Planning	*September 25th*
Financial Tools In Succession Planning	*October 28th*
Management & Family Issues In Succession Planning	*Novemenber 19th*
ESOPs As An Alternative In Succession Planning	*December 3rd*

Each seminar runs from 8:00 a.m. - 10:00 a.m. at the Greater Cleveland Growth Association in Tower City (except the December 3rd seminar which runs from 8:00 a.m. - 12:00 p.m. at the Hermit Club in downtown Cleveland.) Program participants will receive: "An Owner's Guide to Business Succession Planning." This is a directory of local service providers and how much they charge Succession Planning Program participants, worksheets, selected readings and other helpful resource materials. A continental breakfast will also be served.

The cost for attending each seminar is only $20 or all five for $85!

Please contact Alex Teodosio at **(330) 672-3028** to register or for more information.

About the Authors

John Logue (left), **Alex Teodosio** (right) and **Steve Clifford** (not pictured), *work for the Ohio Employee Ownership Center (OEOC) at Kent State University. Steve Clifford, formally with the OEOC is now a Massachusetts based consultant working with the Succession Planning Program.*

When Employee Ownership Makes Sense

The number of Employee Stock Ownership Plans (ESOPs) in the United States has increased from approximately 200 employing 250,000 workers in 1974 to over 10,000 established ESOPs in 1997 covering an estimated 11 million employees. This dramatic increase is due in large part to the implementation of ESOPs as: ***a competitiveness strategy, a business succession plan, a strategy for tax-advantaged corporate financing and a means to avert a plant shut-down.***

The mushrooming of employee ownership over the last decade is due in large part to the legal recognition of ESOPs in the Employee Retirement Income Security Act of 1974 (ERISA). This act gave statutory definition to a concept introduced by Louis Kelso and Patricia Hetter in, "***How To Turn Eighty Million Workers Into Capitalists On Borrowed Money***" (1967).

Kelso and Hetter believed greater economic growth could be achieved through a broadening of corporate ownership. Since capital is the primary source of an affluent society, "*universal capitalism*" is a prerequisite for real economic expansion. Corporate ownership had concentrated wealth and a vehicle was needed to encourage a broader population to accumulate shares of corporate ownership so individuals could gain a viable share of corporate wealth which they in turn could use to develop their personal wealth.

As the number of people with multiplying net worth grew, so would the economy grow at a substantially increased rate. Kelso and Hetter proposed to motivate corporations via tax incentives and finance the leveraged acquisition of new capital through the discount window of the Federal Reserve. Less than a decade later their proposal was made part of U.S. economic policy as Congress awarded ESOPs tax-favored status in the Employee Retirement Income Security Act (ERISA) of 1974.

How An Employee Stock Ownership Plan Works

An Employee Stock Ownership Plan, or ESOP, is a tax-qualified employee benefit plan that invests primarily in stock of the sponsoring employer. ESOPs must meet governmental regulations issued by the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS).

The simplest way to understand how an ESOP works is to conceptualize it as a variation of a traditional profit-sharing plan. Contributions made to the ESOP are tax deductible and income earned by the ESOP is tax deferred. Since the ESOP is a retirement plan for participants, employees are not taxed on their accounts until the money is withdrawn. So what is the difference between an ESOP and the traditional profit-sharing plan or other pension plans?

There are two key distinctions:

*An ESOP is the only qualified employee benefit plan that can borrow money; and

*An ESOP invests primarily in employer stock and may own anywhere from a fraction of 1% to 100% of a company's stock, whereas traditional pension plans are subject to stricter diversification requirements.

Similar to other pension plans, ESOP stock is held outside the company in a trust that is a separate legal entity. The trustee has a fiduciary (legal) obligation to act in the best interest of all employee participants in the ESOP. Within this trust, separate accounts are maintained for individual stockholders.

In a leveraged situation, each year the company pays back part of the principal on its ESOP loan. The loan payments are made through the ESOP to the bank and are therefore tax deductible business expenses, just like other contributions to a pension plan.

Tax Incentives for ESOPs

The most significant tax incentives established by Congress to encourage companies to set up ESOPs are:

1. An individual who sells 30% or more of his or her stock in a closely-held "C" corporation to an ESOP may defer the capital gains tax if the proceeds of the sale are reinvested in other domestic securities. The income tax on the gain would be due upon the sale of the replacement property but if the replacement securities pass into the estate, the transfer to any beneficiaries is treated as a stepped-up basis and no capital gains is ever paid.

2. If the corporation uses an ESOP to obtain a loan, it may **deduct the principal as well as the interest payments** on the loan. For many companies, this is an excellent strategy for corporate financing and can cut borrowing costs by one-third. *Imagine if you could do this on your home loan!*

3. Dividends paid in cash on shares held by an ESOP are deductible by the sponsoring corporation if they are passed through to the participants in the plan or they are used to pay off a loan taken out to finance the purchase of company stock.

4. Participants in the ESOP have tax-sheltered accounts until their benefits are withdrawn, typically at retirement.

Employee Ownership Makes Sense...

Whether you are exploring employee-ownership as a strategy for stable business succession or a tool for tax-advantaged corporate financing, you should begin by assessing your philosophical beliefs and personal comfort level with the underlying concepts of employee-ownership. If communicated effectively and coupled with participation, employee ownership can also be a powerful tool to motivate employees.

...As a Competitive Strategy

In addition to the tremendous tax incentive and financing opportunities there are also many work performance

advantages to employee ownership. The General Accounting Office's (GAO) recent survey of ESOP firms found that the combination of employee ownership and employee participation yielded substantial improvements in firm performance.

There are numerous research studies that indicate this direct and positive correlation between high levels of employee participation on the shop floor in employee owned companies and increased performance and production.

...As a Business Succession Plan

Most employee-owned firms are successful and profitable businesses. Approximately 58% of Ohio ESOPs instituted employee ownership primarily to purchase shares from retiring owners.

As previously mentioned, a retiring owner of a "C" corporation who sells 30% or more of the company's stock to an ESOP trust may defer capital gains if the proceeds of the sale are reinvested in other U.S. operating companies.

This tax incentive is an attractive strategy for the owner to begin exiting the business while still maintaining control and taking care of his or her employees and the community by retaining jobs for the long haul.

...As a Strategy for Tax-Advantaged Corporate Financing

Unlike profit-sharing and other employee benefit plans, ESOPs may borrow money to purchase company stock. In fact, 10% of Ohio employee-owned businesses used an ESOP loan as the primary means to finance company expansion. This is really a tax-advantaged financing tool since the company can deduct both the principal repayments as well as interest on an ESOP loan.

After the ESOP trustee uses the loan to purchase stock from the company, the company may then use the proceeds for any acceptable business purpose such as purchasing equipment, buying another company, taking a private company public, or financing the sale of the stock. This technique will greatly reduce the company's financing costs.

...As a Means to Avert Plant Shutdown

ESOPs may be used as a vehicle to save jobs and anchor capital in communities when job loss threatens. Although employee buyouts to avert plant shutdown are more common in Ohio than any other state only 5% of Ohio firms instituted employee ownership primarily to avert job loss. Turning around troubled companies through employee ownership is a difficult but worthwhile undertaking.

There are approximately 300 companies that were bought by employees through an ESOP loan to avert a shutdown or major job loss in the U.S. A few of these companies are: Northwest Airlines, Weirton Steel in West Virginia, and Bliss-Salem, Ohio. These companies and many others across the U.S. would no longer be operating today if they had not become employee-owned.

How to Get Started

If you are considering an ESOP for your company you may want to begin your exploration by talking with folks from other employee owned companies similar in size and culture.

Sometimes this is the simplest and best way to gain a true understanding of all the costs and benefits of establishing structuring an ESOP. The OEOC has an active Succession Planning Program that assists business owners exploring various alternatives in addition to ESOPs.

You may also want to search the Internet, attend seminars, and research journals to determine if employee-ownership fits your philosophical beliefs. If you find yourself comfortable with the concept, explore various alternatives in structuring an ESOP.

Finally, if you want to use employee ownership to increase competitiveness, it is advisable to establish open channels of communication with the employees and maintain a consistent level of input for employee participation.

Resources Available

The Ohio Employee Ownership Center is a university based program located on the campus of Kent State University.

The Center's staff is experienced in guiding business owners and buyout groups through the process of establishing an ESOP, and can provide lists of the ESOP service providers that you will eventually need in pursuing an ESOP.

The OEOC has an active Succession Planning Program that assists business owners exploring various alternatives in addition to ESOPs. The Center also coordinates administration forums, workshops, training seminars, retreats and various events through *Ohio's Employee-Owned Network.*

For assistance, more information about the Ohio Employee Ownership Center or to receive the Center's newsletter, ***Owners At Work***, free of charge, call **(330) 672-3028**.

About the Author

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Creating A Successful Ownership Culture

by Alex J. Teodosio

The backbone of the American economy is the small family-owned business. The responsibility of running such a business on one's own involves a great deal of both stress and time.

Often, the owner has no one to trust to take care of the company while going on a much needed vacation. Not only is their time for relaxation severely limited, but they also have to shoulder all of the responsibilities of the firm. The obvious solution is to share responsibility, but it is hard to pay competent employees enough to retain them and employees rarely feel the same sense of responsibility that owners have. Sharing ownership with employees offers the opportunity to involve the workforce in the business with the same sense of responsibility that an owner has.

Sharing ownership through an **Employee Stock Ownership Plan** (see "*When Employee Ownership Makes Sense*" in the Winter, 1998 issue of the ***Family Business Journal***) is one of the necessary ingredients to establish a successful ownership culture. However, employee-ownership by itself will not increase employee motivation and performance.

This is the conclusion of the U.S. General Accounting Office (GAO) which compared ESOP companies with traditionally owned firms. The GAO's study found that the **combination** of employee ownership and employee participation yields substantial improvement in firm performance. (*Employee Stock Ownership Plans: Little Evidence of Effects on Corporate Performance.* GAO/PEMD-88-1, Washington, GAO, 1987.) It is precisely this type of genuine employee partnership which can lead your employees to take on some of the responsibility.

According to a U.S. Department of Labor (DOL) study, the high performance workplace provides workers with "incentives, information, skills, and responsibility to make decisions essential for innovation, quality improvement, and rapid response to change. (*High Performance Work Practices and Firm Performance.* U.S. Department of Labor August, 1993)

Further, the DOL suggests, high-performance workplaces exist in companies which integrate their business, human resource, and technology strategies and share the following common characteristics:

* Give workers a stake in the performance of the organization through employee ownership and gainsharing;

* Create employment security strategies that recognize the value of workers to long-term economic performance;

* Push responsibility down to front-line employees, often by organizing work into self-managing teams;

* Provide workers with the information necessary to exercise a high level of autonomy and discretion;

* Build worker-management relations on trust, mutual interest and cooperation;

* Focus on satisfying customers, not simply shareholders; on improving quality, not simply reducing costs; and on building organizations that adapt easily to market change;

* Encourage workers to learn new skills through skill-based pay and pay-for-performance compensation systems;

* Invest in training and retraining to develop workers as critical business assets, rather than treating them as costs to be minimized; and

* Provide workers with safe and supportive work environments.

Though the high performance workplace concept is cited as an optimal solution, the Department of Labor estimates that currently only 4% of U.S. businesses qualify as high-performance workplaces. (*High Performance Work Practices and Firm Performance.* U.S. Department of Labor August, 1993) Interestingly, 25% of employee-owned firms in the U.S. have these high-performance characteristics. Overall, employee-owned firms are more likely than traditional firms to provide sufficient incentives, information, skills, and responsibility to their work forces.

Ownership + Participation + Information + Training = Higher Performance
Studies in the States of Ohio and Washington reinforce the federal government's findings.

The Ohio Employee Ownership Center (OEOC) at Kent State University surveyed 167 Ohio ESOP companies and found that employee-ownership coupled with participation, education and information leads to higher financial performance. Equally important, a study in the State of Washington showed that companies which reward employee participation with stock ownership outperform those which only reward participation with profit sharing.

The transformation of workers into owners requires cultivating a genuine sense of ownership where the employees take the responsibility of ownership seriously and their actions contribute to the company's success. This process

obviously does not occur overnight. Developing an ownership culture among your employees means seeing that they get what you already have: equity, a say in how things get done, information and training. Employees need to understand company financial reports and develop their decision making, communication and problem solving skills.

Ownership

Equity makes a big difference. Consider the difference between renting and owning a home. Unlike a person who rents, the homeowner has equity in his or her investment and therefore will have an incentive to increase the value of that investment.

After all, how many renters do you know that paint the outside of their residence? Just like a homeowner, an employee-owner has a greater incentive to drive the value of stock in his or her company. This could result in reducing scrap, generating creative ideas on how to improve a process, and producing better quality products. This ownership could be in the form of stock options, a cooperative or an Employee Stock Ownership Plan (ESOP). Although rewards like profit-sharing and bonuses are great supplementary incentives, they do not provide employees with an ownership stake.

When employees have an ownership interest in their company and are valued for their input, their jobs become more meaningful. Satisfied employees as well as satisfied customers stay with the company longer! As mentioned earlier, ownership is just the first step in creating a successful ownership culture. The remaining ingredients are participation, training and information.

Participation

Motivated employee-owners need the opportunity to express their ideas for improving the business to management. Effective communication requires that managers listen, appreciate dissent and tolerate opposition. Likewise, supervisors need to lead rather than order, assist rather than discipline, and teach rather than threaten.

It is the responsibility of employees to make suggestions without confrontation, learn basic business concepts, and work cooperatively with others. Open channels for input should be maintained throughout the company.

To initiate increased levels of participation, you might consider creating problem solving teams or shop floor committees.

Whether your company is employee-owned or not, the goal of participation is maximum feasible employee involvement in all areas of company decision-making, from the shop floor to the boardroom.

It is through participation on decision making bodies that your employees can truly accept greater responsibility.

Information

An owner needs access to financial and other strategic information to make sound business decisions. Responsible employees also need access to company information like financial reports, scrap rates, customer satisfaction indicators, and on-time delivery records.

Of course information is only useful if it is communicated effectively.

This information can be in the form of regularly published newsletters, annual or quarterly meetings to review business issues, and company financial statements.

Part of this communication process requires that the receiver be able to understand the information presented. This requires a long-term commitment to education and training.

Training

U.S. firms generally spend much less on training and education for employees than their competitors in Japan, Germany, Sweden, and other advanced countries.

Most of what U.S. corporations spend goes for management training. The American Society for Training and Development confirmed that two-thirds of corporate training monies go into training for those who already have college degrees. (America's Choice: High Skills or Low Wages, Rochester, NY, National Center on Education and the Economy, 1990, p.49.) If you want to create a successful ownership culture at your firm, just informing employees is not enough. They also need to understand the information they receive in order to be informed and involved owners. Opening your books to employees is meaningless unless your employees understand how to read financial reports. Meetings to improve quality lead nowhere if the participants lack effective meeting skills.

Education is a *process* of learning and coordinating an effective training program requires a long term commitment. Training non-managerial employees in problem-solving and group process techniques helps make employee participation programs work successfully.

Getting Started

It is relatively inexpensive and highly cost effective to undertake some combination of employee participation, training, open-book management, and financial incentives to increase company competitiveness.

However, family business owners who are seriously considering the establishment of an ownership culture to increase performance may want to begin by examining their own personal philosophical beliefs.

They may also want to discuss the challenges and potential rewards with other business owners who have implemented policies to foster an environment that allows employees to think and act like owners.

Local Resource

The Ohio Employee Ownership Center (OEOC) at Kent State University is a non-profit, university-based program that assists owners in exploring whether employee-ownership makes sense for their particular situation.

The Center also coordinates a comprehensive succession planning program in conjunction with the Greater Cleveland Growth Association. All Center staff have been Certified as Economic Development Finance Professionals

through the National Development Council.

The OEOC staff provides training that can help your employees increase their understanding of ownership and financial information, and build the problem-solving and communication skills so important to successful employee involvement. For additional information about the Ohio Employee Ownership Center and the Succession Planning Program please call **(330) 672-3028.**

About the Author

Alex J. Teodosio, is the Succession Planning Program Coordinator and an employee educator at Kent State University's Ohio Employee Ownership Center. e-mail: OEOC@Kent.edu or http://www.kent.edu/oeoc.

HIRING RELATIVES...

What Business Owners Say

by Edwin A. Hoover, Ph.D. CMC & Colette Lombard-Hoover, M.S.

Hiring relatives can be like thread ing a needle. It takes patience and steady hands and trying not to stick yourself in the process. It involves tough issues like compensation, ownership, accountability and competence that can be real headaches. LSi conducted a survey of over 600 family owned companies regarding their belief and practices about family participation. We were pleased to receive responses from 60 family business executives.

SURVEY RESULTS

In terms of **Hiring, Compensation and Accountability** over 8% agree that:

Family members should meet the same criteria for hiring as non-family employees;

Compensation for family employees should be based on a *fair market value* for the position held;

Family members should be subject to the same performance reviews and rules regarding firing as non-family employees.

When it comes to **Ownership Practices** slightly over half believe:

Ownership should not be restricted just to family members who are managers but just under one quarter believe that it should be;

One-half believe that ownership should **not** be available to family members **just because they are actively employed** by the business;

Almost one-third believe stock ownership should be available to any family member working in the business.

The important point is that over half of the respondents do not believe that family member employment should, by itself, be a necessary and sufficient condition to own stock in the company. It's likely that other things like contributions to the company, long term commitment and skill level are more important.

The biggest surprise was the response about **Previous Employment Experience and Supervision**. Two-thirds of the respondents either don't think it is necessary for family members to have previous successful employment experience prior to joining the family business or are unsure about its importance.

There is little question among family business advisors or family businesses themselves who have such a requirement, that prior outside experience is always a major plus for family members coming into the business.

The pressure, both emotional and pragmatic, is often great to bypass this pivotal point. Parents can be eager to add the potential capabilities of their daughter or son to the business. Children can easily be enticed to grab the opportunity for a good position and salary earlier in their careers than would otherwise be possible.

What's The Value Of Previous Experience?

We recognize that many family businesses are success stories in which younger family members entered the business without previous employment experience. However, previous successful employment experience leads to the kind of self-confidence that can only be forged when the raw material of a person's own efforts meets the heat of non-partisan measures of performance.

Without it, young family members coming into the business can have difficulty overcoming lingering self-doubt, and others over coming questions, as to how much their current job status and salary has to do with real

Department of Labor Audits...

because:

1. Penalties can be levied if it is determined that the record keeping and the various required documentation is missing or incomplete, and

2. In the event it is determined that overtime should have been paid but was not:

a. the overtime **MUST** be paid

b. the additional pay is subject to all payroll taxes (social security and medicare, federal and state unemployment, workers' compensation, and benefits, if any

c. all payroll tax returns need to be amended

d. all additonal taxes must be paid as well as penalties and interest for the late payments.

You should review your entire payroll and personnel systems, including documentation pertaining to how overtime is paid.

Remember, salaried employees are not automatically exempted from the minimum wage requirements. Also, and very important, officers are **NOT** exempted from having an employee folder that shows all the necessary documentation (it should be the same as any other employee.)

About the Author

Elvira Bellegoni, is an accountant who has been practicing since 1976. She has been an instructor at various colleges and universities. Elvira has published many articles dealing with the smaller business, from preparing a Business Plan to Tax Planning, to Growth Strategies. She has extensively lectured on the same subjects.

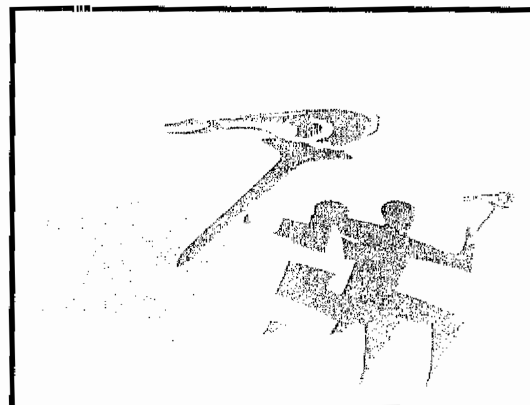
Elvira is also the author of a book called, ***"Bookkeeping & Administration for the Smaller Busines."*** Please contact her if you are interested in purchasing this book.

Contact her at: **(440) 943-4006**

Why Should Family Business Owners Plan for Succession?

A summary of five commonly used tools to transfer the family business.

by Alex Teodosio



Take these facts into consideration:

* 70% of family-owned businesses do not make it to the second generation, and only 13% continue to the third generation. (*John Ward, Loyola University, 1987*)

* 90% of all U.S. businesses are family-owned and controlled according to the U.S. Small Business Administration. These businesses account for 65% of all wages paid and generate 50% of the GNP. More than a third of family business owners are 61 years old or older.

* 56% of family-owned firms **do not** have written succession plans. (*Mass Mutual Life, 1995 Family Business Survey*)

* About half the owners participating in the 1995 American Family Business Survey said they planned to retire or "semi-retire" in the next five years, although two out of five in this group said they had not picked a successor. One in ten plan to *never* retire. (*Arthur Anderson, Loyola University & Kennesaw State*)

* One third of small business owners will have to sell outright or liquidate a part of their firms to pay estate taxes. At least half of these companies expect they will have to eliminate 30 or more jobs in the process. Another 20% expect to eliminate 100 or more jobs. (1992 Gallup Poll)

* 38% of the companies participating in the 1995 American Family Business Survey had little or no understanding of the estate tax due upon the death of the senior generation.

* Only 21% of Cleveland, Ohio business owners surveyed have a written plan for succession. (*Council of Smaller Enterprises (COSE) Small Business Monitor Survey, 1996*)

Here are five commonly used transition tools to consider when planning for succession:

Buy-Sell Agreement

A buy-sell agreement is a prearranged contract for the disposition of an owner's interest in the business. This agreement normally explains what will happen to the owner's business interest in the event of death, disability, and retirement and it establishes the value of the business. Often, life or disability insurance proceeds are used to fund buy-sell agreements because the company and its owners may not have the cash needed to purchase or redeem the departed owner's interest or replace the disabled owner's income.

Cross purchase agreements and redemption plans are the two basic types of buy-sell agreements. In a cross-purchase agreement, the remaining owners agree to purchase the departing owner's interest. Upon the death of an owner, his or her interest typically passes to buy the business interest from the deceased owner's estate, as directed in the agreement.

Redemption plans require that the business owners agree to have the business entity buy back the interest. Upon the death of the owner, his/her interest passes to the estate of the deceased owner. Life insurance on the deceased owner's life is made payable to the company. The business then uses the proceeds to redeem the interest from the deceased estate.

Typically, the most important provisions in a buy-sell agreement are; (1) the purchase price for an owner's interest (2) who will continue to have ownership in the business; (3) who will manage the operations of the business; (4) who is responsible for the debt and unpaid bills when an owner leaves the business, as well as who collects any contract proceeds that are paid after an owner leaves the business.

Family Limited Partnerships

A family limited partnership is a partnership with general controlling partners and limited, nonvoting partners. Families use limited partnerships to centralize the management of family business or real estate,

and pass limited partnership interest to the next generation on an estate and gift tax advantaged basis.

The partnership agreement determines the rights and responsibilities of the partners, generally reserving management authority to general partners. Limited partnership interest may be gifted to others, like children, who are bound by the restrictions in the partnership agreement. The senior generation usually maintains control over the activities of the partnership by retaining the general partnership interest. Limited partnership interest of $10,000 ($20,000) in value if split with a spouse can be transformed free of gift tax to family members. In addition, lifetime gifts of larger amounts may be made using some or all of each owner's lifetime exemption which is $625,000 at the Federal Level. *(This will increase to $650,000 on January 1, 1999.)*

In a family limited partnership, general partners retain management control of the business. General partners can usually control cash flow to limited partnership by the conditions contained in the partnership agreement and by their operation of business. Transfer restrictions in the partnership agreement can restrict limited partners from selling or encumbering their interest without permission of the general partners, which helps control children. Family limited partnerships also frequently provide an incentive for the children to build the valve of the company without diminishing their work ethic, because children have an ownership interest in the business. A family limited partnership can usually be amended, with the agreement of all partners. The limited partners have limited financial liability and therefore they can generally only lose what they have invested.

Grantor Retained Annuity Trusts (GRATs)

A grantor retained annuity trust permits the owner of property to retain an income stream (i.e. an annuity) from the property for a term of years and transfer the remainder interest in the asset. If the owner survives the annuity term and the trust is properly structured, only the value of the remainder interest is subject to a federal gift tax.

In a GRAT, the person who transfers property to the trust (the grantor) receives a stream of income from the trust for a certain number of years. The amount of assets subject to gift tax is equal to the value of the "remainder interest", which is usually considerably lower than the actual current value of the assets. The property passes to the heirs at the end of the annuity term. Since the gift tax on the remainder was paid when the GRAT was set up, all of the appreciation in the property passes to the heirs tax-free. To reduce the amount of the remainder passed to heirs, the grantor may choose a longer term for the trust or a higher annuity payout rate. For a GRAT to work, the trust must have the ability to pay the annuity annually and the owner (i.e. the grantor) of the assets must outlive the term of the trust.

To compute the taxable gift, the annuity retained by the owner (grantor) of the asset is subtracted from the fair market value of the property. The amount subject to a gift tax is not equal to the current value of the gift, but rather the value of the remainder interest. If the rate of return of the assets placed inside a GRAT is higher than the monthly rate used by the IRS, transfer tax savings are realized.

Employee Stock Ownership Plan (ESOP)

An Employee Stock Ownership Plan is a qualified employee benefit plan in which employees receive stock in their company. An ESOP is designed to invest primarily in the stock of the employer company. What makes the ESOP a unique pension plan is its ability to borrow money in order to acquire company stock. The borrowed proceeds may be used for any business expense and upon repayment of the loan, the company may deduct both the interest and the principal payments.

The ESOP typically borrows money from a bank to buy company stock from the owner. The fair market value of the stock is determined by an independent appraiser. The company then repays the loan by making tax deductible contributions to the ESOP. As the loan is repaid, the stock is allocated yearly to the accounts of employees usually based on their compensation relative to the entire payroll.

The owner is able to defer capital gains tax on the sale of his/her stock if the ESOP owns at least 30% of the company stock and the owner reinvests the proceeds in other U.S. operating companies (replacement properties) within twelve months after the sale. Moreover, if the seller holds onto the replacement properties until death, he/she will receive a stepped-up basis on the property and the beneficiaries will avoid any income tax on the gain.

In a non-leveraged ESOP, a company may deduct up to 15% of eligible payroll when making contributions of cash to buy company stock. In a leveraged ESOP, this deduction increases to 25%. In addition, reasonable dividends paid on ESOP stock are deductible if they are paid in cash to employees or used to repay the loan. Because of the unique tax incentives, ESOP companies benefit from an increase in cash flow which may be used for debt reduction, acquisition, and other corporate purposes.

By giving employees ownership interest in the company, ESOPs enable employees to share directly in the equity growth of their company. Federal law requires all employees to be vested within seven years. The company is required to buy back employees vested stock interest upon departure. This typically occurs at retirement. The company may repay departing vested employees either in a lump sum or in equal payments plus interest over five years. A general rule of thumb is that a company considering an ESOP should have at least 20 employees, a payroll of $500,000 and pretax profits of $100,000.

Selling Your Company to an Outside Buyer

There are essentially two types of sales: asset sales and stock sales. In an asset sale, certain individual items that are owned by the company, such as the building, machinery, inventory, contracts, customer lists, land, drawings, patents, and

intellectual property are sold. When a stock sale occurs, the buyer acquires all assets as well as all liabilities, disclosed and undisclosed. In either type of sale there are accounting, legal, tax and estate planning implications.

In order to sell your company to an outside buyer, you will probably need qualified professionals to assist you, such as a financial advisor or investment banker, an attorney and an accountant. The financial advisor performs three important functions: (1) preliminary valuation of the company; (2) marketing the company; (3) negotiating with potential purchasers.

It is advisable to retain one financial advisor to prevent breaches of confidentiality and haphazard marketing. The accountant will get the company's books and records in order for the sales process, and may have to conduct an audit of the company's books to satisfy some financing sources. The attorney provides advice on tax issues and transaction structure, participates in negotiations with purchasers, and prepares the documentation for sale. Although the accountant and attorney typically get paid by the hour, the investment banker or financial advisor usually receives a percentage of the selling price as his/her fee and may require a retainer. Be sure to clarify all fees upfront.

To determine the asking price, the financial advisor will conduct a preliminary valuation of your company based on both macro and micro factors affecting the value. These factors include market conditions in your industry, the legal and regulatory environment, the general economic outlook, and your company's financial condition, operating performance and future prospectus.

Identifying a buyer really falls into two categories. There are financial buyers and strategic buyers.

A strategic buyer is a company in your industry such as a direct competitor, a customer, or a supplier.

A financial buyer is a venture capital or buyout firm or an investment group. Your financial advisor will work with you to identify potential buyers. Initially prospective buyers will need to see complete historical and projected financial information about your company with all the underlying assumptions. You should also include a discussion of new markets and new opportunities within existing markets, as well as new product lines. Prospective buyers should sign non-disclosure agreements before receiving financial information.

What can you do to begin planning for your succession?

The Ohio Employee Ownership Center (OEOC) at Kent State University has teamed up with the Greater Cleveland Growth Association's Council of Smaller Enterprises (COSE) to provide a comprehensive series of business succession planning seminars. These seminars help business owners explore a wide-range of succession planning options.

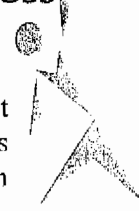
For additional information about Employee Stock Ownership Plans (ESOPs) or Kent State's comprehensive succession planning seminar series, please contact Alex at (330) 672-3028 or e-mail him at ateodosi@kent.edu.

About the Author

Alex Teodosio, is not an attorney. However, the information presented in this article has been reviewed by legal, financial, and accounting experts. Please consult your attorney, financial advisor and accountant before pursuing any of the above legal techniques.

Alex is the Succession Planning Coordinator and an employee educator at Kent State Univeristy's Ohio Employee Ownership Center (OEOC). Alex has assisted many companies in making the transition to employee ownership and he has written several articles on employee and participation topics. Teodosio is a co-author of "***Participatory Employee Ownership: How it Works***" published in 1998.

Top 7 Steps that Lead to Business Fitness



(1.) Refine and define your **Vision** for your business. Put it in writing as succinctly as possible. Post it where you can see it every day.

(2.) **Analyze** where you are in relation to your vision--financially, in the marketplace, operationally and personally.

(3.) Develop a **Strategy** to get from where you are to where you want to be. This becomes the foundation for your Annual Operating Plan.

(4.) Write a detailed **Operating Plan** based upon your strategy that includes the specific tactical actions you believe will lead you toward your vision.

(5.) **Take Action** using your Operating Plan as a guide. Break your plan into monthly components and transfer the detailed tactics to your weekly planner.

(6.) Collect and **Document** accurate data about your business results. Create a detailed monthly Profit and Loss (P&L) statement that includes all information needed to track your business.

(7.) **Monitor** how the numbers on the monthly P&L are affected by the actions you have taken. Make adjustments to your future plans based on results observed.

Marian Banker, President
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the company will survive, because the only thing your employee has is your promise. If the business fails he/she is in no better position than other unsecured creditors.

* Life insurance is uniquely suited as the mechanism of choice because it guarantees completion of the plan in the event of death or disability. You may access the cash value tax-free to pay out deductible retirement benefits, or, if you pay from other assets, the eventual death benefit provides a recovery of your cost, again entirely tax-free. Recent legislation makes this strategy even better, by eliminating the corporate Alternative Minimum Tax.

The Department of Labor permits the use of Non-Qualified Plans for only top management and other highly compensated employees. To cover your rank and file would subject you to the regulations of ERISA.

For the shop owner who wants his/her business to out last him/her and wants to attract and keep the kind of people who will share his/her vision, Non-Qualified Plans are a very effective tool.

For more information, contact the authors directly at Crowe, Chizek and Company LLP at 630.574.7878. Books are available on Amazon.com or special priced bulk orders available through Crowe Chizek by calling Anne Moore at 614.469.0001.

What is it that makes it possible for some families in business to successfully work together for over 100 years, and for others to end up in litigation?

Getting Along in Family Business is a practical guide for business owning families and their professional advisors. Edwin A. Hoover and Colette Lombard Hoover identify the single most important factor to the success of any business: **Relationship Intelligence.** With over ten years experience working with family businesses of all sizes and types, the authors provide practical applications and principles for creating and managing relationships, which helps family business solve problems effectively, plan for the future, bridge differences, and deal with change.

About the Author

John Dunlavey is a financial consultant from Cleveland, Ohio who has been advising individuals and owners of small businesses since 1967.

John is a Chartered Life Underwriter, A Chartered Financial Consultant and a Certified Financial Planner. He holds an MBA from Roosevelt University. He is a registered securities representative and a registered securities principal and is also licensed in life and health insurance. His practice includes estate planning, business continuation planning and executive benefits, as well as financial engineering and investment services for individuals.

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Family Business Profile:

Managing Succession: Harris InfoSource

by Alex J. Teodosio

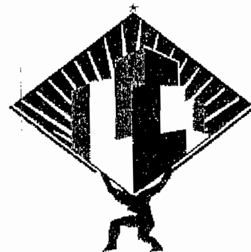
In the 1930's, Albert Harris had a suspicion that the U.S. electronics industry had tremendous growth potential. He was right. Albert found a partner and together they created a publication called Electronics Distributing Magazine in 1936. Shortly after World War II, Albert's son, Robert, joined the business.

With a solid background in economics and a passionate entrepreneurial spirit, Robert was able to expand the business by starting a number of industrial directories. Life was good in Solon for Electronics Distributing Magazine until the 1970's when it became apparent that there wasn't a lot of cultural synergism left between the directories side and the magazine side of the business. As a result, the two original partners split the business on an amicable basis in October, 1971 and Harris Publishing was formed.

Harris Publishing concentrated on the industrial directories and caught a big break in 1973 when Ohio became one of the first states to privatize the manufacturing directories data. Robert was quick to respond with a bid for the directories that the state accepted.

At the same time, Robert's son Bob was finishing his MBA at Boston University and on track to become an importer of Japanese products to U.S. markets. To his surprise, about one week before graduation, Bob received a call from his mother that would dramatically change his life

Human Resources Corner



Please send your Human Resource questions to: Sheldon Barlette Jr., 1691 Georgetown Rd. Suite K, Hudson, Ohio 44236 or fax him at (330) 650-2537.

plans. She explained how the new business was taking its toll on his father. She told Bob about the stressful sixteen hour days and her concerns about his father's health. Although working at Harris Publishing was the furthest thing from Bob's mind, he knew in his heart that joining his father was the right thing to do. Bob's timing could not have been better for the business. After Ohio privatized its manufacturing directory in 1973, other states also decided to privatize. Harris expanded as a result.

The rapid growth experienced as a result of adding states forced Harris Publishing to relocate to a larger facility in Twinsburg. A few years after this move, Bob realized that something was missing. Although they were continuing to grow the company, it remained only marginally profitable. He recognized the firm needed management advice from successful businessmen who knew how to create profits. Bob explained, "I felt we had to do better and neither my father nor I had the ability to do this ourselves."

Bob believed that it was imperative to put together a respectable outside board of advisors if the company was going to survive its growing pains. After six months of interviewing entrepreneurs from various disciplines, the board was finally established. This board ultimately enabled the first stage of succession between father and son.

Bob also realized that management succession was as important as owner succession. In addition to maintaining a board of advisors, Bob established a performance unit formula that would award shares of non-voting stock to key executives based on net revenues and profits. He maintained that "this gave managers the right incentive to do the things that would help the company, and in turn, help themselves." It also marked the transition of the business from family-operated to outside operated.

In 1990 Robert and his wife Beatrice, who was a vice president in the firm, retired from the company after more than seventy years of combined service. The outside board was instrumental in facilitating a smooth transition from father to son.

Although Bob served as Chief Executive Officer (CEO) until 1997, he hired a consultant named Judith Gombach to serve as Chief Operating Officer (COO). It was the COO's responsibility to handle the day-to-day operations of the company. This enabled Bob to concentrate on various sales related areas in the electronics and advertising side of the business while Judith ran the state directories part of the company. As Bob explains, "there were things I could do to help the company but running it from day to day was just not one of them."

In 1988, Harris Publishing was a regional company with just eight state directories. Bob understood that if Harris Publishing did not become a national company, it would not survive. As a result, he wrote a strategic plan to take Harris Publishing nationwide. Judith Gombach embraced the plan and the company went on an acquisition spree. In just 14 months, Judith helped Harris Publishing develop a national database that encompassed all 50 states. This growth placed enormous strains on the company and may have on Judith Gombach as well. Judith passed away at the age of 48 from a brain aneurysm shortly before Christmas in 1994. This left Bob in the position of serving both as CEO and COO He humbly acknowledges, "Judith was really the person who made everything sing and I wasn't able to do it as well as she. While I wasn't blessed with the greatest of leadership skills, I made very significant contributions to the company. I had the presence of mind to recognize my shortcomings and hire people who could compensate for those shortcomings in the best interest of the business."

Shortly afterwards, Bob began a search for another person to run the

Continued on page 8

Family Business Journal

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Be sure to mention that you are attending the Family Business Retreat and receive a special group rate of just $220 per-night for one of their spacious guest rooms with a private balcony. Two and three bedroom villas with jacuzzies are also available at their current season rates. Reservations must be received by the hotel prior to 4/10/00 to be assured of the special group rate.

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company. After 29 hours of interviews, he hired Dennis Abrahams to become the new president of Harris Publishing. Abrahams came from the insurance industry and Bob felt that he had the management expertise to make Harris a profitable growth company. When asked about the hire, Bob simply says "I knew where our company had the potential to be and I knew I couldn't take us there." To entice Dennis, Bob gave him performance units which came out of the Harris family's own shares of company stock. In fact, he gave away more performance units from family shares to bring on additional executives that Dennis attracted. Harris says: "It's true that my family owns less of the rock than ever before, but it is going to be a much larger rock - in fact it is going to be a boulder."

After just two weeks with Harris Publishing, Dennis concluded that the company was in danger of going out of business within six months unless there were radical changes adopted. Harris Publishing had taken on enormous debt with the recent acquisitions. It concurrently invested a quarter of a million dollars in software development to create Selectory®, a Windows-based search engine for Harris' new national manufactures database. Consequently, the company had an enormous cash flow problem.

In August 1995, the company's board voted to change the firm's name to Harris InfoSource.

Dennis worked long hours, day after day - week after week, to control costs and shore-up the company's banking relationships. Once Harris InfoSource secured a critical loan to overcome its cash crunch dilemma, the national manufacturers Selectory took off and became one of the biggest revenue generators in company history. Since then, the company has been profitable every single year.

When asked about the dramatic turnaround, Bob stated: "We brought together a very talented, productive team of management and staff that ensured that the Harris family legacy would continue." Bob has seen a lot of companies "bring in the kids just because they are the kids to keep their family in the business." Harris says that "too often these family businesses lose everything."

Bob Harris' current role is business development. He looks at opportunities to license the database, develop potential partnerships and strategic alliances, and make acquisitions. And what about Robert Sr.? According to Bob, his dad is enjoying retirement in Florida with his mother and he is very excited about Harris InfoSource. "He has seen the success we enjoyed under Judy, and now Dennis, and realizes that this success is far greater then he or I would have been able to accomplish together."

For more information on Harris InfoSource, or its products and services, contact their website at *www.HarrisInfo.com* or call them at: **(800) 888-5900**.

Did you know...

Failure to plan for ownership succession is the greatest threat to businesses with sales of less than $3 million, according to the *American Institute of Certified Public Accountants*. While 80% of American businesses are family owned, only 21% of local small businesses have a written plan for succession. These companies may face serious financial and management crises if something happened to the owner. In order to avoid the instability these crises cause and to ***help business owners explore all of the options available to them***, the **Greater Cleveland Growth Association** and **Kent State University's Ohio Employee Ownership Center** have established the Succession Planning Program.

For more information, contact Alex Teodosio at Kent State University's Ohio Employee Ownership Center at **330-672-3028** or ateodosi@kent.edu.

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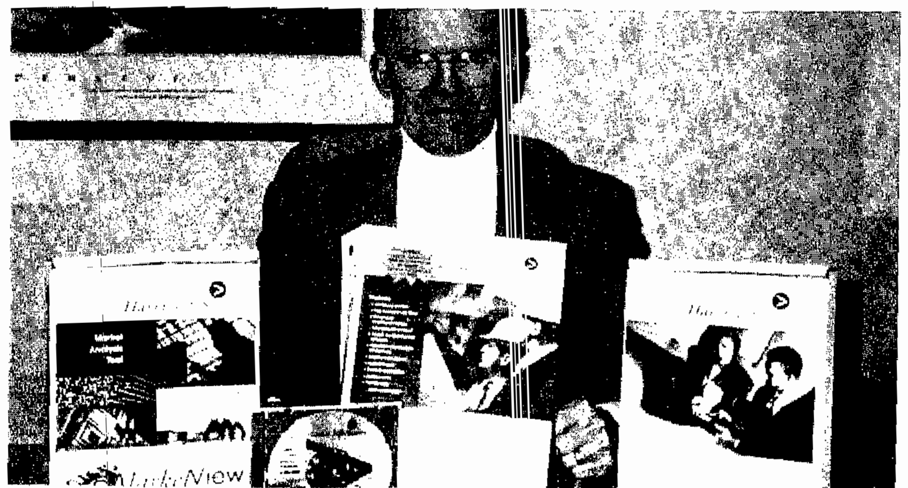
Alex assists retiring owners and buyout groups in making the transition to employee-ownership. He has also written several articles on Employee Stock Ownership Plans (ESOPs) and employee participation topics.

Teodosio is a co-author of:
Participatory Employee Ownership: *How it Works* (1998)
An Owner's Guide to Business Succession Planning (1999).

About the Author



Bob Harris displays some of Harris InfoSource's products.

Implementing Your Succession Plan

by Alex J. Teodosio

Good succession planning *must* begin with the well-defined goals of the business owner. Like building a home, one begins with ideas and develops them into a floor plan. Creating a succession plan can be difficult because the owner may have different and conflicting expectations for the business and family. However, if the objectives of the plan are clearly defined, then exploring the legal options and implementing the plan will be easier.

Summarizing Goals

Once the important information has been collected from family members, other owners and key employees, the owner needs to summarize what he wants the plan to look like. Similar to a floor plan, this "best case scenario" is the owner's goal for the future of the company. It should include answers to three key questions:

Who owns the business?
Who does what?
Who gets how much income?

The answers to these questions may change over time. For example, an owner may decide that over the next five years he wants to hand the business over to his son or daughter. The owner may give shares and responsibilities in stages. Eventually, he will sell the rest of his shares to his son or daughter, the management and/or the employees. This type of staged sale is common and allows for a smooth, long-term management transition.

This formally developed floor plan will help the business owner and the advisors understand the goals. Together, the owner and the advisor can turn this floor plan into a blue print. If an advisor does not clearly understand the goals, he may devise a strategy that misses the point.

Exploring Legal Options

A wide range of technical options are available to meet the goals of the business owner. The size, profits and tax status of the business will narrow the number of solutions. Since every business and family is different, this stage of the process needs to be done individually with a competent professional advisor.

To choose the best advisor, a business owner should interview a number of candidates and carefully consider four factors:

(1) Professional qualification
(2) Experience
(3) Reputation
(4) Trust

The owner will rely on the advisor for important advice and needs to have confidence in this advisor. Once the advisor is selected, the owner should review the best case scenario.

For example, the owner may want to give stock to the top management team to keep them on board and motivate them to help in the transition. There are many ways to do this. The owner could use incentive stock options, non-qualified stock options, buy-sell agreements and even "shadow stock" (a bonus based on stock performance). Each of these will motivate the team to increase the value of the business, but they each have different legal and tax implications.

Once the advisor has a clear understanding of the goals, he can design the most cost-effective way to meet them. The business owner should review each goal and discuss the alternatives available to meet each goal with the advisor.

Recording & Implementing The Plan

There are three important points at this stage of succession planning:

(1) Record the plan and file documents to insure legal standing.
(2) Communicate the plan to family, other owners and key employees.
(3) Revisit the plan regularly to insure it continues to meet the goals.

The attorneys and advisors will help prepare the legal documents required to formalize the plan. These documents should be reviewed and understood especially in regard to how they achieve the goals set forth.

Once the plan is drawn up, writing a summary plan will be helpful. The summary plan should be a clear explanation of how the transition will happen and how the business will ultimately be structured in the end. The advisors should review the summary to insure its accuracy.

Communicating The Plan

Once the plan is written, it should **not** be filed away and forgotten. For the plan to have all its desired results, it should be explained to all of the important participants. The succession

plan provides stability to the business, the owners, family members and other key employees. The long-term plan should be explained to these individuals so they can understand and appreciate the stability that it provides.

The plan can also help convince customers, suppliers and lenders that the business is planning for the future and does not present a risk to them. In this way, succession planning fits into strategic business planning and can help strengthen the business.

Revisiting The Plan

After the plan is written and recorded, it becomes a legal document. This is why it is necessary to revisit the plan regularly. The business, family and personnel seldom remain the same over the years. As a result, changing the succession plan to meet new situations is often necessary. Therefore, the plan should be reviewed annually to insure that it is up to date. Circumstances, which might require changes to the plan that, include:

- Divorce, disability, retirement or death;
- Loss of key management personnel via retirement, firing or termination;
- Substantial changes in the condition of the business.

For these and other reasons, there may come a time when a once good succession plan is no longer appropriate. When this happens, the plan must be changed to meet new circumstances.

In Summary

Ownership and management succession are critical parts of the long-term stability of any business. It is an inevitable process that can help a successful business thrive or undermine the stability of an otherwise strong business. If an owner chooses to plan for succession, he can manage the transition and encourage the continued stability of the business, while providing for his family. On the other hand, avoiding succession planning may leave the changes up to the government and attorneys who will control the transition when the owner is no longer able.

The choice between planning and avoidance is the choice between finishing a career with a crowning achievement or a damaging failure.

Good succession planning hinges on good communication -- an intentional process and openness to objective advice. To be most effective, the process of succession planning should involve all of the important participants: family, the business, key employees and all owners. These people should help set the goals. The owner(s), along with competent advisors, must find the technical tools to meet these goals.

Once a good plan is arrived at, it must be clearly explained to everyone involved to insure common understanding of all the implications. Further, it has to be updated regularly to fit changes in personal and business circumstances. If a careful process involving the important participants is followed and open communication is maintained throughout, the results are likely to be final proof of the success of the business owner.

About the Author

Alex J. Teodosio

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For more information or to register for upcoming seminars, contact Alex Teodosio at Kent State University at **(330) 672-3028** or email him at ateodosi@kent.edu.