NEXT GENERATION DISPUTES IN THE FAMILY BUSINESS: NAVIGATING THE REMEDIAL, ETHICAL AND TAX QUAGMIRES - A CASE STUDY

AN OVERVIEW OF FAMILY BUSINESSES IN AMERICA

By
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OVERVIEW OF FAMILY BUSINESSES

I. **In General**. There are approximately 27 million privately owned businesses in the country, of which 21 million are either part-time operators (e.g., the weekend musician, construction contractor, "moonlighters," etc.), or full-time operators where only the owner is involved. Of the over 6 million businesses which have "employees", only 18,000 have more than 500 employees, approximately 120,000 businesses have more than 100 employees, and less than 700,000 have more than 20 employees.[2.] By comparison, there are approximately 30,000 publicly owned companies in the United States, approximately 3,800 traded on the New York Stock Exchange (NYSE), 750 on the American Exchange (AMEX), 2,800 on NASDAQ, 3,700 on the "OTC Bulletin Board" and 6,200 on the "Pink Sheets" [3]. The remaining 10,000-12,000 companies are traded so rarely they are not listed. From these statistics, it can be seen that privately owned businesses (over 90% of businesses with employees being "family businesses") represent over 99% of all businesses in the country.

Although most "family businesses" are privately owned, an estimated 60% of publicly traded companies are under family control. Studies show an estimated 33% of the "Fortune 500" companies are family controlled, e.g., Wal-Mart, Marriott, Berkshire -Hathaway, Tyson, and News Corporation, and Heinz. Many owners of family controlled public corporations are listed in the “Forbes 400”, e.g., Warren Buffett, Rupert Murdoch, and Christy Walton and family. [4]

It has become increasingly clear from published statistics that privately owned businesses (employing over 58% of all working Americans, generating approximately 59% of Gross Domestic Product, and responsible for 31% of our nation's exports) are the most dynamic and vibrant segment (most new jobs and innovations) of our country's economic system. In fact, many say that America's family owned small businesses are our country's best hope to maintain a successful free enterprise system[5].

Congressional recognition of “small business” (often used synonymously with “family business”) was first formalized in 1950 when both houses of Congress established Committees on Small Business. In 1953, the Small Business Administration (SBA) was created as an independent agency based on the recognition that “small businesses” have special needs, a unique philosophy and different capabilities. Also in 1953, an independent Office of Advocacy within the SBA was created and charged with the responsibility for promoting the cause of small enterprises in Congress and the Executive Branch. Since that time, Congress has consistently encouraged federal agencies to be sensitive to the special needs of small business.

Beginning in the 1980's, “small business" (most of which are privately-owned family businesses) became very popular in Washington. In 1981, Congress authorized, and President Reagan convened, the first President’s White House Conference on Small Business. Another White House Conference was held in 1986, and the most recent Conference was held in June of 1995. The major purpose of the White House Conferences was to create a forum for small business owners to communicate with each other and determine the priority needs and concerns of the small business community with a view towards Congress and regulatory agencies enacting, repealing or amending legislation, regulations, etc., to meet those needs and concerns.

Notwithstanding Congress' general "love affair" with "small business", the practical needs and interests of small business are often overlooked when major legislation is finally adopted, especially when it involves complex tax and employee benefit matters. During the thirty-year period from 1981, there has been a flood of tax and employee benefit legislation (over 30 major Revenue Acts involving changes to over 17,000 sections and subsections of the Internal Revenue Code). Unfortunately, much of this legislation, added significant additional complexities and restrictions and were particularly onerous to small businesses and their owners[6]. From these actions in Congress, it is evident that the small business community (although much "loved") is in need of better understanding and a stronger "voice" in Washington. Since 2001, there have been several major tax laws, which have added even more complexity[7.]

In analyzing the reasons behind the inconsistency in Washington between "mouth" and "motion" ("expression" and "action"), one is drawn to the conclusion that small businesses are typically much less effective (when compared with large businesses) in dealing with proposed legislation. Large businesses have full-time lobbyists monitoring and timely focusing on specific legislative issues, whereas most owners and representatives of small businesses are often not even aware of proposed legislation (especially tax and employee benefit legislation) until the legislation is well on its way to being enacted. Although there are a number of small business organizations which actively monitor legislation (e.g., the National Federation of Independent Businesses [NFIB]; the Small Business Council of America [SBCA] which focuses on tax and employee benefit issues; and the National Small Business Association [NSBA], etc.), the broad diversity of interests of the millions of small businesses, due to the vast differences in size, level of economic success and types of business, often results in the wishes of the "small business community" being unfocused and, in some cases, contradictory. One reason given for much of the tax and employee benefit legislation and regulations (which have negatively affected small businesses) is the notion, held by some in Washington, that small business owners can, to a greater degree than large businesses, manipulate the tax and employee benefit rules to avoid paying their "fair share" of taxes or to avoid providing appropriate levels of employee benefits to their employees. In recent years, this notion has been expanded to include large businesses after the Enron, WorldCom, Tyco, Parmalot, and Lehman Bros., debacles, and the implosion of the banking and financial sector which led to the passage of the Sarbanes/Oxley legislation designed to protect shareholders, and the Dodd-Frank legislation to protect the public from various practices of large financial institutions which contributed to the current recession. It is the author's opinion that much of the reason for the “hyper” frequency of legislation in Washington is to be found in the basic nature of our political environment which reflects the public's clamor for both “action” and “fairness” and puts strong political pressure on members of Congress (aided by dozens of highly competent and specialized staff) to stay active and to promote new legislation, especially in the tax and employee benefit area, which has resulted in enormous “complexity.”[8]

The constant change and expansion of our laws has had a disproportionately negative impact on small businesses, which have little or no internal specialized staff, by increasing the need for costly outside professional support to help them comply with the ever more complex and constantly changing rules[9].

Congress did, however, adopt some tax legislation specifically designed to encourage small businesses, e.g., Subchapter *S*, added to the Code in 1958. The rules of Subchapter *S* were partially in response to earlier proposals (which continue to this day) to eliminate the taxation of corporations entirely on the theory that "double taxation" is inherently unfair. Critics of the system (pointing to Subchapter *K* and its taxation of partners) argue that a tax at the corporate level, in addition to a tax on shareholders, amounts to a penalty for conducting business in corporate form. Although Congress did not eliminate taxation at the corporate level (in fact, for some, it increased the corporate level tax in 1986 with the legislative elimination of General Utilities), significant changes were made in the taxation of small business corporations electing under Subchapter *S* which, for the most part, results in a single tax at the shareholder level[10]. More recent legislation further simplified and expanded the usefulness of Subchapter *S*[11].

II. Importance of Family Businesses.

A. Important Segment of U.S. Economy. With over 6 million full-time privately owned businesses with employees (90% family owned and operated), small business is the most dynamic segment of our economy representing more than 99% of all businesses, 58% of all working Americans, 59% of Gross Domestic Product, and 31% of U.S. exports. The net worth of these businesses is estimated to be in excess of $10 trillion. Small businesses are responsible for most new jobs which have averaged 64% of all new jobs over the past decade.[12]

B. Large Portion of Transferred Wealth. It is estimated that over two-thirds of the wealth of this country has been created since World War II, much of which is represented by family businesses. A large portion of this wealth consists of businesses under control of an aging generation of entrepreneurs. Within the next two decades, many members of this generation will die or retire, and the transfer of wealth from the older generation to the next is estimated to be the largest in U. S. history[13]. A study by the Family Enterprise Center at Cornell University estimated that over $6.5 trillion in wealth would be transferred from one generation to the next during the next 25 years with over $10 trillion being transferred by the year 2040[14]. Another survey estimated that almost 40% of all family businesses would change leadership within the next five (5) years.[15]

C. Importance Recognized by Institutions and Businesses. Prior to 1990, there was little or no research on, or academic interest in, "family businesses." However, within the past twenty (20) years, family business programs have become a part of business school curriculum at over 100 colleges and universities throughout the country (e.g., Wharton, Harvard, Northwestern, Baylor). One of the first programs (also ranked as one of the best along with Harvard and Northwestern) was established at Kennesaw State University, in Atlanta Georgia, which offers a full range of courses on family businesses as part of its business school curriculum[16]. In discussing the reasons for establishing its Family Business Center, the founding director of the program at Kennesaw described the importance of the "family business" in the following manner:

> "The family unit has long been recognized as the foundation of our society and the family business is the foundation of our economy. Family businesses have special problems and opportunities that traditional business education does not address."
>
> -Craig Aronoff, Kennesaw State College (1989)

In addition, a number of private sector family business "programs," including insurance companies, law firm practice groups, etc., were developed during this period. For example, Massachusetts Mutual Life Insurance Company (Mass Mutual) and National Life of Vermont (in conjunction with the Small Business Council of America) have conducted research and have sponsored "family business" institutes; and law firms, WilmerHale, Troutman Sanders LLP, and McDermott Will & Emery along with many other large firms, have created special "practice groups" that focus on Closely Held and Family Businesses. Further, there have been dozens of books and hundreds of academic research studies, popular press articles, newsletters and seminars on "family businesses," almost all being published or presented since 1990[17].

D. <u>Important Part of Professional Practice</u>. Family businesses (and the individual family members) are a significant part of the practices for many professional advisors. Surveys show that accountants, lawyers, financial planners, life underwriters, bankers, and industrial psychologists (in the order listed) are the closest advisors to the owners of family businesses and are uniquely positioned to be of the most help[18]. A 1992 Mass Mutual survey showed that among the 53% of family business owners who have prepared written estate plans, 74% reported that a lawyer played a major role in the planning process, followed by accountants (38%), financial estate planners (29%), and insurance agents (14%). A recent survey shows the number of owners who have engaged in estate planning has increased to 81%, and lawyers and accountants are the top two advisors[19]. For the very large family businesses, there has been an explosion of "wealth management" advisors and so-called "Family Offices" which provide personal, business and investment advice and other family services (e.g. protection, coordinating family meetings, etc.) to family business owners and their families.[20]

E. <u>Family Businesses Need Special Attention</u>. Research shows that less than one-third of the family businesses succeed into the next generation, less than 15% make it into the third generation[21] and less than 4% make it to the fourth generation. It is widely recognized that family businesses have special problems in addition to the normal business problems which make them uniquely vulnerable, especially at the time of transition of management and ownership to the next generation.[22]

III. **Reasons for Family Business Failures.** It was not until 1993, that the first comprehensive study was made to determine the reasons why such a large number of family businesses failed at the time of transition of ownership and management to the next generation. The study, sponsored by National Life of Vermont and the Small Business Council of America (conducted by Prince and Associates), was based on personal interviews with next generation owners of 749 family businesses that had failed within three years following the death or retirement of the founder. All of the businesses in the study had previously been successful and in business for at least 10 years, many between 20 and 40 years.

From these interviews, it was determined that the transition of management and/or ownership occurred: (1) in 75% of the cases, following the death of the founder (often unexpected); and (2) in 25% of the cases, following the founder's retirement (often due to his unexpected disability).

Although the survey showed a number of reasons for these family business failures, the major reasons given for failure of the businesses following the death or retirement of the principle owner and CEO are described as follows.

A. Lack of Adequate Capital. It was long assumed that lack of adequate capital was a primary reason for failure of a family business upon transition of ownership. However, it was not until the National Life/SBCA study in 1993 that the truth of this assumption was confirmed, both following the death of the principle owner or his retirement.

1. Death of Principal Owner/CEO. Lack of capital was cited as the largest single reason for failure of over 70% of the family businesses which failed following the death of principal owner. Lack of capital was primarily caused by estate tax obligations or the need to provide retirement funds to a surviving spouse; however, lack of access to

capital or credit from traditional sources for current operational needs was also cited as a major problem. This, typically, was the result of trade and banking sources being less accommodating to the successor owners (and managers) following the death of the principal owner/CEO. In many cases, these financial strains led to the bankruptcy of the business. With the onset of the Great Recession in 2008, the unmet need for capital by many family businesses, whether or not in transition, has dramatically increased. Today, the ability of many small businesses to borrow has been severely restricted due to significant increases in banking regulations and oversight scrutiny by State and Federal regulatory agencies.

2. Retirement of Principal Owner/CEO. Where the principal owner/CEO retired from the business during his lifetime, the study showed the owner often retired without adequate financial resources, most of his wealth consisting of his interest in the business. This resulted in additional financial burdens being placed on the business to distribute funds in order to make up for the shortfall in the owner's retirement needs and this financial burden was cited as a predominant reason for the failure of the business. This same failure to provide adequately for his and his spouse's retirement is also given as the prime reason why many owners are unwilling to voluntarily relinquish control of the business.

B. Family Conflict Over Assets. Lack of “fairness” in the distribution of the founder's estate was also cited as a key problem. Almost 81% of the failed businesses were negatively impacted by family conflicts among the survivors. Often, these conflicts grew out of a perception by the survivors of unfairness in the division of the founder's assets between heirs active in the business and those who were not. From the writer's own experience, this conflict results because many parents are strong in their determination to treat their children "equally" in the distribution of their estates. Unfortunately, "equal" is not always "fair", and "fair" is not always "equal", where a family business represents a large portion of the principal owner's estate, especially where some children are active in the business and some are not. This inflexible desire of parents to give "equal" treatment to their children is often given as a principal cause of failure of the business[23].

C. Loss of Key Employees. In many cases, the loss of a non-family key employee (especially after the founder's death) significantly contributed to the failure of the business. Almost 60% of those surveyed (where a non-family key employee had left the business following the principal owner's death or retirement) cited this loss as an important contributing reason for the failure of the business.

D. Poor or No Transition Planning. The studies also reveal the basic (and often preventable) underlying cause behind most of these failures as being little or no prior planning for either the capital needs or the transition of management and/or ownership of the business. Not only is "failure to plan" the biggest obstacle to successfully passing on a family business to the next generation, it often results in lifelong family feuds. The National Life/SBCA study showed that 97% of the successor-owners of the 749 failed businesses in the survey stated that the founder had no written succession plan and 40% had no succession plan of any kind. The 2003 Mass Mutual/Raymond Family Business Institute survey showed that only 63% of family businesses utilize a written strategic business plan in their operations, that 20% of the business owners have no written "estate plans" beyond a will, and only 38% have a written "business" succession plan. Although almost 90% of business leaders surveyed recognize that failure to have an effective succession, estate, and investment plan and a strategic business plan for the company would greatly promote the successful transition of the business to the next generation, less than half of the family business CEO's who expect to retire within five (5) years, had chosen a successor[24]."

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[2] Small Business Administration, "Small Business Profile" (2009) based on latest source information from U.S. Department of Treasury, IRS Report, Tax Returns; U.S. Dept. of Commerce, Bureau of the Census, and U.S. Dept. of Labor, and Bureau of Labor Statistics; J. Astrachan and M. Shanker, "Family Businesses' Contribution to the U.S. Economy – A Closer Look," (2002) at 213.

[3] Web Sites of NYSE, AMEX, NASDAQ, OTC Bulletin Board, and Pink Sheets (September 2011).

[4] See J. Astrachan and M. Carey, "Family Business in the U.S. Economy," presented at The Center for the Study of Taxation, Costa Mesa, California (1994); and J. Astrachan and M. Shanker, "Family Businesses' Contribution to the U.S. Economy – A Closer Look (2003) at 214; 'Forbes' (Oct. 10, 2011); R. Sorenson, "Family Business: The New Heartland of America", *p*resented at the Center for Family Enterprise, University of St. Thomas Opus College of Business, September of 2008.

[5] See "Blood and Money," *Newsweek* Special Edition, "The 21st Century Family," Winter/Spring 1990, at 82-84; "The Adolescence of American Family Business," FBN Newsletter, No. 9 (May 1994); and "Politics and Policy," *Wall Street Journal*, June 14, 1995, at A20; and J. Astrachan, "Family-Sponsored Ventures," (April, 2003).

[6] H. Apolinsky, "Need for Ten Year Moratorium," Survey for Small Business Council of America (1997), and H. Apolinksy, "Need for Fundamental Tax Reform" Survey for the American's for Fair Taxation (2002).

[7] "Economic Growth and Tax Relief Reconciliation Act of 2001," (EGTRRA),"Jobs and Growth Tax Reconciliation Act of 2003," ("2003 Tax Act"), "Working Families Tax Relief Act of 2004", " Tax Increase Prevention Reconciliation Act of 2005", "Small Business Jobs Act of 2011", "Tax Relief and Health Care Act of 2006", "Economic Stimulus Act of 2008", "Health Care and Education Reconciliation Act of 2010".

[8] For an interesting analysis of the reasons for the proliferation of laws at all levels of our legal system. See I. Younger, "Socrates, Law, and the Congress of the United States," Charles Evans Hughes Memorial Lecture delivered at New York County Lawyers' Association, New York, N.Y. (May 1980).

[9] "There are No Simple Businesses Anymore," The State of Small Businesses at 72-78 (1995).

[10] Subchapter *S* Revision Act of 1982, Pub. L. No. 97-354, (1982).

[11] See Small Business Job Protection Act of 1996, Pub. L. No. 104-188 (1996); The American Jobs Creation Act of 2004 Pub. L. 108-357(2004).

[12] J. Astrachan and M. Carey, "Family Business in the U.S. Economy," presentation at the Center for the Study of Taxation, Costa Mesa, California (1994); and D. Kirchoff, Entrepreneurship and Dynamic Capitalism: The Economics of Business Firm Foundation and Growth (1994); "The Facts of Small Business," SBA Report (2009).

[13] *Fortune,* May 7, 1990, at 81, and Hale and Dorr, "Family Business Report," June 1994.

[14] See R. Avery and M. Rendall, "Inheritance and Wealth," presented at the Philanthropy Roundtable (Nov. 1993); and, "There are No Simple Businesses Anymore--Will the Family Business Survive?" The State of Small Business, at 70 (1995).

[15] Mass Mutual Financial/Raymond Family Business Institute, "American Family Business Survey," (2003) at 2; "Major Findings of the Family Business Survey," Massachusetts Mutual Life Insurance Company (Oct. 2007) at 4.

[16] "Can You Teach Entrepreneurship?" *Business Week*, Nov. 7, 1993, at 140; and Mass Mutual

Financial/Raymond Family Business Institute, "American Family Business Survey," (2003) at 32.

[17] See, e.g., C. Aronoff and J. Ward, Family Business Sourcebook (1991); "Are Your Kids Good Enough to Run the Business?" *Inc. Magazine*, August 1994; "Estate Planning for the Family Business Owner," American Law Institute/American Bar Association Annual Seminar on Family Business (July, 2003); and The Family Firm Institute, Family Business Review, Vol XVI, No. 1 (March 2003). C. Aronoff and O. Baskin, Effective Leadership in the Family Business (2010); A. Schuman, "Nurturing the Talent to Nurture the Legacy"; Preparing Yourself to Relinquish Control of Your Family Business" (2010).

[18] "Major Findings of the Family Business Survey," Massachusetts Mutual Life Insurance Company (Oct. 2007) at 8.

[19] "Major Findings of the Family Business Survey," Massachusetts Mutual Life Insurance Company (Sept. 1994) at 22; and Mass Mutual/Raymond Family Business Institute, "American Family Business Survey," (2003) at 27 and 30. "Major Findings of the Family Business Survey," Massachusetts Mutual Life Insurance Company (Oct. 2007) at 4.

[20] "Private Wealth", Advising the exceptionally affluent. Vol. 5. No. 5 (Sept/Oct 2011)

[21] J. Ward, Keeping the Family Business Healthy, at 1-19 (1987); "Blood and Money," *Newsweek* Special Edition, "The 21st Century Family," Winter/Spring 1990, at 82-84. Richard M. Segal, Family Firms vs. Their Counterparts- Best Practices for Success, Corp. Magazine, January 1, 2008, Private Wealth", Advising the exceptionally affluent. Vol. 5. No. 5 (Sept/Oct 2011).

[22] See G. Le Van, Getting to Win-Win in Family Business, at 218 (3rd ed. 1993); See also, L. Danco, Beyond Survival: A Guide for the Family Business Owner and His Family, at 4 (4th ed. 1982); "Are Your Kids Good Enough to Run Your Business?" *Inc. Magazine,* Aug. 1994, at 36; and S. Danes and P. Olson. "Women's Role Involvement in Family Businesses, Business Tensions, and Business Success," The Family Firm Institute, Family Business Review, Vol. XVI, No. 1 (March 2003) at 53-68; R. Segal, "Family Firms vs. Their Counterparts- Best Practices for Success", Corp. Magazine, January 1, 2008,; "Private Wealth", Advising the exceptionally affluent. Vol. 5. No. 5 (Sept/Oct 2011).

[23] See G. Le Van, Getting to Win-Win in Family Business, at 182 (3rd ed. 1993); and "Succession Planning: Family Continuity vs. Business Continuity," *The Family Business Professional*, July 1997, at 1; and K. Smyrnios, et al, "Work-Family Conflict: A Study of American and Australian Family Businesses," The Family Business Review, Vol. XVI, No. 1 (March 2003) at 35-50.

[24] "Mass Mutual/Raymond Family Business Institute; "American Family Business Survey" (2003) at 1, 25, and 26, updated: (2007) at 4.