SUSTAINING THE FAMILY BUSINESS LEGACY

A ROUNDTABLE ON SUCCESSION PLANNING & STEWARDSHIP

Bessemer Trust

FAMILY BUSINESS ROUNDTABLE

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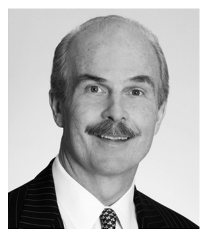
INTRODUCTIONS

Steve Akers is a managing director of Bessemer Trust and one of the country's leading authorities on legacy planning developments. One key aspect of his work with clients and estate planning advisors is helping to integrate succession and estate plans for business owners.

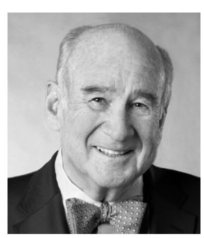
Benjamin León, Jr. is the executive chairman and founder of Leon Medical Centers in South Florida, a healthcare firm he launched in 1996. With more than 40 years of experience in the healthcare industry, León originally founded the business to serve the influx of Cuban refugees like himself who didn't have easy access to healthcare because of language barriers and a scarcity of providers.

Carlyn McCaffrey is the co-head of the private client practice at the international law firm McDermott Will & Emery. She devotes a substantial portion of her time to helping individuals transfer the interest in a family business to the next generation as economically as possible.

Tom Nicholas is an associate professor at Harvard Business School who teaches courses on topics ranging from the life cycle of companies to American business history. Many of the case studies analyzed in his classes involve family companies that have sustained themselves from one generation to the next.



Bryant Seaman is head of Bessemer Trust's Private Asset Advisory Group, which advises clients on issues ranging from family business ownership and energy holdings to real estate and insurance. The group's Family Company Advisory team provides corporate finance advisory services to family businesses to help them achieve their strategic objectives. They have worked with more than 350 family companies ranging in size from $50 million to $10 billion.



Rod Ward, Jr. is of counsel in the international law firm Skadden, Arps, Slate, Meagher & Flom. Having initially practiced as a litigator, he formed Skadden's Delaware office in 1979. A descendant of C.L. Ward, who founded the Corporation Service Company (CSC) in 1899, Rod is also a senior member of the board of directors of WMB holdings, the holding company of CSC. Privately owned by three families, CSC has 1,000 employees and offers legal, compliance, and trustee services for companies and law firms worldwide.

PART ONE: SUCCESSION PLANNING

MODERATOR

Tom Nicholas, Associate Professor of Business Administration
Harvard Business School

PANELISTS

Steve Akers, Managing Director, Fiduciary Counsel
Bessemer Trust

Benjamin León, Jr., Founder and Executive Chairman
Leon Medical Centers

Carlyn McCaffrey, Partner and Co-head of the Private Wealth Practice
McDermott Will & Emery

Bryant Seaman, Managing Director, Private Asset Advisory Group
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Rod Ward, Jr., Of Counsel
Skadden, Arps, Slate, Meagher & Flom LLP
Senior Member of the Board of Directors of WMB Holdings

Tom Nicholas, whose commentary appears in gold, moderated the following discussion.

CASH FLOWS & OWNERSHIP INTERESTS

Tom Nicholas: Steve, what do you see as the biggest family business succession issues?

Steve Akers: Most business owners intuitively assume that their big concerns will center on who is in line to lead the company and how the next generation can be treated in an equal and fair manner. These are certainly major issues that can easily derail a succession plan if they are not addressed successfully.

However, the most pivotal succession issue, in our experience, centers on cash flow. An income stream is almost always a critical consideration for the senior generation when they exit. In order for a family succession to move forward, there must be enough money to continue to provide primary owners with the income they expect. Oftentimes, the desired cash flow isn't available. If that problem isn't solved, family succession is unlikely to occur.

When does this issue ordinarily get resolved?

Steve Akers: Proper cash flow planning can take a long time, and it is imperative for business owners to look at this issue earlier rather than later. Of course, that can be said for virtually all the issues related to a family business succession, including naming the successors, ensuring that an appropriate management team is in place, governance, training, preparing customers, taking into account appropriate tax strategies … the list is considerable.

The worst time to review succession issues is upon the death or disability of the primary owner. I understand how funny that sounds, but those of us at this table who work with family companies can tell stories of business owners who simply waited too long. Many of these entrepreneurs busy themselves with daily operating issues, and succession continually gets pushed back to the end of the priority list. By the time they decide to make key succession and tax-related decisions, time is no longer on their side.

We seek to persuade business owners to begin their succession planning at the midpoint of the business — when the company is successful and growing and past the initial risk taking. That gives you some idea of how long the process might take, if it is done correctly.

Carlyn McCaffrey: I'm in general agreement with Steve, but one exception is when you advise someone who has just started a business at age 55 or 60. Oftentimes that person is a serial entrepreneur, or perhaps he or she has completed a core career but doesn't want to stop working. If someone is in that age range, you may want to start succession planning almost immediately. It can be counterproductive to wait for the business to mature. There are certain advantages to starting while still in the risk-taking phase: The value of the business isn't that great and it's much easier to transfer assets to the next generation tax-free via trust.

Steve, is there a distinction between leadership succession and ownership succession?

Steve Akers: They can be very separate, although in most cases there will be some crossover. Family members who receive ownership interest do not necessarily have to be leading the business. In some families, for example, it may be essential to provide ownership to children or others who play no role in the family enterprise. This frequently occurs when an entrepreneur has almost all of his wealth tied up in the business — which can make it difficult to leave something of significant value to children who are not involved in the company.

Entrepreneurs have to be careful that providing ownership interests to those outside the business does not reduce the incentive or authority of the company's designated leaders. Governance should be reserved entirely for those children who are actively involved in a business.

When ownership shares are split between children in the business and outside the business, it often is advisable to create trusts to own the stock that has not been assigned to the key movers and shakers in the firm.

Rod Ward, Jr.: Assigning ownership shares is always a challenge. I was head of the comp committee of CSC for a long time, and we asked each of our 20 senior managers to rank everybody else, with total anonymity. Sometimes these views tracked with the opinion of the CEO, but sometimes not. My son, who is now CEO, understands that it is important for family business owners to have a realistic view of the strengths and weaknesses of family and outside managers. In the end run, however, he will tell you that ownership almost always trumps leadership.

Carlyn McCaffrey: I agree with your son, Rod. Ownership will ultimately dictate leadership in most cases. That is why it is important to have an agreed-upon exit strategy if there is more than one branch of a family. When a particular family branch has been chosen to control the company, it can be very important for the other branch or branches to have a clear understanding of how they can or will disengage from the business. Perhaps five or six years after the head of the family dies, the uninvolved family branches will have the right to "put" — or sell — their stock if they decide they don't like the way the company is headed.

Rod, I understand that three families have ownership control of CSC. I suppose any of those families could conceivably have more than one branch. What happens if one decides to withdraw?

Rod Ward, Jr.: Since you don't want to drain the treasury, you can give stockholders the right to sell a small percentage of their shares — say, five percent — back to the company each year. The price per share would be set by the annual independent evaluation. The board should have the right to decline to buy the shares only if it would damage the company. In substance, this would be a qualified or limited "put" in the hands of the shareholders. By exercising the put, stockholders can, if they want, reduce their holdings over time, in order to diversify or for any other reason. At CSC we have such a provision in our stockholders' agreement and it is reassuring to our stockholders that they are not locked in forever to an illiquid asset.

Carlyn McCaffrey: We recently executed the same strategy for a family business, Rod. Using puts, we gave the branches the ability to get out, but only on a gradual basis so as not to hurt the company. I suspect this will work well for all concerned.

On the subject of taking a gradual approach, what are the advantages and disadvantages of exiting the family business via a phased sale over time versus a sale of 100% all at once? Bryant, please start us off.

Bryant Seaman: Both approaches can work, but usually the family's circumstances or market conditions will favor one approach over the other. A phased exit over time allows the family to maintain control while reaping the benefits of securing additional capital and expertise from the right minority partner. This approach also allows the family to set aside a diversified investment portfolio, before later exiting at an expected higher valuation.

There are many reasons, however, that families consider the outright sale of 100% of the company. Family tensions due to disparate needs for income can create pressure for larger distributions and, ultimately, the sale of the company. Although a weak operating performance may be the catalyst for a sale, other considerations are often just as important. For example, the family might decide that the concentration of its wealth in an illiquid family business is too risky, or that it is an opportune time to take advantage of a strong market environment with high valuations, or that a pending unfavorable change in tax laws provides the impetus for a sale. Sadly, medical or other personal family issues may require a complete exit from the business.

One note of caution is in order on this point. Some investment banks are primarily in the business of promoting transactions. They might therefore routinely suggest that the only solution to some of the issues we just mentioned is to sell the company. In situations where preserving the family business legacy is a high priority, we work closely with the family to develop alternatives to a sale, such as a recapitalization, that can accomplish their objectives without requiring an exit from the business.

Benjamin León, Jr.: Bryant, I'm a believer in a gradual succession plan, whenever possible. For starters, this is more conducive to a smooth transition of the business to the next set of owners. Involving family members and other members of management in a gradual transition also reduces the possibility that somebody else swoops in like a vulture to try to buy the company outright. If everyone has skin in the game, the transition process can be extended to reap the benefits Bryant mentioned, without too much fear of disruption.

Rod Ward, Jr.: In a 100% sale, the seller captures the control premium. If you sell the company piecemeal, control passes after a series of transactions. In general, partial sales of ownership are better used to raise capital or to diversify, if the shareholders are selling.

Steve Akers: If the business is to be sold to external interests, a better price can typically be achieved with a well-timed sale during the owner's lifetime rather than subsequent to his death. One reason is that the buyer may want the owner to stay on as a consultant to facilitate the transition to the new ownership/management team.

If the business is being sold within the family, an advantage of a phased-in sale is that various minority interest ownership blocks can be transferred over various years. This may allow valuing each separate set of shares or units with a minority discount, in order to minimize the purchase price paid to the senior family member. In some situations, that may be desirable.

FAMILY DYNAMICS

Tom Nicholas: Steve, is it rare to encounter family dissension related to succession plans?

Steve Akers: No family is immune to differences of opinion during the succession process, Tom, but some handle disagreement far better than others.

One method to dampen potential family enmity when a succession is called for — and, more importantly, to avoid litigation — is to insist that everyone agree to buy into the plan from the outset. In sum, family members pledge to support the ultimate succession-related decisions.

Some family members may want to be directly involved in the business, but some won't. For the latter group, it's crucial to allow them to express their opinions, with the understanding that their input and backing of the final outcome will make the company stronger. It also is important for each family member to recognize upfront that his or her opinions will not necessarily dictate the succession plan. That is the job of senior family members.

What happens if a family cannot achieve consensus?

Steve Akers: If enough family members don't agree to buy in, there is a strong possibility the succession process will be impractical and unlikely to work. Selling the company outright may become the most realistic option.

Bryant Seaman: Unfortunately, that is not an uncommon development. We have seen situations, for example, where the founder is intent upon maintaining the business in the family, but inadvertently undermines the succession process. This is especially common with hard-driving entrepreneurs who believe they are the only one in the family with the leadership skills and business expertise to continue the company's success. This becomes a self-fulfilling prophecy if the entrepreneur fails to delegate responsibility and properly train a successor. Eventually, the family has no choice but to either hire professional management or exit the business, because the CEO has not provided the foundation for a transition in family leadership.

Once a family business successfully gets past its first succession, do successions become somewhat easier?

Bryant Seaman: In some cases, Tom, but not necessarily. Family leadership succession in second- and third-generation companies can present its own set of problems. Without a strong commitment to stewardship in the management of the family business, the operating performance of the company may not justify continued ownership. In addition, just as with the first succession, the next generation of leadership has to build a consensus with non-management family members regarding strategic objectives, the company's risk profile, dividend distributions, and liquidity opportunities. If some family members don't value the family business legacy or have pressing financial needs, we have found that buy-sell agreements and annual redemption provisions can be effective mechanisms to avoid a sale of the company.

Ben, how has Leon Medical Centers handled succession?

Benjamin León, Jr.: It may seem obvious, but our major priority is to ensure that our next leader — my son — is entirely capable of fulfilling the CEO position and showing leadership. Obviously, our family and the company's professional management have great respect for his capabilities, or we would not place him in this situation. Nevertheless, both he and our other family owners have to be confident he can make the right decisions for the company and be conservative or aggressive at the right times and in the right situations.

I provide him with ample room to make many executive decisions. At the same time, I think he will agree that it is helpful to have me around to monitor his hands-on executive training and fine-tune his abilities as a leader. I am fortunate to have this opportunity to evaluate my successor.

Ben, are there any contingencies if, say, your son believes in ten years' time that the company should transition out of managed care? What if he thinks in a decade that managed care will be a slow-growing industry and wants to take the company in a different direction?

Benjamin León, Jr.: It's not a matter of whether I could prevent it, or if I would even *want* to prevent it, Tom. If prospects for the managed care industry become lackluster, the family and our trustee would likely decide to sell the company outright, as future generations would be affected. It makes no sense to stay in an industry out of sentimentality. At a certain point, you have to do what is in the best interests of the future generations.

PUTTING A PRICE TAG ON A BUSINESS

Tom Nicholas: When there is a succession plan or an exit, how do you determine the value of the company?

Steve Akers: To a certain degree, that depends upon who the buyer is. For example, a family company's approach to its valuation may differ if the buyer is an outsider versus if there is a buy-sell agreement that enables a family member to exit. Should discounts be taken into account, such as minority interest, marketability, or control premiums? Do you evaluate just on a total company basis pro rata, or do you apply discounts when a 10%, 15% interest is being acquired? The answers to questions like these will be determined to some extent by context.

Bryant Seaman: Context certainly matters, as Steve noted, especially if it is an intra-family transaction. For sales to third parties, we apply three valuation methodologies to determine the fair market value of the family business. These include discounted cash flow analysis, which is the primary approach for a private company, as well as analyses of comparable public company trading values and comparable company M&A transactions. We weigh all three methodologies and make adjustments for intangibles, such as the company's positioning within its industry, the prominence of its brand, and any intellectual property. It is also important to keep in mind that many industries have special valuation metrics that need to be taken into consideration.

Are family business owners helpful when you are evaluating the brand and other intangibles?

Benjamin León, Jr.: Family member involvement in the valuation process can be problematic, regardless of how insightful they may be and how well they know their company and its market. In principle, I would give greater weight to the opinion of a respected, trusted outside advisor. Even if family business owners are well meaning, their judgment will always be colored by a personal attachment to the company. That's a wonderful trait if you want family members to gel as a staff, but it is not necessarily conducive to establishing an appropriate valuation.

Rod Ward, Jr.: There are circumstances when some family business owners may want high valuations and some may want lower. Since these circumstances may change, the most credible way to gauge a valuation is to use discounted cash flow analysis and determine a company's market cap equivalent. This is not a rote exercise that can be conducted by just any investment bank or financial advisor. The advisor should be familiar with the family company's particular industry, as valuations can differ markedly from one business segment to another.

In the case of an exit or partial exit, doesn't an auction ultimately determine the value of the business, regardless of how the sellers and their advisors may value the intangibles?

Rod Ward, Jr.: Auctions can prove to be very efficient. Consider a family-owned company that has control stock and non-control stock. How much value do you put on the former? That's a much-litigated issue and nearly impossible to deal with unless it's through an auction.

Bryant Seaman: Auctions certainly have an important role to play in complicated situations, such as the one noted by Rod. On the other hand, they do not provide the same degree of flexibility as negotiated transactions in situations where a family seeks to maintain elements of the family legacy after the sale. Such considerations might include retaining employees for a period of time or continuing the operation of local facilities.

Surely these conditions will seriously impact the price a buyer is willing to pay?

Bryant Seaman: Yes they do, but we have worked with families that are prepared to accept a valuation discount under certain circumstances.

A hard-headed observer might suggest that if the family wants to be philanthropic, it should ask its advisors to try to get the top price. Afterwards, some of that money can be earmarked for charity.

Bryant Seaman: For many of these family business owners, it is not a matter of being philanthropic, Tom. Rewarding and protecting employees who have spent 20 years working at their company is a more personal commitment to them than writing a check to United Way. It is a loyalty issue and a commitment to family values and the local community.

Carlyn McCaffrey: That's one of the fundamental differences between a private and public company, isn't it? In a private company you can attempt to be true to your family values and take care of your employees, which a public corporation cannot always do.

Steve Akers: For a patriarch or matriarch who seeks to take care of the employees, employee stock ownership plans (ESOPs) can be an effective vehicle. However, these have to be thought out and implemented well before an exit.

Rod Ward, Jr.: Frankly, I would side with Tom's hard-headed observer. In all likelihood, the employee is best taken care of by running a profitable company, providing decent salaries and, as Steve suggests, creating an ESOP. In the scenario Bryant described, I assume the business is failing and the family seeks an exit with a control premium. Placing conditions on the buyers in regard to retaining plants or employees doesn't make complete economic sense to me.

Bryant Seaman: In the case of a failing business, you make a reasonable point, Rod. The situation I had in mind, however, was a successful business in which there was no heir apparent, and the decision had been made to exit the business and distribute the proceeds to family members. As part of the process, the family was prepared to make a sacrifice on behalf of what it viewed as fair and equitable treatment for loyal employees and their families. I don't believe that this should be taken to an extreme, but I can respect the sentiment behind it.

We have talked about company valuation in terms of exits, but what if the transition is within the family? What are the best ways to structure a sale of the business from one generation to the next?

Bryant Seaman: In general, the most effective process is to combine creative corporate finance strategies with legacy planning structures that have been implemented over time. If the next generation will be purchasing the family business, it is important to avoid excessive leverage that could limit capital expenditures and growth initiatives.

Rod Ward, Jr.: In some cases, Tom, the stockholders' agreement may call for transfer at book value. Even if that is so, a market valuation will be helpful, and perhaps decisive, in defending a tax case.

How do trusts fit into this?

Steve Akers: Holding a business in trust promotes both operational stewardship and succession planning. Often the best way to sell to the next generation is for the owner to establish one or more grantor trusts for that next generation. The owner makes a gift of some value to the trust and the trust purchases the owner's units in return for a note. A sale to a grantor trust (designed so that it is treated as being owned by the grantor solely for income tax purposes) is advantageous because the owner does not recognize a gain on the sale.

The transaction is structured so that the note amount is not greater than nine times the net value of the trust. This is often the most tax-efficient method of transferring ownership to the next generation, or even to more remote generations. Cash flow from the business, particularly for flow-through entities such as partnerships or LLCs, can be used to help service payments on the note.

You mentioned that a trust can promote stewardship. How so?

Bryant Seaman: As trustee, we have a responsibility to evaluate whether the company's business model and operating performance offer the potential for stable growth and a secure future for the beneficiaries. We review the company's governance, capital structure, growth strategies, employment of non-family executives, and dividend policy … these are all stewardship issues that are important for a trustee to consider. Our fiduciary responsibility positions Bessemer to encourage family business owners to prioritize stewardship considerations and to take appropriate and timely action.

PART TWO: FAMILY BUSINESS CONCERNS

STRENGTHS & WEAKNESSES

Tom Nicholas: A statistic I find startling is that the majority of businesses globally are family-owned. In the United States, where ownership is typically more dispersed, families control about a third of the top 500 companies and half of all publicly traded companies. Given the significant influence of families in our economy, I would like us to first discuss the strengths and weaknesses of family-owned firms.

Carlyn McCaffrey: Based on the statistics you just quoted, Tom, families clearly bring considerable strengths to the business sector. Unfortunately, there is also the potential for disaster. It is not unusual for a family's anxieties and problems to bleed over to the business side. That compels the family to address issues both within their household and on the business front, which can be a particularly difficult challenge when a business transition is required.

Fortunately, the same intimacy that propels these anxieties can also work to a company's benefit. A tight-knit family can move cohesively towards a unified goal and help the business to flourish. We should not underestimate how significant a competitive advantage that can be.

When you work with a family business in your law practice, Carlyn, is it quickly apparent to you if the family dynamic will hinder a succession or prove to be a strength?

Carlyn McCaffrey: That varies widely. Some families are immediately forthright about their weaknesses, while others hope to conceal family fissures. Some families don't realize how deeply they are divided until they begin to discuss the logistics and implications of a business succession or another significant strategic issue.

It is important for advisors to have a clear, upfront understanding of the family dynamic before a business succession is addressed. Asking a family to describe its interpersonal relations can be a delicate proposition. There is always the possibility of uncovering old wounds that family members had tacitly agreed to forget or ignore.

As a family business owner, Ben, do you think the weaknesses outweigh the strengths?

Benjamin León, Jr.: I've experienced both sides. During a previous venture with my brother, the two of us failed to focus as much attention as we should have on how to divide up responsibilities. Even with the best of intentions, we found it difficult to agree on who should run this or that aspect of the company.

I learned from that experience when I started my next venture, Leon Medical Centers. From day one it was very much a family business, with my son, two daughters, a son-in-law, and my wife of 46 years. This time I made certain to ensure that all family members would be assigned to well-defined positions. I did not leave the door open for unproductive turf battles.

In our case, the family has been a source of great strength. We work toward common goals and understand that Leon Medical Centers is not just a family business, but a family mission as well.

Rod, what's your take on family firms?

Rod Ward, Jr.: It's like the Longfellow poem about the little girl with the little curl, Tom. When family businesses are good, they are very good. When they are bad, however, they can be horrid.

On the plus side, a private, family-owned company can benefit from a high degree of stability, independence, and unity, especially when ownership and management are on the same page. This allows the company to take the long view and adapt quickly to change. That particular ability may be an important reason why family businesses have been so successful in our country.

A family's common vision and policy alignment also can be particularly helpful with succession planning. Assuming the next generation is acclimated to the business and properly trained, there is less likelihood of disruption after the business has been handed off from one set of family members to another.

There are disadvantages as well. One, certainly, is access to equity capital to fuel growth. An S corporation can only have one class of common stock. The common can be apportioned between voting and non-voting stock, but the dividends and liquidation preferences must all be the same. It may be difficult to sell non-voting, more or less illiquid, common stock. If a large amount of voting stock is sold, control may be affected; if that hurdle is overcome, the new owner may push for (or demand) more in the way of dividends than the legacy owners will want to pay.

There are dominant owners who have good judgment and can pick the right members of their family to take the reins. Unfortunately, this is not always the case. It is nearly impossible for some parents to admit that their kids have serious flaws. On the other end, dominant owners often have a tendency to overstate their children's flaws and don't give a smart, capable kid the room to make good decisions.

Another disadvantage is that family businesses oftentimes invite disharmony among the controlling family. CSC has been very fortunate in that the three families with controlling interests get along so well. However, we recognize that this is not necessarily destined to last forever, since no family or group of families is immune to disputes. These quarrels can become quite intense; I once litigated a case in which the brother said of his sister, "I should have strangled her in her crib."

[Laughter]

Steve, what strengths and weaknesses do you see in family businesses?

Steve Akers: A major strength for family-owned businesses is the opportunity to assume risks that larger companies may be prone to avoid. To a certain extent, this is a function of a family business's ability to consider time from the perspective of years and decades. A public company with a multitude of shareholders and the need to meet quarterly goals may not be as willing to alter the status quo.

Risk aversion also can become a succession issue. The owner, who has worked for decades to accumulate ample personal wealth, may become hesitant to embark on new corporate endeavors that have a substantial potential downside. Meanwhile, the next generation may be less risk averse and more willing to take calculated gambles in order to build their own personal fortunes. A meaningful gap between the risk appetite of younger and older generations can be difficult to bridge.

Bryant Seaman: Interestingly, family businesses in general have a tendency to assume less risk than publicly traded companies with respect to their capital structure and the assumption of debt. This is, in part, because the private markets are not as robust as the public markets and leverage is constrained by bank covenants. However, in many instances it is a matter of the family business owner's aversion to debt. When we consider how many family-owned companies are less leveraged and have more modest capital expenditure budgets than their public counterparts, it is quite remarkable that they are as competitive as they are.

Unfortunately, a company that avoids long-term debt, maintains excessive amounts of cash, and postpones important growth opportunities risks falling behind its competitors. Clearly, that has negative implications. On the positive side, however, a moderate capital structure can be a source of stability in economic downturns and can be very attractive to certain strategic and financial buyers, if and when the family decides to exit.

Ben, are you ever concerned that your company is too defensive and is not using its capital as effectively as it could?

Benjamin León, Jr.: We have no interest in using capital solely to maintain the status quo. It is vital for us to continue to grow with our industry. We reinvest when we see opportunities to enhance and diversify our revenue streams or become more competitive in terms of what we offer patients. When managed care providers stop reinvesting in themselves, it becomes apparent very quickly.

Some of the best-known public companies reinvest quite aggressively and have not paid dividends for years. Family businesses ordinarily don't have that option. How do family businesses establish a reasonable balance between dividends distributed to shareholders and the need to reinvest?

Bryant Seaman: Especially in the type of growth situations Ben just mentioned, it can be challenging to balance the need for capital investments with the cash flow requirements of the non-management family shareholders. This can become a source of tension when family members outside the business depend on distributions to help pay their mortgages, school tuitions, and other expenses.

How do you address this?

Bryant Seaman: In many instances, a practical solution is to analyze the payout ratios used by publicly traded peer group companies. This enables us to establish an objective benchmark, which can provide the basis for a rational discussion regarding distributions among family members.

Rod, could you weigh in on this as well?

Rod Ward, Jr.: When there is any question as to how dividends and reinvestment should be balanced, I agree with Bryant that the most apt model is a publicly traded company in the same industry. The family-owned companies I work with in my legal practice tend to pay out substantially less than 50% of after-tax income to stockholders. All shareholders are treated similarly, whether they are in management or not.

Steve Akers: Family dividend disputes often center not only on how much shareholders receive, but on how consistently dividends are distributed. Family members who depend upon the business for income can become frustrated if the distribution policy is erratic and always subject to change. It is very important for a family-owned company to have a formal, well thought out and clearly communicated distribution policy. Some family members outside the business may not be happy with the level of distributions, but at least they will appreciate the transparency and consistency of the distribution process.

OUTSIDE HELP

Tom Nicholas: Is it crucial for a family business to have professional managers, Rod?

Rod Ward, Jr.: I would venture that a great portion of CSC's success has been due to the willingness of our family owners to hire top-notch professionals. Our company was built by professional managers, who augmented the efforts of family management. Even though my father was a banker and my brother and

I are lawyers, the family did not produce anybody in our generations who had first-hand experience running a global company.

It is my impression that some family businesses hesitate to hire talented executives because they are concerned that family members will be overshadowed or that the outsiders may begin to play too prominent a role in the company. That is shortsighted.

Benjamin León, Jr.: It is vital that professional management be brought into a company when necessary, and be allowed to do their job without unreasonable interference by family members. As Rod suggested, a lot of family businesses suffer from an insecurity that doesn't allow for this freedom. If a manager begins to believe that his wings are clipped, there isn't much incentive for him to try to do his best work. Given more freedom, his strengths as well as his weaknesses will be clarified. In the end, of course, the family will benefit, too.

As a business grows, it becomes impossible for family members to cover every aspect. Family employees also may lack the experience to take advantage of new opportunities. Families that shun professional management can limit their company's growth to a dangerous degree.

Bryant Seaman: I'm in full accord with Ben and Rod. It is critical to be able to attract the best and the brightest outside managers by providing them with the right incentives. Families that are open and welcoming in this regard are far more likely to flourish than those that insist on always having family members in senior posts, especially if those individuals are unprepared or lack the requisite qualities.

Rod, how does CSC attract talented outsiders?

Rod Ward, Jr.: The company has been quite profitable, which provides it with the ability to be very competitive from a compensation perspective. We give outside professionals a share in the business through phantom stock and stock appreciation rights. We also go to great lengths to ensure that the senior managers are treated the same as members of the family. There is not a hint of snobbism or separation between the professionals and family employees. We are committed to maintaining this environment. Good outside managers will not stick around if family members exhibit a sense of entitlement.

Steve Akers: Professional managers can be very effective in a relatively large firm like yours, Rod. However, this can be problematic for an entrepreneur who runs a smaller family enterprise. Many successful entrepreneurs have very controlling temperaments. Consequently, good outside people sense that they will be denied real responsibility and input, and therefore are difficult to attract. Talented executives understand that they are not infallible, but they don't want to be overruled repeatedly by the entrepreneur. Ben's "clipped wings" comment is exactly on target.

Another challenge is compensation. Equity ownership is limited to family members, so there must be alternative ways to reward valuable professionals. As Rod suggested, phantom stock plans or related arrangements can give outsiders a greater stake in a company's performance. The family also should be prepared to provide good professionals with very competitive base compensation and a generous bonus arrangement.

Carlyn, is there a tendency among small, family-owned businesses to delay bringing in outside management as long as possible?

Carlyn McCaffrey: That appears to be true for most small businesses, Tom. So long as family members believe they have the requisite experience, they tend to make a concerted effort to avoid external expertise. When they decide to proceed, it often is because the company has grown to such an extent that they have no choice. The downside to depending exclusively on family management often becomes all too evident when a family manager makes a significant strategic mistake or rapid growth creates instability.

Carlyn and Steve, even if the business doesn't bring in a professional, do you recommend that one or more outsiders be placed on the board?

Carlyn McCaffrey: Family members on the board often bring an intense focus to the business, which is desirable. The disadvantage is an inability to perceive risks and opportunities that might be self-evident to outside board members. We see that all the time.

Steve Akers: We have observed that as well, Carlyn. Advice can become ingrown and result in a damaging feedback loop when it stems from boards that are too narrowly constituted. Family members may share a common vision, but lack the varied perspectives a board needs.

Rod Ward, Jr.: In the case of a small company, a board of advisors can alleviate deficiencies in expertise and help the CEO to formulate practical strategies. They also can warn of dangers such as overreaching and too much aggression or timidity. As a family company grows larger, however, it should place a high priority on developing all critical expertise within the organization, in order to decrease its dependency on specific, external board members.

Benjamin León, Jr.: All of us agree that a board with outsiders can be advantageous, but that benefit may dissipate if these directors begin to oppose the family on important strategic issues. The resulting gridlock can be extremely damaging. Family companies have to walk a fine line: You want a board that isn't filled with yes men, but you also have to ensure that outsiders and family members are disposed to reconcile differences of opinion.

While we are on the subject of advisors, what can clients do to ensure that professional advisors are well equipped to help a family with succession planning?

Rod Ward, Jr.: Prospective advisors should be thoroughly interviewed and vetted by one or more of the family company's executives, even if an advisor is recommended by a credible source. It is optimal to find advisors who have extensive succession planning experience, no inherent conflicts, and an in-depth understanding of your industry. It's a little like doctors: Professionals who handle these matters on a regular basis are likely to be more helpful and less prone to make errors in judgment.

This applies to tax and estate lawyers as well as to investment bankers. Unfortunately, it is not unusual to find law firms that have a higher regard for their expertise in the more rarified areas than is actually warranted. In short, the family-owned company should do its homework.

Ben, what are some of the danger signs of an advisor who is not well equipped to help a family with succession planning?

Benjamin León, Jr.: The single biggest danger sign is if the advisor is not cognizant of family dynamics or shows no interest in understanding those dynamics. It is not always self-evident how much authority and influence a family member carries within the business. Nor is it always easy to discern how well various members or branches of the family get along with one another, or if there are hidden alliances. Advisors who make an effort to understand these dynamics can help the family avoid landmines during the succession process.

Carlyn, how do family-owned companies or their family offices establish which advisors they'll use for tax planning or other needs?

Carlyn McCaffrey: There's no one answer, Tom. Each family business is different. One of the larger family-owned companies I work with decided that two brothers who owned a large piece of the business needed some estate planning. One brother used my firm, based on a referral from the head of the family office. The other brother already had his own lawyer. Together with a couple of accountants, we discussed estate planning ideas and implemented them. Another family business might have taken a totally different approach and perhaps may have used only a single attorney. The point is that there is no template. Families should use counsel in the way that best fits their disposition and financial needs.

TAX & LEGAL ISSUES

Tom Nicholas: What are important taxation issues for family businesses, Carlyn?

Carlyn McCaffrey: The income tax imposed on the business can be a major issue. Most family businesses don't want to be organized as a C corporation because of the potential double layer of tax, and so a large number are either S corporations or, increasingly, limited liability companies. That, of course, requires annual distributions to the shareholders in order to provide them with the resources to pay their tax. This seems to be a doable arrangement.

Can you elaborate on the limited liability structure?

Carlyn McCaffrey: In my experience, most new companies will be organized as limited liability companies as opposed to subchapter S, because the exit strategy out of a subchapter S company is much more difficult versus an LLC.

An S corporation, if it's already successful, is usually prohibited from a tax point of view to make the switch to an LLC. One of the strategies that we may pursue when we have a growing S corporation is to try to move some of the businesses out before they mature into a limited liability structure. The owners of the S corporation spin them off but continue to own them, so that the growth is in the limited liability company.

Carlyn, what about the estate tax?

Carlyn McCaffrey: It's the big-ticket item, Tom. This is the real problem for a closely held business as opposed to a publicly held business. Publicly held companies aren't worried about the potential total disruption of the business if somebody dies. Taxes can decimate the estate of the owner of a closely held business by 50% if the family and its advisors don't act quickly. The best way to manage this issue is to deal with it early on, through various transfers that can be made easily during a lifetime.

How do you put contingencies in place if there is an unexpected death of a family matriarch or patriarch?

Carlyn McCaffrey: You plan early on to shift as much to the children or the next generation as you can, usually through a grantor retained annuity trust (GRAT). If you haven't been able to transfer as much as you want, the ultimate technique in this situation is a TCLAT, a testamentary charitable lead annuity trust. Obviously, you have to have some philanthropic interest to use a TCLAT.

A TCLAT can zero out the remaining assets in the estate of, say, a matriarch who has $500 million in her name. After she dies, there will be an obligation to pay a charity the $500 million of assets over a 20- or 25-year period — rather than an obligation to pay the estate tax on $500 million. However, the surviving family members probably do not want the charity to own the business. The next critical step, therefore, is for the surviving family members to obtain court approval to buy the $500 million of assets from the estate.

If this can be achieved, what goes into the TCLAT is not the business but a note that will be paid out by the family over a 20-year period. That can help save the business if the family hasn't been able to get everything out before the owner dies.

That's pretty impressive.

Carlyn McCaffrey: It can literally save the life of a family business, especially if that business is a corporation. If you have a $500 million estate attracting a $250 million liability, most of the money the family ordinarily will need to pay the taxes is inside the business. With this strategy, the money will be taken out of the corporation as dividends — and income taxes would be due on the dividends.

Rod Ward, Jr.: My alma mater just received a donation of $180 million from somebody who had been enriched by Warren Buffett's genius. I assume a TCLAT could work very well for her and my alma mater.

Carlyn McCaffrey: That's possible, Rod, but the TCLATs my clients set up usually don't give the stream of income to a particular charity. It's either the family foundation or family members who choose the charities on a year-by-year basis.

Do you think Congress will take a sharp look at that?

Carlyn McCaffrey: They haven't yet.

Steve Akers: For family members who now control the business and still owe some estate tax at the owner's death, another available alternative is the ability to defer the estate taxes for up to 14 years. Five years of interest-only payments, then 10 years of equal payments, with the last payments made in the beginning of the 15th year. This can help to avoid that huge liquidity crunch all at once. I suspect that most families feel they can deal with this obligation over 14 years. The problem is the big payment due at nine months after the date of death.

Is this option open to all family businesses, Steve?

Steve Akers: The business has to be at least 35% of the estate and there have to be 45 or fewer owners. But many family businesses meet those requirements. Carlyn has suggested some effective strategies, but whether a business owner uses a TCLAT, one of the various types of GRATs, or life insurance, it is crucial for these approaches to be put in place as early as possible. There are plenty of instances where business owners started too late to move forward on plans of this nature and compromised the potential tax minimization of the transfer.

You had mentioned GRATs before, Steve. Could you expand a bit on their use?

Steve Akers: The stock of the company or the membership interest in the LLC can be put into a GRAT or a straight grantor trust. The company has to make distributions in order for the shareholders to be able to pay their income taxes on the flow-through income. Since the trust owns the stock, the company makes the distribution to the trust, which the trust can then use to make the payment to the grantor.

The grantor uses that money to pay the IRS. So the same money that is used to pay the IRS can effectively be funneled through and represent payment for the stock. Over the years, I've seen many companies in which parents have been able to transfer all of the company in that manner without any gift tax at all. It's an incredibly powerful strategy for an S corporation, an LLC, or a partnership.

Benjamin León, Jr.: Our family has derived great benefit from grantor trusts. We placed 40% of our company's assets in the hands of the next generation and sold 60% of the ownership to the grantor trust. It is very manageable for the senior generation to pay income tax, even in the worst-case tax scenario.

Carlyn McCaffrey: So you no longer own the 60%? The trust owns it, and you have a note that the trust is gradually paying off?

Benjamin León, Jr.: Yes, the trust pays interest on the note, the lowest amount allowed by the IRS. We have frozen the value of the company for tax purposes. Through our investments, we have enough dollars to pay the estate taxes, and will not have to depend on the company to meet that tax bill.

Are the types of arrangements described by Carlyn, Steve, and Ben something that family-owned firms think of themselves? I presume not.

Steve Akers: Typically, advisors bring this idea to the family.

Carlyn McCaffrey: Some larger family businesses have very clever people working in their family offices who come up with these ideas and reach out to outside counsel for implementation.

Steve Akers: At times they come up with ideas that are a little too far out, and the advisors are compelled to rein them in.

[Laughter]

LOOKING AHEAD

Tom Nicholas: Rod, do you think we will see more or fewer family-owned businesses in the future?

Rod Ward, Jr.: For the sake of argument, Tom, I will present the negative view. The entrepreneurial spirit is still strong in this country, but we face a lot of challenges, including the prospect of higher taxes, more government regulation, less access to credit and, for many companies, pricing pressures tied to global competition. These and other obstacles might prompt existing family businesses to say, "We've had enough," and sell to larger concerns. Cashing out and investing the proceeds may be a more appealing alternative for many long-established family enterprises than taking business risk in an uncertain and unusually difficult business environment.

Benjamin León, Jr.: I'm mindful that the current business landscape is strewn with obstacles, Rod. Nonetheless, I'm optimistic about family businesses, including my own. My business sees turnover every 20 years or so, and in 100 years the population will be replenished. That should spell opportunity for us. We have seven locations today and we're planning for more.

If a large number of family businesses decide to cash out due to the economic climate, this should result in even greater wealth transfer to the children and grandchildren of entrepreneurs — which conceivably could provide start-up capital for a whole new generation of family business owners. Young people who appreciate what their parents have achieved will understand the value of launching another family-owned business. It is entirely possible that family businesses will reemerge, perhaps at a greater rate than public companies.

The failure rate for start-ups is high, Ben, even in relatively friendly economic environments.

Benjamin León, Jr.: It has always been that way. Success will continue to be there for real excellence.

Carlyn McCaffrey: With high unemployment today, many people don't have many choices *but* to develop businesses. Ironically, we may see an increase in family businesses as a result of this difficult economic environment — and some of them will succeed and make their owners very wealthy.

Rod Ward, Jr.: Good point, Carlyn. Corporate formations actually do increase when people are laid off. There's no public corporation that didn't start as a private corporation. But as private companies pass through the pipeline, it's tough to tell if they will opt to become public companies at the same rate as in previous decades. This may depend to a large extent on what the federal government does with regulation and taxation.

Bryant Seaman: Increased regulation of publicly traded companies does appear to have been a factor in the significant decline in the number of IPOs over the past several years. Perhaps more ominously, the prospect of higher taxes on capital gains and income earned from private companies could also lead to less entrepreneurial activity in the years ahead as well. Even for private company owners, the risk/reward ratio may at some point be too far out of balance to justify continuing the commitment to the family business legacy.

I do have faith, however, that a majority of the legislators at both the federal and the state level understand that family businesses are a critical growth engine of the U.S. economy and employment. It is clearly in the public's best interest to provide family businesses with the incentive to innovate, compete, and grow, as they have done so successfully since the founding of our country.

From my perspective, this has been an insightful and informative roundtable and has given me a great deal to think about. I want to thank each of our panelists for their participation and also thank Bessemer for bringing together this accomplished panel.

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