Unplanned Business Succession After the Death or Incapacity of the Business Owner

by Barbara A. Dalvano and Constance D. Smith

This article addresses some of the issues presented in an unplanned business succession situation and includes suggestions (some involving minimal advance planning) to reduce the problems that arise in an unplanned business succession.

Estate planning practitioners generally are familiar with business succession planning techniques, but may not have much experience with situations in which a business owner becomes incapacitated or dies with no written succession plan for the business. The owner's business succession planning objectives often are difficult to identify and accomplish in an unplanned succession.[1]

Immediate Family Needs

When a business owner dies or becomes incapacitated, the first concern of the business owner's spouse generally will be to replace the business owner's income. Possible sources of cash flow include payments under a disability insurance policy, long-term care insurance policy, or public benefit programs. Hardship distributions from retirement plans and liquidation of other personal assets also could be considered. If the business owner is incapacitated, life insurance policies should be reviewed to determine the best use of any cash value. The spouse should not borrow against the cash value or surrender any life insurance policy if the policy is pledged as security for any contractual obligations or if the cash value will be needed to pay premiums on the policy. The spouse will need to evaluate whether the cost to maintain the policy is worth the future death benefit.

Equity Interests

If the business appears financially sound, the business owner's compensation income could be partially replaced by distributions (dividends from profits) on the business owner's equity interest. Alternatively, the business could redeem all or part of the equity interest. Attention should be given to the owner's retained interest for control and future economic needs, as well as business liquidity that may be needed for long-term plans. If there is more than one business owner, a sale of the business owner's equity interest to one or more of the co-owners could be negotiated, though favorable terms might be the exception without a prior binding agreement. If a buy-sell agreement exists, it might trigger a sale, forcing liquidation of the owner's equity interest. This would provide for the family's cash flow needs, while eliminating the family's concern for the business's future.

If any planning is permitted before incapacity, the attorney could suggest an employment agreement between the owner and the business with salary continuation and qualified or nonqualified deferred compensation provisions. This would provide some short-term income continuation for the benefit of the business owner's family on the owner's incapacity or death.[2] The salary could be continued for the waiting period under the owner's disability or long-term care policy. An employment agreement for a single-owner business may seem counterintuitive but nonetheless could be effective. Of course, the liquidity of the business should be weighed against the family needs for cash flow.

Health Insurance

The family's health care insurance likely will be the next priority. If the business has an employee health care plan, the spouse could take advantage of federally mandated[3] continued employer health care coverage at an increased cost. Another option is to employ the spouse in some capacity in the business and to begin family health care insurance coverage in the spouse's name. Employment in the business provides income to the family, along with some of the employee benefits the disabled or deceased owner may have enjoyed. Even if the spouse's compensation income is significantly less than

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that previously earned by the business owner, the other employee benefits alone may favor use of this option. The spouse must actually provide services to the business and be reasonably compensated for those services. Working in the business provides the spouse with exposure to the business and its operations, but working offsite may be advisable if the spouse's presence would negatively affect other employees.

Immediate Business Needs

Continuation of the business operations after the incapacity or death of the business owner also must be addressed. The immediate needs include cash flow (accounts receivable and current expenses), performance of outstanding contractual and tax obligations, and the continuation of critical licenses and other permits needed to run the business. Any reduction of expenditures must be weighed against the insecurity created for employees, suppliers, and customers. All short-term decisions should be made only after evaluating their effect on long-term solutions and options.

If the business owner had no business succession plan prior to death or incapacity, some stop-gap measures might be needed to maintain the business operations. Retaining key employees; avoiding lenders' acceleration of debt; and good communication with customers, suppliers, and other third-party contractors all should be addressed early to preserve the value of the business until long-term decisions can be made. For example, key employees could be identified and offered incentives to continue with the business. These incentives could include an employment agreement with a signing bonus, bonus program, profits interest, or phantom stock in the business.

Legal Representative for Incapacitated Business Owner

Assuming the business owner did not have powers of attorney, a conservator and guardian would need to be appointed to act on behalf of the incapacitated owner. The broad powers granted by such appointments could create conflicts and disputes within the family as members vie to protect their individual interests.

The appointed conservator could (but might not) have control over the operation and continuation of the business. CRS § 15-14-301 provides the spouse with statutory priority for appointment as guardian, but adult children and ex-spouse guardians of minor children may contest the spouse's appointment as conservator to protect their personal financial interests. This may be of concern where the business continuation benefits some heirs and immediate liquidation benefits others. Requesting separate conservators for the owner's personal financial affairs (for example, the spouse) and the business operations (for example, a receiver or special administrator) might reduce tension among family members and protect the business value.

The conservator has the authority to design for court approval an estate plan that could be biased for or against certain beneficiaries.[4] Additionally, the person appointed as guardian may have the ability to divorce the spouse, thereby removing all statutory, marital agreement, and other spousal rights.[5]

If only estate planning was agreed to by the owner before incapacity, a limited power of attorney designating an agent who is familiar with the business to vote the equity interest could provide for short-term business continuity. This limited power of attorney would be separate from and in addition to a general durable power of attorney for the owner's nonbusiness financial affairs. If the owner is agreeable, a written business resolution can identify key employees and grant them short-term management authority when the owner is unable to act. Creation of a transitional advisory board (in which fiduciary liabilities are limited and indemnified) could provide much-needed assistance for continued business operations in the absence of an owner.

Interim and Long-Term Planning

After the initial crisis of an owner's incapacity has passed, the conservator will need to address both estate and business succession planning issues. CRS § 15-14-411 permits the conservator, with court approval, to engage in a variety of estate, tax, and Medicaid planning, including creation of trusts and lifetime gifts. A valuation of the business will be needed as part of this planning.

Armed with detailed business structural, operational, and financial information and considering, to the extent possible, the interests and objectives of family members, the conservator for the business interest should evaluate the long-term prospects for the business. This will include evaluating the continuing viability of the business activity; the human resources needed to continue the business (the family and key employees' capabilities, experience, and expertise); the compatibility of necessary individuals; and the current and future financial stability of the business. These factors will determine whether the business should be continued long term, either held by the owner's family or sold, or whether the business should be liquidated.

As part of structuring the owner's estate plan during incapacity, the conservator should separately consider who will control the business and how to equalize the economic benefits from the estate, if desired among beneficiaries. As part of the plan, the business may be recapitalized to create voting and nonvoting equity interests and/or to create preferred or fixed value interests and common or growth interests, though an S corporation cannot have preferred interests. A recapitalization would facilitate discounted transfers, by gift or sale, and discounted values for equity interests retained in the owner's estate.

Transfers of nonvoting interests would permit transfers to family members of economic value while retaining controlling, voting interests or transferring them to the chosen future business managers. In families where some but not all heirs want to continue the business, the voting, growth equity interests could be transferred to family members participating in the business and nonvoting, preferred equity interests could be transferred to those family members who are not active in the business. Trusts could be created to hold the voting equity interests for inactive or young family members with suitable trustees appointed.[6] Trusts are advised for minor children of prior relationships, if transfer of voting interests to them cannot be avoided, to prevent ex-partners from having any voting rights in the business as legal guardians of the children. All trusts holding S corporation stock must be qualified shareholders.[7]

Where possible, a majority equity (controlling) interest should be given to one person who is expected to continue to run the business and nonvoting equity interests or other estate assets should be given to other beneficiaries. A disposition that provides for the business interest to pass first to the surviving spouse and then equally among the children may not be appropriate. This common disposition gives the surviving spouse control over the entity and

such spouse may not desire or be able to continue the business for the children's benefit. Passing the business equally to the children creates potential deadlock and conflict between those children who are active in the business and those who are not. Instead of giving the business to the spouse and then all children as part of the estate assets, estate planners should consider the facts and circumstances in each case.

If there are multiple owners of the business, a buy-sell or other co-owner agreement will is advised. The conservator may be able to initiate the agreement using the incapacitated owner's circumstances as a catalyst. The co-owners will need to address myriad issues regarding the structure and terms of the buy-sell agreement. If corporate-owned life insurance is considered to fund buy-out arrangements, the rules added by Pension Protection Act of 2006 for acquiring life insurance on employees must be considered.[8] These rules include notice provisions and specific requirements that must be met to avoid ordinary income tax on the insurance proceeds.[9]

If the business activity is viable but there are no family members who want to operate the business, the business could be sold to key employees or to an outside third party. Possible merger candidates could be cultivated. If there are distinct business activities within the business, a tax-free division of the business could be considered with separate business activities continued by different family members or sold to employees or third parties.[10]

Where the owner agrees only to estate planning, the attorney should consider provisions in wills and powers of attorney that exonerate the fiduciary in connection with its administration of the business interest. Any personal representative nominated also should be granted the powers to retain, acquire, and sell business interests; reorganize the business; make non-pro-rata distributions of the business interests to beneficiaries; and determine whether and to what extent other estate assets can be employed in the operation and continuation of the business.[11]

Intestate Death of Business Owner

If the business owner died before estate or business succession planning was accomplished, many of the issues that could have been dealt with during the business owner's life now must be resolved through the intestate administration of the owner's estate. The spouse has statutory priority for appointment as personal representative, but family members may contest such appointment.[12] It will be necessary to determine the impact of the decedent's death on any contractual obligations, including, in particular, life insurance, loan agreements, and any related security instruments. To the extent the decedent personally guaranteed any debt, the liability of the decedent's estate to perform under those guarantee agreements must be assessed. A variety of legal consequences concerning the ownership of the business interests can arise, depending on the structure of the business, as discussed below.

C Corporations

If the business was a C corporation,[13] the death of the decedent does not cause a dissolution or termination of the business. The decedent's personal representative would hold the decedent's stock interests in the corporation and could vote such stock pending the

Multiple Business Owners

If there are multiple co-owners and no buy-out or other business succession agreement exists, the decedent's estate and heirs could be shut out of all managerial power to operate the business and all decisions regarding distribution to owners. Absent any prior agreement or fruitful negotiation with the other co-owners, the heirs will have only those default rights available under the Colorado law for the relevant business entity.

If the surviving spouse is the parent of all of the decedent's children or if the decedent had no children, under the Colorado intestate succession law[24] the spouse would receive 100 percent of the decedent's estate, including the business interest. The equity interest passing by intestate succession to the spouse should qualify for the unlimited marital deduction for federal estate tax purposes but, depending on its value, could create a taxable estate for the spouse at the spouse's subsequent death.[25] The spouse might consider a post-mortem disclaimer of all or a portion of the equity interests equal to the decedent's applicable exclusion amount[26] remaining at death. If a minority equity interest was disclaimed, applying appropriate valuation discounts, the surviving spouse could leverage the decedent's remaining applicable exclusion amount in favor of family members. Additional valuation discounts of the minority equity interest might be appropriate if a post-mortem recapitalization of the business was performed and the surviving spouse disclaimed nonvoting equity interests.

If the surviving spouse is not the parent of all of the decedent's children, Colorado's intestate succession law provides that the surviving spouse will inherit 50 percent of the decedent's intestate estate and all of the decedent's children would inherit the other 50 percent of the decedent's intestate estate. There is no Colorado authority permitting the personal representative to make non-pro-rata distributions of the intestate estate assets in the absence of the consent of the heirs. In addition to possible federal estate tax liability, the pro-rata distribution of the business interests can create conflicts and deadlock with only the state law default resolution mechanisms available to eliminate the deadlock.[27]

Conclusion

The potential for conflict and deadlock among beneficiaries, as well as loss of value of the business interest, should demand the business owner's attention to matters involving estate and business succession planning during his or her lifetime. However, motivating the business owner spend time and money on such planning often is difficult.[28] Some resources to assist the estate planning attorney are listed below.[29] Because the Colorado business entity laws do not coordinate well with the Colorado Probate Code relative to fiduciary powers for certain entity structures, the estate planning attorney may need to co-counsel with a business attorney to determine the best plan design for a particular client.

Notes

1. *See generally* Scroggin, "Seven Realities of Family Business Succession," *J. Prac. Estate Planning* 27 (Feb.–March 2007); Brink, "Handling Business Interests (with Forms) (Part 1)," *ALI-ABA Estate Planning Course Materials J.* 35 (June 2002); Brink, "Handling Business Interests (with Forms) (Part 2)," *ALI-ABA Estate Planning Course Materials J.* 39 (Aug. 2002).

2. Any such agreements must be reviewed for compliance with or exemption from IRC § 409A.

3. 5 U.S.C.A. § 8905a.

4. *See* CRS § 15-14-411.

5. *See* CRS § 15-14-315.5.

6. All trusts holding stock in an S corporation need to qualify as S corporation shareholders. *See* IRC § 1361(d) and (e). *See also* Howell-Smith, "What types of Trusts are Permitted Shareholders of an S Corporation?" 34 *Estate Planning* 26 (June 2007).

7. *See* IRC § 1362.

8. Pub. L. No. 109-280, 120 Stat. 780 (signed into law on Aug. 17, 2006); Grassi, Jr., "New Rules Concerning Employer-Owned Life Insurance Affect Buy-Sell Agreements (With Sample Drafting Language)," *The Practical Tax Lawyer* 7 (Winter 2007).

9. Pub. L. No. 109-280, 120 Stat. 780 (signed into law on Aug. 17, 2006); Grassi, Jr., *supra* note 8.

10. *See* Brislawn and Brown, "Exit Routes for Business Owners," *Estate Planning* 29 (Feb.–March 2005).

11. For a checklist of the common noncharitable estate planning techniques that can be used by the closely held business owner, *see* Grassi, Jr., "Estate Planning for the Closely Held Business After the Pension Protection Act of 2006," Vol. 32, No. 02 *Tax Management Estates Gifts and Trusts J.* (March 8, 2007). *See also* Mezzullo, 809-2nd T.M, "Estate Planning for Owners of Closely Held Business Interests."

12. CRS § 15-12-203.

13. A C corporation is a corporation that is taxed for federal income tax purposes pursuant to IRC §§ 11 and 301 *et seq.*

14. CRS § 5-1-804(2)(l).

15. IRC Reg. 1.1361-1(h)(3)(ii)(B).

16. The requirements for maintaining the S status of a corporation after an individual shareholder's death are set forth in IRC §§ 1361 *et seq.*

17. CRS § 7-80-704.

18. CRS § 7-80-701.

19. CRS § 7-80-702.

20. CRS § 7-62-401.

21. CRS §§ 7-62-705 and 7-61-122.

22. CRS §§ 70-60-101 *et seq.*

23. CRS §§ 7-64-101 *et seq.*

24. CRS § 15-11-102.

25. IRC § 2056.

26. IRC § 2010.

27. *See* Naples, "Business Succession Planning Changing the Ground Rules," *Probate & Property* 50 (March–April 2006).

28. *See* Markstein III, "Business Succession Planning That Meets the Owner's Needs," 22 *Estate Planning* 20 (July 2006).

29. Allen, "Motivating the Family Business Owner to Act," *ALI-ABA Estate Planning Course Materials J.* (Feb. 2001); Spratt, Jr., "The Art of Crafting Business Succession Arrangements," *Probate & Property* 20 (Nov.–Dec. 2003); Sildon, "Getting the Family Business Ready to Sell (with Sample Confidentiality and Letter of Intent Forms)," *ALI-ABA Estate Planning Course Materials J.* 21 (Oct. 2006).