

THE SPOTLIGHT

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WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

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**THE FAMILY BUSINESS
AND SUCCESSION PLANNING ISSUE**

ROBINS KAPLAN LLP

REWRITING THE ODDS

WELCOME TO THE SPOTLIGHT

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The Spotlight is the result of ongoing collaboration between our national trial practice and estate planning groups, with the goal of providing a forum to discuss the latest news and other issues impacting the trusts and estates community. Whether you are a trustee, beneficiary, trust officer, attorney, financial advisor, or other professional in this area, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

As leaders and teachers in the field of wealth planning and administration, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations from basic to complex testamentary planning. We counsel individuals and business owners in all aspects of estate planning and business succession, providing them with peace of mind and reassurance that their legacy is in the best of hands.

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Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of the Spotlight? Let us know at SPosthumus@RobinsKaplan.com.

- Denise S. Rahne and Steve A. Brand

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PASSING THE BATON: PITFALLS TO AVOID IN FAMILY BUSINESS SUCCESSION PLANNING

BY STEVE K. ORLOFF AND ERICA A. RAMSEY

The old saying “when you fail to plan, you plan to fail” pertains to almost any business endeavor, but particularly to family business succession. Four out of 10 family businesses do not have a succession plan in place¹. Every business owner should consider succession planning, and for those owning a family business there can be unique family dynamics in play. Below are five common missteps to avoid when preparing a succession plan for your family business.

1. NOT SEEKING OUTSIDE ADVISERS.

Entrepreneurs traditionally have a “do it yourself” state of mind, which is not necessarily in the best interest of the business or the family when it comes to transitioning the company. Third-party advisers with backgrounds in multiple industries – such as CPAs, attorneys, bankers, and insurance agents – can be instrumental when navigating the breadth of issues businesses face today. Outsiders can offer an objective perspective on family conflicts, especially on hot-button topics such as the right direction for the business. Impartial, trusted advisers can listen to both sides of an argument to determine what makes the most sense for both the business *and* the family. They also can keep open lines of communication between outgoing and incoming leadership. More often than not, it is a mistake to keep it entirely within the family when planning for the next chapter.

2. KEEPING THE BUSINESS PLAN A SECRET.

Typically, company employees do not have ready access to the company’s financial and operational details. But communication is essential to a smooth transition: Key players (both family and non-family) need to know what is going on. The same holds true for family members *outside* the business – to help manage expectations when the succession plan is announced. As discussed above, a team approach can help achieve effective succession, and closed lines of communication will prohibit the next generation from obtaining the knowledge needed to succeed. Further, withholding information can also lead to speculation about arrangements made behind closed doors during the transition.

3. NOT PREPPING THE NEXT GENERATION.

In the same vein, open communication is needed to equip the incoming leadership with the knowledge, tools, and contacts to maintain the foundation of the business. Although it is common for an outgoing CEO to want to maintain total control until the last day, it benefits the incoming leader to take on real responsibilities prior to the departure. This allows the incoming leader to gain trust from employees and take ownership of the business while the prior chief is still around. However, a balance must be struck. Prematurely promoting a close family member can send the wrong message to employees who believe they should have been considered for the role. It may also undercut the promoted family member’s credibility, because employees may assume the successor was chosen simply because of the family connection. Instead, if a son or daughter shows interest in the business, a more appropriate path could be for formal education in the field plus several years of employment – perhaps with another company first.

4. IGNORING INDIVIDUAL DIFFERENCES.

It might be OK to divide ownership of the company evenly, but when it comes to management and day-to-day responsibilities, there needs to be a clear chain of command. Heirs are often not equally equipped (or enthused) about running the family business, which can lead to resentment when some put in much more effort than others but everyone reaps the same benefits. Moreover, the next generation may not share the same goals. One may want to run the company; another may want to sell. It is best to consult with all heirs to determine level of interest, expectations, and competency. Going forward, there should be a clear determination of the role each new member will play and the responsibilities falling under each new role.

5. WAITING TOO LONG.

Succession planning requires working through a number of issues, including voting rights, ownership stakes, taxes, estate planning, and business liability. This takes time and means starting the process years in advance. A company's founder may hesitate to prepare for the next chapter, but putting off the decision will only complicate the process. Succession planning cannot take place overnight. It takes time to put together advisory teams, prepare incoming leaders, and decide the future direction and management of the company. Often, a family member working in the business already knows the company's operations. That same son or daughter, however, might have had no exposure to the financial and administrative aspects of running a company. It takes time for a manager to become well-rounded, and not taking time to allow a new leader to fill in knowledge gaps could cause problems down the road.

TAKEAWAYS

The bottom line is that succession does require careful planning; it will not simply fall into place as you head out the door to retirement. Even small family businesses should create a succession plan and revisit it regularly. Doing so can protect prior generations' hard work in establishing the business, as well as family relationships both inside and outside the organization.

¹ 2019 US Family Business Survey. Retrieved April 2019. <https://www.pwc.com/us/en/industries/private-company-services/library/family-business-survey.html>



SUCCESSOR LIABILITY IN ASSET SALES OF FAMILY OR CLOSELY HELD BUSINESSES

BY ROBERT F. CALLAHAN, JR. AND PETER N. FOUNDAS

In creating an estate plan, owners of closely held family enterprises may use asset sales to transfer business assets from one generation to the next. Generally, asset sales allow a purchaser to buy assets without also buying a seller's liabilities, as would be the case with an equity sale. In the context of family businesses, asset sales could remove the burden of liabilities from other family members. However, structuring a transaction as an asset sale does not eliminate the risk of liabilities passing to family members. The involved parties must give careful consideration to state law doctrines of successor liability and tax statutes to minimize the risk of liabilities accompanying assets in a sale.

COMMON LAW SUCCESSOR LIABILITY

Under traditional corporate law principles, a seller does not transfer its liabilities when a buyer purchases only the seller's assets. Across most jurisdictions, however, courts have developed four exceptions to this general principle: (1) where the successor expressly or impliedly assumes the predecessor's liabilities, (2) where the transaction constitutes a *de facto* merger, (3) where the successor's business constitutes a mere continuation of the predecessor's, or (4) the sale is an attempt to fraudulently avoid the predecessor's liabilities.

Given their inherent nature, there is a heightened risk of the *de facto* merger and mere continuation exceptions applying to closely held family businesses. For a *de facto* merger, courts consider a number of factors, including whether the predecessor's management, physical location, assets, and business operations continue as before; whether there is continuity of ownership; or if the predecessor dissolves immediately and the successor assumes the predecessor's obligations to maintain the predecessor's normal business operations. No one factor is determinative, but a combination of the above can lead to successor liability. The factors for mere continuation are similar, with courts generally focused on whether the predecessor's and successor's owners and managers are the same and only one entity exists at the end of the transaction so as to make the asset sale appear as a corporate reorganization.

Family members may be tempted to transfer assets among themselves for little to no consideration. However, these transfers can lead to successor liability under a fraudulent transfer theory. While fraudulent schemes to avoid creditors come in a variety of forms, courts often evaluate whether a transaction has a "badge of fraud" if no direct evidence exists. Some factors relevant to this analysis are whether the seller is rendered insolvent after the sale, whether reasonably equivalent consideration was paid for the assets, whether the transaction was done openly or in secret, and whether the transaction occurred right before or right after the seller incurred a large debt.

STATE TAX STATUTES

In addition, state tax statutes generally impose liability on an asset purchaser where a seller has failed to pay its own sales, use, employment, and corporate excise taxes. The purchaser's liability may be in the form of a lien on purchased assets or penalties for failing to withhold the amount of unpaid tax at the time of closing. While each state has its own statutes for assessing successor tax liability, there are ways to decrease the risk of such liability. An asset purchaser should carefully review the applicable state tax statutes to ensure that adequate notice of the sale is provided to the appropriate taxing authorities. Additionally, an asset purchaser should obtain a tax clearance letter from the taxing authority to confirm there are no outstanding tax liabilities as part of the transaction's closing. If there is an outstanding tax liability, a buyer can then attempt to renegotiate the sale price or withhold the outstanding tax amount in escrow from the purchase price at the time of closing. Asset purchasers can also insist that the controlling asset purchase agreement contains strong representations, warranties, and indemnity provisions to ensure that the ultimate liability for unpaid taxes rests with the seller.

BULK SALES LAWS

Another trap in transferring assets is the possibility of a state's bulk sales law applying. A bulk sale is typically defined as a sale of the majority of a business's assets outside the normal course. Bulk sales laws require a purchaser to give notice of the sale in a specific manner and possibly withhold funds if the purchase price falls within certain parameters. Failure to comply with the law's requirements could make the buyer liable for the seller's outstanding liabilities. While

many states have repealed their bulk sales laws, California is a notable holdout. Fortunately, only certain asset sales are subject to California's bulk sales requirements.

TAKEAWAYS

If the risk of successor liability is properly appreciated, asset sales can be useful in transitioning closely held family enterprises as part of a larger estate plan. Those seeking to transition their family-owned business from one generation to next would be prudent to understand the doctrines of successor liability and state tax statutes to ensure the next generation does not face unwelcome surprises.

HOLD ME CLOSER TINY SHAREHOLDER: PROTECTIONS FOR MINORITY SHAREHOLDERS IN CLOSELY HELD CORPORATIONS

BY THOMAS F. BERNDT

Whether you already own or are considering buying shares in a closely held corporation, it's worthwhile to understand the unique risks minority shareholders face and the varying levels of protections offered to minority shareholders throughout the states. This article provides a brief overview of the legal landscape and offers practical suggestions to current or prospective shareholders.

DEFINITION OF A CLOSELY HELD CORPORATION

The term "closely held" (or "close") is generally used to describe corporations having relatively few shareholders and whose shares are not freely traded. Compared with publicly traded corporations, often having thousands of shareholders, closely held corporations typically have only a handful. Many closely held corporations are family-owned, with the shareholders actively involved in managing the business and simultaneously acting as officers, directors, and/or employees.

Corporations can become closely held either affirmatively or passively, depending on which state's laws apply. Some states—including Delaware, Illinois, and Wisconsin—have statutes allowing (but not requiring) corporations to designate themselves as statutory close corporations in their articles of incorporation. In other states, a corporation is considered closely held if it possesses certain attributes. In Minnesota, for example, the Minnesota Business Corporation Act defines a closely held corporation as "a corporation which does not have more than 35 shareholders." Minn. Stat. § 302A.001.

COMMON FORMS OF MINORITY SHAREHOLDER OPPRESSION

The lack of a readily available market for closely held corporations oftentimes renders the shares difficult to sell. This illiquidity can enable majority shareholders to "squeeze out" or "freeze out" minority shareholders.

A common form of shareholder oppression occurs when a majority shareholder fires the minority shareholder and ousts them from the board while also withholding dividends. Other examples include siphoning off profits through excessive salaries for the majority shareholder, self-dealing transactions, forcing redemption of a minority shareholder's stock, or "cashing out" minority shareholders at an unfairly low price through a merger.

COMMON LAW PROTECTIONS

Hoping to protect minority shareholders from such oppressive conduct, nearly every state offers minority shareholders some degree of protection. Most states recognize the similarities of closely held corporations to partnerships and hold that shareholders of a closely held corporation owe each other the same fiduciary duties as partners owe to one another. In such states, minority shareholders can sue majority shareholders for breach of fiduciary duty or, as it is sometimes called, shareholder oppression.

STATUTORY PROTECTIONS

In addition to common law fiduciary duties, many state legislatures have enacted legislation giving minority shareholders statutory claims for oppression. Many states have enacted a form of the Model Business Corporations Act § 14.30(a)(2), which allows courts to dissolve a corporation if a shareholder establishes that “the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent.” However, this provision applies only to non-public companies with 300 or fewer shareholders and a market value below \$20 million. MBCA § 14.30(b). Additionally, the only remedy provided by the MBCA is dissolution—the traditional remedy for shareholder oppression.

As dissolution is a drastic (and sometimes unfair) remedy, state courts and legislatures have increasingly allowed alternative options, like a forced buy-out of the oppressed minority shareholder. The vast majority of states, either by statute or common law, currently allow a buy-out remedy. Minnesota’s Business Corporation Act is an example of expansive statutory protection for minority shareholders. Specifically, Section 302A.751 of the Minnesota BCA allows not only dissolution and a buy-out remedy, but more broadly authorizes other equitable relief based, in part, on “reasonable expectations of all shareholders.” In contrast, Massachusetts’ statute is narrower, where the only ground for dissolution is deadlock; there is no relief available for majority oppression. See Mass. Gen. Laws Ann. Ch. 156D § 14.30.

DELAWARE HAS NO SPECIAL PROTECTIONS

Delaware, the most influential state for corporate law, offers no special protection to minority shareholders of closely held corporations, either by statute or common law. In *Nixon v. Blackwell*, the Delaware Supreme Court refused to fashion a buy-out remedy to protect minority shareholders of closely held corporations. 626 A.2d 1366, 1379-81 (Del. 1993). The court reasoned that it is preferable for those purchasing shares of a closely held corporation to negotiate for protections at the time of purchase, rather than create judge-made law to protect minority shareholders. The court stated that “[t]he tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration.” *Id.*

KEY TAKEAWAYS

While the law varies from state to state, the above examples illustrate the spectrum. The differences in state law protections should motivate shareholders to choose wisely when deciding where to incorporate.

Minority shareholders can also negotiate contractual protections rather than rely on state law remedies, which often require litigation to enforce. For example, prospective shareholders planning to be employed by the company can negotiate an employment agreement requiring cause for termination and providing severance benefits. Prospective shareholders could also negotiate a buy-out remedy at a fairly appraised price in their stock purchase agreement. Language could also be included to preserve board seats and voting power. With careful planning, shareholders can avoid many of the risks particular to closely held corporations.



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