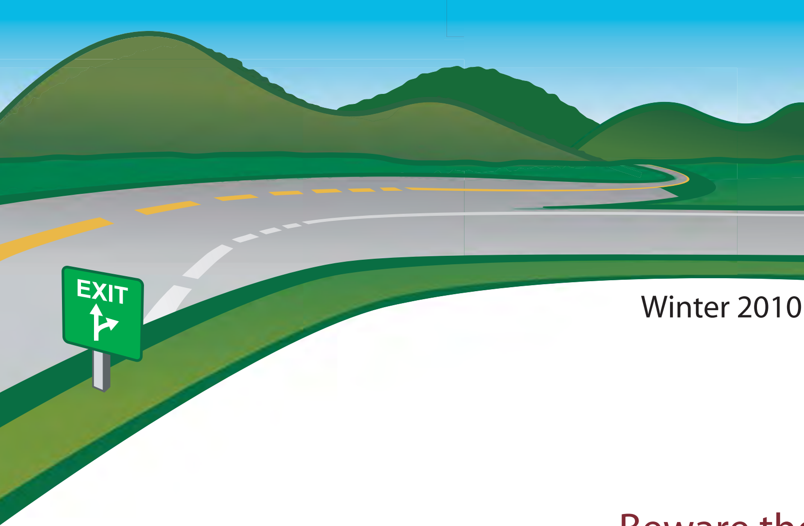

Changing Lanes

Transition planning for entrepreneurs and family businesses

Winter 2010

LOFTUS ALLEN & CO.
CHARTERED ACCOUNTANTS and FAMILY BUSINESS ADVISORS

with compliments from

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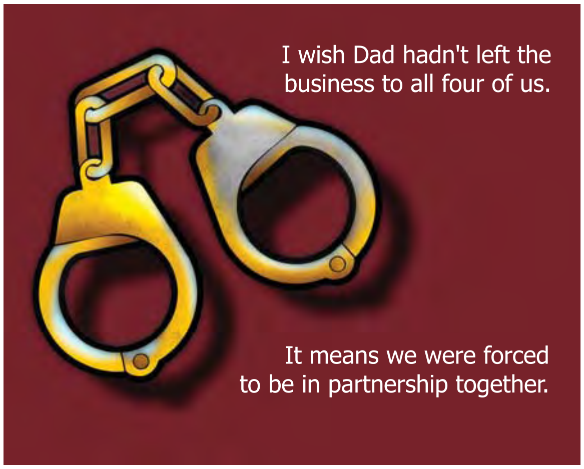
Inside....

Beware the Golden Handcuffs

From the day they are born, our parental instinct is to give the same amount of love and attention to each child. Whether it is putting the same number of marshmallows in their hot chocolate or ensuring that each receives a gift when we return from a business trip, it is inherent in us to treat our children ***fairly***. And to the recipients, that usually means ***equally***. (If you doubt that - just ask the child who got fewer marshmallows!)

But the ***fair and equal*** mantra isn't as easy when children grow up. While an equal division of liquid assets is reasonably straightforward and perhaps considered fair in the eyes of some parents, it can conceivably be deemed unjust by the son or daughter who has contributed more time and effort in support of the aging relative.

Similarly, it isn't such a good strategy when it comes time to hand off the ownership of your family business. It is extremely difficult to achieve fairness through an equal gifting of the shares. Typically, not all siblings are involved in the day-to-day operation of the business so the perception often exists that they do not have the same entitlement to the rewards. The alternative, forcing siblings into an equal partnership they would not otherwise have chosen can be a recipe for disaster. This is what we call the 'golden handcuffs'. These sibling teams find themselves locked in what is often a financially-rewarding but stressful partnership with no easy way out. In a worst-case scenario, it can destroy family unity and the profitability of the business.



When it comes to relinquishing the shares of a family enterprise, the goal is to find a process that is ***fair and equitable*** to all concerned. This edition of Changing Lanes focuses on equipping the Communication Vehicle with an agreement that ensures a fair entrance and exit policy that incorporates effective decision-making and compensation policies.

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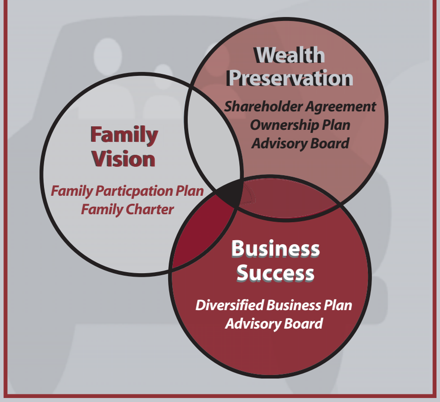
Keeping the Wheels Aligned

Hitting potholes on the Family Business Highway will undoubtedly throw your vehicle off balance. Keeping the wheels of your communication vehicle aligned with an equal focus on the family, the management, and the ownership areas of the family enterprise is necessary to ensure a smooth ride on the journey. The map below is designed to help you keep that balance through appropriate communication channels.

From family vision to business success and wealth preservation, there is a lot riding on this vehicle. Not only does it carry a precious cargo – your family – but it is also the only way to unify the goals of the family with the business, and ulitmately create a common purpose.

In this issue, we focus on the ownership circle where the objective is to preserve the family wealth by:

Equipping the Communication Vehicle



- Ensuring the principles that are the foundation of the Family Charter are embedded in an Ownership Plan and Shareholder Agreement that not only protect the physical assets but also provide for independence rather than golden handcuffs.
- Linking the role family members will play in the ownership of the business with the Family Participation Plan.
- Exploring the power of an advisory board that ensures an appropriate level of responsibility, accountability and risk management for both the current and subsequent generations of stewards.
- Clarifying the overreaching ownership philosophy so it can be woven into a Diversified Business Plan that has the ability to deliver the family's vision.

So consider the approach we outline in this edition of Changing Lanes and then call us for help to get started.

Put Away the Shotgun

All too often, a business owner's succession plan is a Will that divides the estate equally among his or her heirs, and a Shareholder Agreement that allows for a shootout among siblings.

Our approach is to put away the shotgun and instead open a dialog around the family's 100-year plan and the philosophy for future ownership of the business. This discussion is the foundation of a principles-based Shareholder Agreement – an agreement that incorporates a structured entrance and exit process that essentially creates an internal stock market for the shares of the privately-owned company.

In fact, a principles-based Shareholder Agreement is a critical component of a fair and equitable distribution of the business owner's estate, and absolutely necessary when you need to trim the tree during the transition process.

When planning for the transition of physical assets such as the shares of the business, the goal should be to treat offspring ***fairly and equitably*** rather than equally.

But what is considered fair and equitable? Is it fair that the child who works in the business inherits the shares while the remaining family assets are split among the other children, regardless of any disparity in value? What message does this deliver to the non-involved siblings? What message does it deliver to the children of these siblings about their status in the family?

Or is it considered more acceptable to gift one child the shares of the business while the others inherit an equal value in other assets? While it is possible to equalize the monetary value of the gifts using insurance and other investment strategies, how do you equalize the levels of risk and opportunity in managing an operating business versus managing the more liquid assets?

And who decides what is fair and equitable? The first step is to engage the next generation in discussions around their aspirations for the future, but ultimately the decision lies with the exiting business owner or the parents of these heirs. (As most families discover, siblings making major decisions for siblings is rarely seen as objective or fair!)

Read on to learn how to create a principles-based Shareholder Agreement that can be signed with confidence by all!

Clarify Your Ownership Principles

The first step in creating an effective Shareholder Agreement is to list what needs to be addressed in the areas of ownership and decision-making in order to achieve all your goals for the family, the preservation of wealth, and the success of the business entity. Here is a checklist of items to get you started:

- Wealth protection and preservation
- Future ownership and leadership
- Financial independence for each generation
- Asset distribution
- Business reinvestment
- Tax management
- Company mission
- Compensation philosophy
- Decision-making philosophy

For each item, we can help you review the various options and the consequences of each.

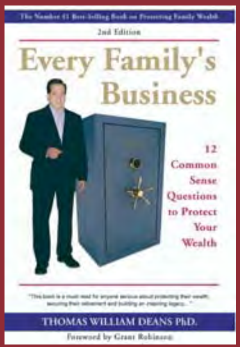
The next step is to extract the most important elements and from these draft what we call your ***transition principles***.

These transition principles can then be used by your lawyer to craft a Shareholder Agreement that supports a fair and equitable distribution of the shares of the business. *(See an example of one family's transition principles on the right.)*

12 Common Sense Questions

***You can also develop your transition principles from your answers to the twelve questions outlined in the best-selling book* Every Family's Business.**

These questions, originally crafted and used consistently by the author's own family to map out the future of their three generations of businesses, were specifically designed to protect family wealth and relationships.



Every Family's Business *is available online through Chapters or SuccessCare's online store. Alternatively, you can order the book directly from the author Tom Deans. For exact ordering information, feel free to contact us.*

Sample Transition Principles

These are the principles Thom and Sophie Penmaen used as a foundation for their Shareholder Agreement.

1. *The Family Asset Transfer Principle:*
   The assets will remain intact for ownership to direct family descendants.
2. *The Ownership vs. Management Principle:*
   Assets will be split "fairly and equitably". Compensation is based on results and responsibility (pay for the job).
3. *The Leader Principle:*
   The Company needs a leader with the following qualities:
   - *He/she can work in a collaborative fashion with other shareholders and management.*
   - *He/she can create the vision and assist in initiating the vision (using the collaborative point above).*
   - *He/she has a full understanding of the pieces of business, financially and operationally.*
   - *He/she has good community relationship skills.*
   - *He/she has a passion for Thom and Sophie's vision.*
   - *He/she is adaptable.*
4. *The Exit After Thom and Sophie Principle:*
   We believe subsequent generations should have an exit strategy that preserves the assets and relationships.
   - *The Penmaen Family asset base is a stewardship program.*
   - *The asset base is worth less separated than as a whole.*
   - *Exiting shareholders will be paid out over time so the company can remain viable.*
5. *The How We Invest Our Money Principle:*
   - *Whenever the whole team is committed to a project.*
   - *As a continued step-by-step process to keep the assets growing and current in the marketplace.*
6. *The Bottom Line Principle:*
   - *Cathy, Diane and Derek will be connected and focused on the business game plan.*
   - *An 'exit' is in place, which will keep the opportunities possible.*
   - *Taxes are managed to keep as much as possible for the Penmaen family.*
7. *The Independence Principle:*
   Each member will have financial independence starting with the company first.

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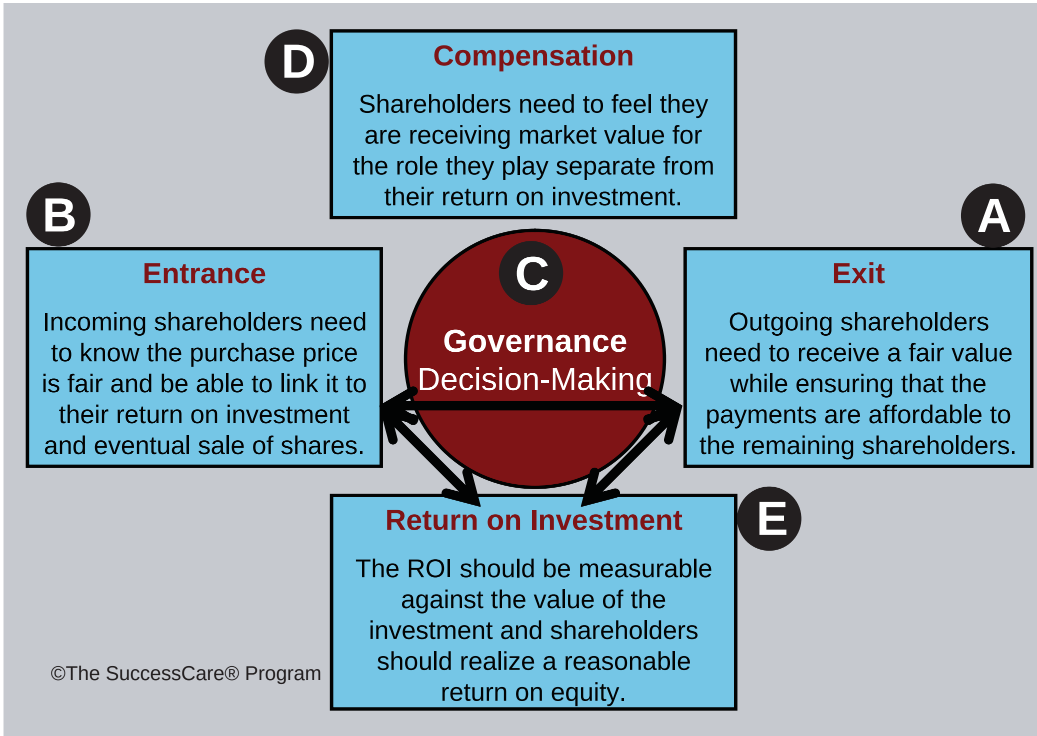
Creating an Effective Agreement

Our approach to structuring an effective Shareholder Agreement ensures a link between your ownership philosophy and transition principles, and the legal requirements of such a communication document.

When working with your trusted advisor and your lawyer to build a Shareholder Agreement that everyone feels confident signing, the following five components should be structured to reflect the objectives of the transition principles.



Component A addresses the process for shareholders to exit, either voluntarily or involuntarily as a result of death, disability or bankruptcy. It also deals with tax management and liquidity issues and how shares are redistributed.

Component B focuses on the shareholder entrance process, particularly in conjunction with an exit by another shareholder. It documents the rules for purchase including setting the purchase price.

Component C deals with the area of governance and provides guidance around a myriad of issues such as voting and decision-making, dispute resolution, indemnification, responsibilities, privileges, signing authority, confidentiality, and guarantees.

Component D ensures there are specific processes for compensating those shareholders who contribute to the day-to-day management of the business both on a regular basis or as directors or consultants to the business. It also stipulates acceptable forms of remuneration.

Component E handles the subject of shareholders' return on investment, particularly the criteria for measurement and distribution of the proceeds.

The result is an extremely powerful communication tool. But remember, the process for developing such an agreement is as vital as the document itself. It is the process that creates the buy-in!

Remember, creating that fair and equitable distribution of assets begins with a discussion between you, your spouse and your trusted advisor. At the end of the day, you should be able to attest to the following:

- *Your children have been given equal opportunities to connect to the business.*
- *You have had meaningful conversations with all family members about their future involvement in the business.*
- *There is a vision for family to be connected.*
- *The family vision as opposed to a tax plan is driving your family wealth decisions.*
- *You able to look your children in the eye and explain why your estate plan is fair and equitable.*

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