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VIEWPOINT
by Hal Warfield

Divvying Up the Family Business

When it comes to who inherits what, equal shares often aren't really fair. Instead, consider each individual's contributions

When I was recently asked about the difference between the value system that works in families and the one that works in businesses, I shared the old story about the family with three cookies on the kitchen table. With three kids at the table, naturally each one gets a cookie. Does the same necessarily apply in business?

In families, "fairness" typically means "equality" (see BW Online, 1/26/05, "[Equal vs. Fair in Family Businesses](#)"). But when complex assets, such as a family business, are involved, and senior-generation family members do their estate planning, it often helps to give the process a closer look.

THE BEST-LAID PLANS... My late neighbor, Saul, knew how much his adult children loved visiting him at his summer home on Long Island Sound. He also wanted to ensure that his kids would remain "close and connected," so he stipulated in his will that the property be left to the three children as equal partners.

Saul died suddenly, and that's when the turmoil began. One child wanted to fix up the property and spend weekends there with his wife and their children. Another wanted to leave it as it was and rent it out. The third wanted to sell it and invest the proceeds.

The children never had a prior opportunity to discuss their own desires and expectations, because they didn't know of their father's plans in advance of his death. Now, they were left with a situation ripe for significant conflict.

SIBLING DIVIDE. A new client, Harry, is a 63-year-old widower who has two children. His son, Jon, has been in business with him for 13 years and functions very effectively as chief executive officer. His daughter, Julia, is a dentist.

Harry, who admits he's a bit of a control freak, plans to retain 100% of the stock in this small business, which he founded 33 years ago. According to his most recent estate plan, upon his death, Harry intends to leave the business to Jon and to leave other assets of equal value to Julia.

When Harry shared his plan with his family, Julia questioned why she wouldn't inherit half of the business. Harry explained that the success or failure of the business would be in the hands of her brother, who worked in the business. Why should she suffer the risks or enjoy the rewards resulting totally from his efforts?

COMPANY ROLES. Meanwhile, Jon was uneasy as well. He wondered what the words "equal value" meant.

Jon told me he was very grateful that his father planned to leave him the business, and added, "Dad's the one who has built the business to its current level. Whatever it's worth now rightly belongs to him. But he has been slowing down to less than half-time, and plans to fully retire in five years.

"I'm passionately committed to this company and its growth. It's my life. Because of my role in the company, I feel that any change in value between now and then will actually be the result of our joint efforts. And once

dad is fully retired, any further change in value, up or down, will be the result of my efforts alone and not my father's."

PLAYING FAIR. After meeting with Harry and his two children, it was clear to me that, left unchanged, Dad's well-intentioned current plan could create enduring conflict and resentment. So, how to resolve the issue?

Individual conversations with the siblings and Harry revealed a genuine desire for fairness. Julia said she didn't want to share in anything her brother had rightfully "earned." Likewise, Jon didn't want his sister to be excluded from a "fair" inheritance, and Harry wanted a plan that was "fair" and wouldn't impair his children's relationship. After much discussion, we developed the following financial model.

Upon Harry's death, Jon will inherit the company, and nonbusiness assets equal to one half the "ultimate" value of the company will go to Julia. This "ultimate" value was looked at as having two parts. Part one is the current fair market value of the business, as determined by a valuation specialist. Since all agree that Harry and Jon deserve equal credit for any change in the value of the business between now and Harry's retirement, the valuation will be updated upon Harry's retirement.

A CREATIVE SOLUTION. One-half (Harry's share) of the difference (positive or negative) between that valuation and the current valuation is part two. Since Jon will have the ultimate responsibility for any changes in the company's fair market value from Harry's retirement time forward, it was agreed that no such changes would be attributed to Julia.

While the formula may appear to be complex, when numbers are put to paper, it really is quite simple: It allows Harry to give Julia assets equal to one-half of his actual contribution to the value of the business, and allows Jon to own the business and enjoy the reward/punishment for his sweat equity and contribution to its success or failure.

Parents and grandparents frequently believe that shared and equal distribution of assets is the "right" thing to do. It's perceived as "fair" and is expected to minimize conflict among the heirs. When the interests and desires of family members differ, however, a creative solution is necessary to achieve the desired result.

READER COMMENTS

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