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Once Removed: Ownership and Control of Family Business After Owner's Death

Episode 58 Summary

A prior episode looked at estates that feature a key asset, such as a family business, which owners hope to pass along to the next generation as a source of family wealth, stability, unity and identity. Unfortunately, in many cases the transfer of a business can lead to the opposite: tension, dispute, and sometimes the break-up of the company or even the family.

This episode explores the source of those tensions and provides strategies for an owner or founder to implement a business succession plan to address potential problems before they arise.

Transcript:

(0:00):

Hello and welcome back. I'm Steve Murphy, a trust and estates attorney with McGuireWoods LLP, and this is Legacy Planning, Once Removed, my podcast on legacy, family, property, taxes, and everything else on my clients' minds.

For those who are returning, welcome back, and for those who are new to the podcast, again, welcome.

On this podcast, we try to help people with estate planning, but also to help people with their overall legacy plan, how to build it, and how to work towards it.

So, we have a tagline here. We say: Walk like you leave footprints.

This is another episode on business succession planning.

In many cases, a client's legacy plan will include an important asset like a family business or closely held business, and we want to think through what happens to that business upon the death of an owner or maybe on the death of the founder.

In a prior episode, I talked about these kinds of companies. I talked about them as family businesses or closely held businesses instead of a small business.

And I talked about a particular challenge that many people perceive, that upon death, they're concerned about a large amount of estate tax being due. And I talked about a few specific strategies to help manage or reduce that tax.

In that episode, I talked about the metaphor of a plane. I said running a public company can feel like flying a large plane, but running a family business can feel like flying a small plane.

And dealing with succession after the death of an owner of a family business, that can feel like landing a small plane.

(1:51):

Estate taxes at an owner's death can certainly cause a liquidity crisis and a bumpy landing. But in many cases, as I talked about in the prior episode, that can be managed, and it wouldn't necessarily force a sale of the company altogether.

But I worry that there is another issue that could cause the company, and perhaps the family, to fall apart after an owner's death.

And that's how the ownership passes to the next generation.

And that's the subject of this episode.

Before we begin, another comment about terminology.

Many of my clients talk about the ownership of a company, but let's break that down. I think there are three elements to that ownership.

Number one, who gets the economic benefit of a company, and what does that look like?

Is it regular dividends from the company?

Is it just the value of stock on someone's balance sheet?

And who decides who gets that economic benefit?

Secondly, control.

Who controls the company? Who makes the strategic decisions that would be made by the shareholders or the board of a corporation?

(03:40):

And third, exit.

Can an owner exit the company? On what terms? And who decides?

So, as we talk about ownership, let's talk about those three elements, economic benefit, control, and exit. And as we'll see, each of those elements, if not properly managed, could cause tension, dispute, and the company, and maybe the family, to fall apart.

First, let's think about that economic benefit after an owner's death. We can already spot the tension.

If the company has a profit, what happens to that profit?

Some owners might want that profit paid out in cash as a dividend that they can then use for living expenses and their own endeavors.

Others might want that cash reinvested in the company for other purposes. You can see that tension already building of different people who might have different views of the economic benefit of the company.

Secondly, control. Again, another tension.

Think about that strategic direction for the company after an owner or the founder's death.

Some owners might think of this more like a value stock, where the company's doing great, the infrastructure is in place, let's just keep it going, and by the way, maybe pay out those dividends.

Some others might look at the company more like a growth company, where the company should expand, pivot, enter new markets.

(04:33):

Again, you could imagine tension between different family members with different views on that subject.

Again, the key question is, who controls after the owner's death?

And then third, what about this exit? There's more tension.

I think of two main issues.

Number one, should the company itself sell to a third party, to a strategic buyer? That would result in, often, a sudden influx of cash to the owners that some might really value. It might lead to more flexibility for the owners who receive this cash.

But we've also seen that the sale of a family company can cause a loss of family identity, and that should be carefully considered before thinking about whether to sell the company.

And that second issue, what if an owner wants to sell his or her shares in the company? Should we allow that? Should we allow them to force that?

So, for example, should we allow one owner to buy out another to consolidate control in the hands of a smaller group?

Or should we allow one owner to require the sale of their stock to another, to require someone else to buy out their shares and convert that to cash?

(05:47):

And importantly, who gets to decide?

Who gets to force the sale or the purchase, and on what terms?

My law students seize on this issue immediately as we talk about it.

One of the key concerns with any kind of buyout is the valuation. With these family companies, they're very difficult to value. Some might value the company highly, others lowly, and it might vary from year to year.

How do we put in place a structure that treats everyone fairly and carries out the owner's intent while avoiding any gamesmanship, including issues like the timing of the sale?

Someone might be able to take an opportunity and force a sale or a purchase for someone else when they're cash-strapped.

That might, again, put them in a better position than they would've been otherwise.

Another concept or source of tension with passing a family company to the next generation has to do with a term called insiders and outsiders, and the tension between those two groups.

Imagine the insiders. Those are the ones who might be working for the company, who might have worked for the company for a long time, have invested a lot of that sweat equity, might even hold positions and officer positions in the company.

Then also imagine the outsiders. Maybe they look more like just passive owners.

These two groups often take very different approaches on these above issues of economic benefit, what does that look like, control, and exit.

(07:20):

So how do we address these three?

Well, there's a number of ways to address this in a succession plan. As an example, upon one owner's death, the owner could provide shares to certain family members who want to stay involved and hold the company, and maybe offsetting cash or investments to others.

For many clients, that's just not possible.

Maybe the company is such a large share of their estate and can't give different groups shares of equal value.

But even if the client can set up that structure, there's the question of value.

How do we value the company upon someone's death?

You can imagine different people taking different positions of whether the company's worth a lot or a little on the owner's death.

Secondly, we could include buy-sell provisions in the documents to specify whether one owner can force a buyout or force a sale of his or her interest. But again, that question of value and the other terms of the sale will be critical.

You could also divide the classes of shares or membership interests into voting shares and non-voting shares to very clearly delineate who has control and who only has economic benefit.

Again, being mindful of some of these tensions that could arise.

And some clients just decide to leave it to the next generation and let them decide. But we can see how all these potential pathways, all these issues, build tension that can require the sale of the company, even tear the family apart.

(08:53):

That is, it causes that plane coming in for a landing to crash and burn, and that result is tragic and ironic. The owner often hopes the family company will be a source of family cohesion and harmony and purpose for generations to come.

But in these cases of this tension and dispute, the family company ends up being the opposite.

So, what's the answer? Well, unfortunately, there's no right or wrong answer here to business succession planning.

Or rather, maybe there's a wrong answer. The wrong answer we find is if there's no planning at all.

So, we encourage the owners of those companies to give some thought to this succession planning and consult with their advisors.

And in our next episode, we'll talk through some important questions to ask to start this process.

I'm Steve Murphy and this has been Legacy Planning Once removed my podcast on thoughtful legacy planning.

Thanks for listening.

And until next time: Walk like you leave footprints.