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Leadership Contingency Planning During COVID-19 and Beyond

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During the COVID-19 crisis and related economic turmoil, strong family business leadership is more important than ever, but the pandemic also increases the likelihood that owner-operators, chief executives or controlling shareholders may become incapacitated by illness for a substantial period of time. Further, the pandemic has stressed our health care system, which could incapacitate a family business leader for a greater amount of time that would normally be expected even for illnesses or injuries unrelated to COVID-19. Any family business that relies primarily on the leadership of one or two principal owner-operators should outline a leadership contingency plan (Plan) and make sure that it is supported by appropriate documentation.

Leadership contingency planning is always important for a family business. Empirical research and anecdotal evidence in the world of public companies demonstrates that when a company unexpectedly loses its CEO, company value declines until a successor is appointed. Even after the successor is appointed, it can take a couple of years for the company to recover its lost value. In a family business, the loss of a chief executive who also is a family member and a major shareholder (Principal) will be further complicated by family dynamics and the effect on shareholder voting. By adopting and properly documenting a Plan to be implemented upon the temporary or permanent loss of a Principal, a family business can substantially mitigate the economic disruption that such a crisis otherwise might cause.

The primary Plan document is a memo that describes the Plan in detail, but the memo has no legal effect. It must be supported by legal documents, including (if necessary) updates to the business's governing documents, various contracts and the Principal's estate plan.

Describe the business and the Principal's role or roles in that structure: A family business often consists of multiple companies or business entities. Parts of the Plan will affect the whole business, and other parts of the Plan may include specific provisions for different elements of the business, depending on the Principal's role in each of the entities that the business comprises.

Define the events or actions that would trigger the Plan: The Plan should include a definition of disability or other triggering events, identify who has authority to declare that a triggering event has occurred and provide one or more individuals with authority to obtain health care information needed to determine whether a triggering event has occurred due to a health event.

Grant authority to vote the Principal's stock upon disability or death: Voting authority may be addressed through a power of attorney, proxy, voting trust or living trust.

Replace the Principal on the governing board: A director cannot act by proxy or through a fiduciary. Therefore, an incapacitated director must be replaced or the board must be able to function with an empty seat. If the Principal is the sole director or if his or her absence might cause a deadlock on the board, the Plan should include a self-implementing solution.

Replace the Principal as chief executive: It may be most appropriate to name an interim chief executive/president, who will serve until the Principal can return to the post or until the newly constituted board has time to find a permanent replacement.

Mitigate the effect on business relationships:

- **Third parties:** If the business's contracts with third parties, such as lenders, vendors or franchisors, would terminate or otherwise be adversely affected by the disability or death of the Principal, the Plan should describe a means to mitigate those effects.
- **Related parties:** In addition, if the business has informal economic relationships with family members or affiliated parties, the terms of these relationships should be formalized in written agreements so they will survive a sudden change of leadership, assuming that it is desirable to preserve them.

Anticipate and address cash needs: The Plan should identify cash needs that might arise for the business upon the disability or death of the Principal, such as cash to avoid acceleration of debt or cash needed to keep key personnel who can help stabilize the business. Similarly, the plan should identify cash needs the Principal's family might have upon losing the Principal's compensation and perhaps incurring federal estate taxes. For the business and for the family, the Plan should specifically identify cash available for these needs, such as lines of credit, disability insurance or life insurance, or liquid resources in family trusts.

Developing a leadership contingency plan that addresses these key issues can help a family business prepare to survive an unexpected and premature leadership transition, and can also help the owners develop their ideas about long-term succession planning.

If you have questions about your family business's succession planning, please contact an attorney in Reinhart's Family-Owned Business Group.