How Family Businesses Can Make Effective Decisions about the Future of Their Companies

Once the founder steps away - by choice or not by choice - there are four possible futures for the business he or she leaves behind. The decisions made today - or not made - will determine which one of the four unfolds.

- The company ownership, control, and management will stay in the family into the next generation.
- The company will be sold to new owners at the right price and the right time to take care of the family's financial needs.
- The company will be liquidated with the proceeds providing for the family's future.
- The family will be forced to sell the company without regard to favorable market conditions and will realize whatever value they can for their security.

If you founded a business that has been as much as a member of the family for many years, which outcome makes the most sense for you? The traditional dream of entrepreneurs is to watch both the business they have grown and the family they have raised merge in a new generation of ownership.

Or, you may be like many younger business founders today, whose hope is to nurture their companies like an investment, realizing tremendous profit at some point in the future. You probably feel that, in a world that changes so quickly, it is hard to visualize a company through a multigenerational lens.

For other founders, the success of the business afforded the children the opportunity to forge their own careers, The nature of the business may make difficult to exist, let alone sell, without the founder's own hand on the wheel. So liquidation is the best strategy to secure lifestyle comforts for the parents and a legacy for the family.

The fourth outcome is easy to plan for. Just do nothing. But the other three make admirable fantasies. The reality is statistically different for retention. Only one-third of all family business make it to the second generation, only one in seven to the third. And the breakdowns include some pretty gory family stories chronicled for everyone to read. Meanwhile, selling at the right moment can be dramatically undercut by the death or disability of the founder, and the family finds itself with a forced sale and dramatically undercut value. And liquidation requires having the most valuable assets to sell at right time to sell them. In other words, there is a difference between having a dream and having a plan.

A plan for family business succession involves close coordination among legal, accounting, finance, and risk experts, as well as active participation of family members and the company management, to make transitions occur in the right way.

But that is only the beginning. You can't just start a business and expect it to run by itself forever. You plan over a time horizon, then you periodically review and adjust the plan and move the horizon out a notch. Succession plans cannot be initiated and then ignored either. A few years can create revolutions within families and between partners, not to mention swings in the value of the business. There is a good probability that a plan which has not been reviewed within the year will be veering off course a few degrees and a few years after that will expand the arc even further.

Retain or sell or liquidate, the goal of business succession planning is the same - to eliminate or at least reduce the possibility of financial, management, or family obstacles disrupting progress to the ultimate destination for the business. Retention is no doubt the most complicated outcome to achieve among the three choices. What are the steps that must be taken to construct the plan effectively?

First, the founder must define his or her goals. Unfortunately for long term planning, many entrepreneurs rely on instinct for decisions, which can lend a sense of confidence. But succession goal-setting requires questioning of assumptions and conclusions, and the founder's advisors are often in the best position to expose contradictions and gaps in thinking - if the founder will grant them that freedom. Defining goals should lead to quantifiable objectives to assure the succession plan assure...

- Voting control of the business remains and sufficient salary income is generated in the event of a disabling accident or illness to the founder.
- Assets can accumulate outside the business to diversify net worth and to build funds to support retirement lifestyle goals.
- Control of the family business will pass into the right hands.
- Income will be provided to the surviving spouse and dependents who are not active in the business.
- Equitable non-business inheritances will be generated for inactive children.
- Transfer costs will be minimized and cash will be provided to avoid forced liquidation of estate assets.

Next, perform a financial and non-financial analysis of the business. This analysis of the business assets and liabilities, as well as the ownership structure, makes up most of the work the advisory team will perform. In addition, for the non-business assets and liabilities, strategies can be developed to equalize income and inheritance objectives for non-active family members.

However, analysis should be equally qualitative. For example, it is essential that owners familiarize the advisory team with the business - products, markets, operations, employees, etc. With this understanding they will be better equipped to anticipate changes that could occur when the founder leaves either expectedly or unexpectedly. And it is equally important for them to establish close communicate with family members, because one of the common traps of family business succession planning is that the founder shields his or her advisors from the family, paralyzing their decision-making.

Third, determine the value of the business. Valuation will determine the price at which the business will change hands between a willing buyer and a willing seller, assuming neither is under any compulsion to sell or buy and both have reasonable knowledge of the relevant facts. In the case of succession planning, valuation provides the benchmark for estate tax liabilities and for determining the distribution of non-business assets for the fair and equal treatment of non-active children. The founder's strong identification with the company distorts his own perception of value, and estate tax purposes requires an unbiased view. The role of a valuation specialist can be critical to the advisory team's succession planning recommendations.

Don't neglect to define the involvement of the spouse in the business. Entrepreneurial businesses usually originate through joint participation of spouses. Sometimes this was a cost-saving necessity, but it also happens that each partner had specialized knowledge that contributed to the initial success. That partnership may still be in place, or in time circumstances may have led to one spouse withdrawing from day-to-day business concerns. Withdrawal is seldom complete or final, and the spouse probably continues to act as a sounding board for strategic and management decisions. Even when there was no control or direct involvement in the business it is virtually certain there was a very real control and involvement with the family members around whom the plan will be constructed. In every case, the spouse's involvement in the succession plan is essential.

Also define the involvement of the children in the business. Most owners make the distinction among their children as either active or inactive in the business. While this makes the plan clearer, it can become cloudy when this leads the founder to extreme efforts to treat all children equally in the plan. A more productive mindset may be to make sure all children are treated equally - meaning all children will have the same ownership percentage in the business and all other assets and inactive children have the same voting power and management voice as active members. This makes for irresolvable problems later.

- One faction wants to grow the business and reinvest profits. The other faction thinks of it as a mature business, avoiding unnecessary capital outlays.
- One faction sees salaries high, while dividends seem extraordinarily low. The other sees the very opposite.
- The need for consensus for reasons of family harmony causes delays in decision-making for business purposes. Opportunities are lost forever.

Fair treatment starts with the premise that children will not receive the exact same inheritance. The non-active children receive assets, usually in an acceptable ratio to the business asset, such as cash, non-business real estate, life insurance death benefits and real estate and equipment which is leased to the business. The ratio recognizes that the business asset usually represents a higher level of risk than the non-business assets and that the non-active children will have more investment flexibility with their inheritance.

Prepare for the risk of disability.For people under the age of 60 the risk of disability is much higher than the risk of death. And at such a time, the fact of disability can turn out to be a more catastrophic financial fact for the family than the fact of death. The succession plan must deal effectively with this contingency. Disability insurance will insure the income of the founder, as will a properly structured salary continuation plan. But the plan must also assure competent successor management in the event of permanent disability if the goal of retaining the business is to be achieved.

Finally, prepare for the inevitability of retirement. If the founder has no concept of retirement and wants to go from office to funeral home on the last day, he or she must realize that this independent streak can lead to a dependence on the business for income. It makes more sense for the founder to build assets outside the business in order to achieve independent wealth retirement, which will also make succession planning and estate distribution considerably more effective.

Of course, the business succession plan will involve other layers of complexity. For example, life insurance can play a fundamental role a funding vehicle for various aspects of the plan. Also, there are sophisticated estate planning options for the business succession goals, including creation of family limited partnerships and charitable remainder trusts. But unless the decision team first addresses these seven issues fundamental to family business succession, and without a commitment to annual plan review, smooth succession is not likely.