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THE ART OF BUSINESS

Entrepreneurs blend passion and profit

By Carol Latter

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An Eye on the Future

An owner's willingness to develop and implement an effective succession strategy will often determine whether a family-owned business lives or dies.

When an entrepreneur opens the doors of a family business for the first time, the question of who will inherit and run the company when the founder is no longer willing or able to do so is rarely given more than a passing thought. But inevitably, the day arrives when control must be handed over to the next generation, or the business must be sold.

In light of the dismal survival rate of family-owned businesses from one generation to the next, an owner's willingness to develop and implement an appropriate succession strategy is often a key factor in whether the company lives or dies.

That's a lesson that members of family businesses often learn too late, according to Bryon W. Harmon, a partner with Shipman & Goodwin, Connecticut's largest law firm. But Harmon, the firm's trust and estate expert, says with some advance planning and effective follow-through, an owner can help ensure that the family business he or she has worked so hard to build will continue to thrive with a new family member at the helm.

"Only one in three family businesses makes it through to the next generation, and only one in 20 makes it to the third generation," he says. What do the survivors have that the casualties do not? Harmon says it all boils down to one thing: "Communication between and among family members who are in the business, and very importantly, family members who may not be in the business in an operational sense, but stand to inherit a portion of the company."

Harmon says every company, large and small, must deal with succession issues at some point—and often repeatedly, as ownership or operational control passes from one person to another. But family businesses present a set of unique dynamics that can make the succession planning process far more complicated.

In a non-family company, he points out, the investment is usually more financial than emotional, so when it comes time to part ways with the business, the owner will "simply sell it and move on."

Moreover, ownership is generally separate from management and control, which allows for a far greater degree of objectivity as to what course of action is in the company's best interests.

Many of these companies, especially larger ones, have boards of directors, with "independent board members who are objective and have a fiduciary duty to employees and shareholders to make those tough decisions, and to steer the CEO or the first generation into making those decisions."

With a family business, when it comes time to think about handing over the reins, "there's a strong desire—an emotional desire, and sometimes a financial desire—to leave it to the next generation and have it continue for the benefit of your kids." That means sorting out which family member or members should take over, and when—an emotional task that is fraught with hidden dangers.

Complicating things further is the fact that in most family businesses, the issues of ownership, management and control are combined. "In other words, the creator or the second or third generation owns most, if not all, of the business, and they're managing and operating the business," Harmon says. If there is a board of directors, it's "either stacked with family members, or the matriarch or patriarch control them anyway, so at a time when you need that objectivity, it's just not there." This makes coming up with an effective succession plan challenging for both owners and their advisors.

Danger: Pitfalls Ahead

When it comes to determining who will take over a family business, there are a number of potential pitfalls.

First of all, "parents have a strong desire in most cases—whether it's a family business or stocks or bonds or the house—to treat children equally. And when they attempt to do that in family businesses, it causes a lot of problems," he says.

An example is a company in which the daughter has been running the business, and her brother has moved away and taken up another line of work. He may still expect to help run the business—or even take over—once his parents die, "and he certainly thinks he's going to get half the value of the business upon his parents' death or retirement." In this example, "first, the son probably doesn't have the skill or aptitude, and he certainly doesn't have the experience, to come in and run the business. And second, the daughter is probably going to be quite ticked off, and leave the business at the time when you need her leadership the most. Sometimes those things happen, and that spells the end of it right there. The business is sold or liquidated." He says a better solution might be to treat the two children unequally, or to make up the difference with other assets.

Sometimes, the issue is whether there is any suitable family candidate to take over the company. He says owners must be honest with themselves about whether their children or other relatives have the ability, aptitude and interest to run the business. "If the answer is no, then the [solution] is pretty easy. You look for longtime employees, other managers or third parties, or you just sell the business. If the answer is yes, then you have to ask the tougher questions: who do I choose, can I choose more than one, can they both run the business, what are their experience levels, what are their aptitudes, how do they get along, how do their spouses get along? Even if the kids get along, it's sometimes the spouses that create the problem. That really happens in spades in family businesses."

In some cases, a parent will choose a child who wasn't previously involved in the business, which can present its own set of problems in terms of retaining employees who are critical to the company's survival.

If that's the case, Harmon advises, "Let the child work in a stockroom or let them drive a truck. Let them earn their way or work their way up, rather than putting them in the CEO's seat and then handing the keys to the child. But you have to make sure that you retain these key employees somehow. And you can do that in several ways: you can give them financial compensation and sometimes you can give them an interest in the business." While family members generally retain controlling interest in the company, he adds, key people can be offered a minority interest or a limited partnership interest in the continuing business.

Finding Solutions

Whoever is chosen to lead the company into its next phase, advance planning is key, Harmon says, noting that a five- to 10-year lead time is ideal. This allows for a smooth rather than abrupt transition, and will reduce the likelihood that critical decisions will be have to be made in a crisis situation—after the owner dies unexpectedly, for example. It also allows the company to make prudent decisions that will minimize the transaction costs and taxes associated with the eventual transfer.

Yet even once the successors are decided and the plan is in place, implementation can be another hurdle—again, thanks to emotional issues.

"We often see clients, a matriarch or patriarch, who've started a business and built it, oftentimes from nothing, into a successful venture. Be it big or small, it's very important to them, financially and emotionally. When they become 60 or 70 years old, or they're in frail health at a younger age, they understand that it's important that they step back and begin a transition process to a younger generation, but they find it very difficult. They accept it intellectually, but no matter how much confidence and respect they have in 'Junior,' they still think they can do it better," Harmon says.

"We've had situations where we've planned a family succession to the next generation and we've begun to implement it over a period of two, five or 10 years. And then right at the last minute, when the last partnership shares or controlling shares to go from 51 to 49 percent [ownership] are to be transferred, the father or mother says, 'Not so fast.' For business owners, no matter how intelligent or rational or objective they are, it's difficult to be objective in all cases when it comes to both your role in the business and also choosing ... who is the most interested in the business, and who has the best capacity and skill to continue the business after you've retired or died."

He adds that while lawyers, tax advisors, investment bankers and accountants can advise owners on the most efficacious way from a tax or legal perspective to leave a family business, the "softer" emotional and psychological issues can be more problematic. "And the answer is, communicate. Communicate with the kids, whoever might be involved, and whoever might be left out, about what the plan is. That's what we advise, and we find that when clients listen to that advice, things go more smoothly, and there are fewer challenges after the fact" in probate court.

Lack of communication and mediation by the owner during his or her lifetime can create family dissension after death, he warns, because the company founder and head of the family is no longer around to explain the rationale behind the decisions that have been made.

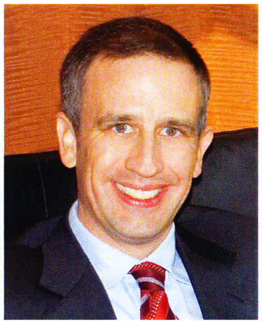
Surprisingly, given the many benefits of creating a succession plan, most family business owners don't have one. Only about 30 to 40 percent do, according to Harmon, and of those, "only half or fewer have a written plan. And I'm a lawyer. If you don't have a written plan, you don't have a plan."

He says most owners put off the issue of succession planning to another day, for two reasons. One, they're "too busy" attending to their day-to-day business affairs, the same reason half of all people don't have a will. "They're attentive to their businesses, and they think they don't have time to get a lawyer and others involved. It's a distraction and an expense. They also don't want to think about their own mortality." But he believes the primary reason is that most owners don't want to deal with the issues of deciding who will succeed them. "They know they're going to have to listen to someone tell them why it's in their interests or their kids' interests to give up control. They frankly don't want to hear that, and they don't want to make the tough emotional decisions as to choosing between and among kids."

Still, he notes, the benefits far outweigh the discomfort. "The benefits to a transition and succession plan are, one, the business has a much greater chance of surviving to benefit your children and employees, and carry on your legacy," he says. "It greatly increases the chance of overcoming those very overwhelmingly negative statistics that most family businesses don't survive to the next generation."

Secondly, a plan can reduce the chances of family discord. "You don't want your children to be fighting, you don't want them in probate court, and you don't want to lose the business and the relationships between and among the family members. And that's what's at stake. You're not just talking about an asset; you're talking about family relationships as well. And it would be devastating to parents to think that not only is the business that they worked so hard to create not going to survive, but their children might be fighting over this, and it might ruin relationships."

With that much at stake, why don't all family business owners make a plan? "It goes back to the fact that they don't necessarily want to make these decisions," Harmon says. "But when they do and when they can, the success rate is much greater."



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