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How to Transition Your Family Business and Maintain Business as Usual

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PLEASE SILENCE ALL CELL PHONES AND PAGERS AT THIS TIME. THANK YOU.

Passing the torch – the family transition conundrum

Many senior family members dream that their children will join them in business, eventually taking over the family business. With proper planning, this dream can become a reality. With poor or no planning; the chance for success is greatly diminished.

Successful family business transfers happen with forethought and planning for issues such as:

- The business is a good business, and it's in a strong industry with excellent growth prospects.
- The business is not being stressed. Cash is not being stripped to run the company to support the lifestyle of too many family members.
- The next generation has the ability and training to grow the business in a responsible manner.
- The business is treated like a business first and a family enterprise second.
- The younger generation learns to appreciate the work the older generation did.
- The older generation is able to let go and allow the younger generation run the business.

Each of these issues offers both opportunities and challenges at the same time. Thoughtful consideration these issues will often mean the difference between success and failure in transitioning ownership in the family business.

But first, what is a family business?

A family business is any economic enterprise where there is more than one generation working in and managing a business. Some family businesses have two employees and some of the largest businesses in the country are classified as being family businesses.

First generation family businesses are known as founding owner enterprises. Starting as a privately held business, the firm becomes a family business as soon as someone in the founder's family—a spouse or a child—becomes an employee.

Second generation family businesses are called sibling enterprises. At this stage, control and ownership of the business is moved to the second generation. Often these businesses will have siblings who both work and own stock in the business that one or both of their parents started. Less than 30% of businesses in the United States make it to a second generation of management and much less than 15% are successfully passed to children.

The third generation family business is called a cousin consortium. For a business to make to the third generation it must not only be economically successful, but also have strong corporate governance systems. Operating a business with siblings is difficult. Operating a business with cousins becomes much, much more difficult. Less than 10% of the businesses in operation for ten years ever make it to the third generation.

If we pay attention to third generation businesses and understand what makes them successful, we can do a much better job of understanding what direction earlier generation businesses should head to maximize chances of long-term success. The discipline that is required in the third generation is a good habit to form in first and second generation businesses.

The first questions

Every private business owner has to think about whether they want to turn the business into a family business enterprise, most of the time this question is answered by default and not with forethought. I suggest that you spend some time thinking about your business and deciding whether you would like to make your business into a family business. If the answer is yes, there are activities and actions that will help you make the transition more successfully.

The first question you should answer is one about the quality of the industry you're in. My favorite way of finding whether your industry is one for transfer is by asking yourself the following question: If I were to start my business from scratch today, would I choose this industry as one to start my business?

If the answer is yes, then you have a good business for family involvement. If the answer is no, and you want to be involved with your children in business, you might want to look to another industry to start a business. Remember, having a child join you in business is a twenty to thirty year commitment for your family.

The next question you should answer is whether your child or children have the ability to successfully work in your business now, as well as capacity to run the business in the future. You don't want to be in the position of having to tell your child that you won't let them take over the company after they've been working in the company for five to ten years. Having systems in place for evaluating the prowess of your children as managers and owners is a way to make sure you don't have the messy conversation described above.

There are two rules I like to see as a pre-condition for children joining the family business. The first rule is that the child must work successfully for a minimum of three years outside the business before joining the family firm. The second is the child cannot take a position at a level higher than the last job they had before joining the family firm.

Family businesses that have been around for over fifty years often develop a family constitution which includes the rules for children to work in the family business. If you intend to have your family own, manage and control your business for many generations, you will want to consider establishing a detailed set of rules that children must follow before they can work full time in the family business.

The economic realities of family business

Most of the time the family business will have to support the lifestyle of the parents, the lifestyle of the children working in the business and provide enough excess capital to keep the business growing and moving forward. Before deciding whether you will pass ownership of your business to your children,

you must understand the lifestyle needs of the family as well as the capital requirements of the company.

If the income and capital needs are in excess of 60% of the available cash the company creates, you might have a problem supporting the family and business needs if there is a business downturn. Spending time with a financial planner who understands family business can help you understand the cash needs your business has. If the analysis shows that your business doesn't have enough cash flow to support your plans, you have the opportunity either to change your personal plans or to institute business changes that can improve cash flow.

I often like to see owners of private business purchase the real estate from which they operate their business. Many times the rent from a paid off building will pay for the parents' lifestyle, leaving the cash flow from the business to support children and business growth.

Intergenerational support

A complaint I hear from parents about their children is "my children don't appreciate the work I've done in building the business." On the other hand, a complaint I hear from children about their parents is "my parents are control freaks; they won't let me do anything to make the business better."

In many cases both statements are true. Children rarely appreciate the hard work and effort it took to get the business started. Likewise, parents rarely let their children make mistakes that are necessary for them to learn and become excellent managers.

First, to the children:

If you ever want your parents to let you have control, you must walk a mile in their shoes. Take some time and learn to appreciate the time, effort and sacrifice your parents made to get the business off the ground and the skill it took to make the business successful. Remember, only five businesses out of one hundred make it past their five year anniversary. The fact that your parents are in a position to turn their business over to you makes them one of the very few. Appreciate them for what they have done. When you do so, your parents will feel better about the prospects of you taking over the business.

Second, to the parents:

When you delegate a job to your children, you must let them do the job. The only way you're going to know whether you can risk entering retirement is to know whether your children have the ability and ambition to run the business. They must have the opportunity to prove to you that they have the "right stuff" to run your business.

Along the way, your children will make some mistakes. When these happen, you want to ask them what they learned. If the answer is reasonable then let them continue. If not, then you must do some teaching. If the teaching is not successful, you will want to think about other transfer options for your business.

When first delegating responsibility to your children, make sure you start with responsibilities that won't put the business at risk. As your child successfully completes the assigned tasks, give them new responsibilities that have a larger impact on the success of the business. This is a safe way for you to find out whether your children are capable to continue the family business.

A successful transfer of the family business can be one of the most satisfying events in the history of a family. Following best practices for family transitions will help you improve the odds of a successful transfer.