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What to Do With the Family Business

Are the kids really ready to take over? Sometimes, an outright sale to a third party does more for the client's best *interests.*

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by Lewis Schiff

For a successful transfer of a family business to a child, several special ingredients are required to create the right recipe. The child needs to be well-suited to run this particular company at this time in his or her life. The transfer should support the financial and personal goals of the owner. At its core, a handover must represent more than just a ready-made career for the child. At the time of the transition, the owner should have met all other financial and family obligations — and set himself up so that his life will be satisfying and give him peace of mind.

Advanced planning teams look at several critical details before they develop a transfer plan between an owner and children or other family members:

- Identifying the client's exit goals regarding:
  - Financial security
  - Equitable distribution of assets to the children
  - The timeframe for leaving day-to-day management of the company.
- The value of the family business.
- The motivators that will keep key employees — some of whom may be disappointed by the succession plan — to continue building the company and support the transition.
- Analysis of which is better for the client: transfer to one family member or to more than one and their respective roles.
- Contingency plans to protect the business in case of death, disability or early retirement, if the transfer of management and/or ownership takes place over several years.

Once the advanced planning team has these details, they can develop the transfer strategies using the right combination of gifting and purchases, buy-sell agreements and so on. Equalization of the estate among all of the children, charitable planning, retirement-income planning and estate-tax reduction should also be a focus of the team.

A positive transfer experience occurs when a son or daughter who has worked in the business and has demonstrated the ability to adapt to change and grow the company has highly evolved organizational and intercommunication skills. In short, the prospective new owner needs to have an excellent senior-management profile. He or she must be able to lead siblings (if they are also working in the business) or at least effectively split the duties with them. At the same time, the new owner must maintain a solid working relationship with nonfamily members who may have many years working in the company and are more financially dependent on it.

Selling Outright As an Alternative

Instead of the owner giving up his desk to the next generation of management, the outright sale of the company may prove more advantageous to the owner. Such a liquidity event bypasses issues like continuing dependency on the business for income, an under-prepared child running the business and difficult management dynamics between family members and nonmembers, among other issues.

If the client sold the business, would the children be in a better financial and personal position without the additional role of small business owner? The answer may be yes, but the client may not realize that a sale could place him and the children in a better place.

Children have taken over family businesses out of a sense of obligation — and ended up feeling tethered to it. Several decades ago, a father and mother started a very successful sound-equipment company in Boston that serviced popular nightclubs and entertainers. Well-known singers and comedians became very fond of the kindly couple, who treated them more like family than customers. The son worked briefly in the business then went on to larger ventures on the west coast. When the daughter took over after both parents died, she barely knew which end of a microphone to plug in the cable. She called her brother in Los Angeles and told him she didn't know what she was doing sitting at her mother's desk in the office. She asked him to come back and run the business. He declined. It's for Mom and Dad, you need to run it, he told her. Out of a sense of obligation to her parents, she managed the business with the help of employees for about another 15 years — at times even lending it money to overcome cash flow problems —before deciding it was time she could retire.

"We've seen manufacturing companies, for example, which were turned over to kids who were really much better suited to be college professors," says Ian M. Weinberg, CFP and CEO of Woodbury, NY-based Family Wealth & Pension Management LLC. Out of obligation, guilt, greed, fear — out of all those emotions — they stay in that business. It breaks the entrepreneurial spirit of a family-owned business, when the next generation steps in and they're not well suited for it."

Holding on for Too Long?

Every advisor has met owners of family businesses who say they'll never retire. Pride, lack of interests outside of business and a driving entrepreneurial personality make an alternative pursuit unappealing. The other factor that keeps some owners from forming an exit plan is desire to hold onto the family business for two unrealistic reasons — 1) expecting a child who isn't in the business to develop a new interest in it; and 2) expecting the business to maintain its value or even grow, regardless of what is happening in its industry.

Weinberg notes that he's spoken to business owners who were offered tens of millions for their firms within the last two years. The owners didn't respond. They thought that if somebody offered them that kind of money, they were on solid ground for similar offers in the future.

An online training company started in the late '90s on the west coast by a father and his sons found some success in its marketplace of professional education. A few years later, a major Internet player offered over $100 million for a buy-out, which represented many times the parent's investment. Expecting the company to garner even better offers as the value of the company continued to grow during those explosive years, the father and his sons waited. Very soon, the dot.com bust came and that original offer — and any others of that magnitude — was just memories.

"We've been involved with a number of clients, advising them on succession plans for businesses in which the industry itself was fading away, such as the textile manufacturing business," observes Weinberg. "I've seen many fathers hold on to businesses way too long, bypassing exquisite offers to sell the business for a fear of not knowing what their son or daughter's career path would be or the children's source of income. If someone offered a father $50 million for a manufacturing business, he would very well be able to set himself for the rest of his life and also contribute to the beginnings of something else for his kids. Something to put them on a different path and perhaps even support them while fostering some independence."

The Emotional Fallout of Selling a Family Business

"It can be an emotionally-charged issue," notes Peter Carnathan, CFP, senior vice president at Washington, DC-based Fiduciary Investment Management International. "It's often that family business that has been the agent for the family wealth that's under discussion. It can be very difficult at times for the patriarch or matriarch of the family who has either started the business or is a generation or two from the original founder, when they realize there just is not a viable alternative within the family to keep the business running."

"I've seen reactions of great disappointment and I've seen more ambivalent reactions of ‘Well, it is what it is. My kids decided to be social workers or doctors or artists.' At that point, the time has come that they need to have an alternative on the table that is not involving a family member running the business going forward."

Conclusion

Advanced planning teams addressing a client's small-business transfer to a child or sell outright to a third party often find that the raw truth of the data and analysis won't necessarily persuade the owner initially. Especially when much of a client's self identity is tied to the business — and from an extra sense of obligation to parent and grandparents who started the family business — he or she needs to work through the emotions before implementing any plans. Otherwise, the owner will find reasons to stall. When the family name sits above the business's doorway, more than a stock sale is involved.

Is the Designated Successor Fit to Lead the Family Business?

Qualifying Criteria

- Is there a good fit between education/experience and the leadership role?
- Has he/she shown career success outside of the family business?
- Can the results of his/her projects and roles be objectively measured?
- Is he/she aware of deficiencies in training/experience and ways to rectify them?
- Does he/she act in a mature professional manner to defuse concerns about nepotism?

Standards for Operating

- Can he/she achieve self-identified goals?
- Does he/she take personal responsibility for gaps between what's promised and what's delivered?
- What is the quality of his/her hires, especially managers?
- Does he/she treat family and employees impartially?
- Is there a board of directors or outside consultants of high caliber to offer objective advice?

Circumstantial Measures

- Is he/she willing to take on difficult challenges that demonstrate abilities?
- Does he/she work from a strategy that accounts for available resources and the given timeline to produce results?
- Can he/she motivate and collaborate with others?
- Can he/she take the blame for mistakes and share the glory for successes?
- Will he/she give the effort necessary to succeed?

Family Dynamics, Business Politics

- Would someone else in the family or businesses threaten by his/her leadership position and management decisions?
- What do rivals say about him/her?
- How would he/she make sure that stakeholders don't receive distorted information?
- Would stakeholders respect his/her management decisions?
- Would he/she place the company's interests paramount, even if some family members would be disappointed?

(**Adapted from* The Tests of a Prince, *Ivan Lansberg,* Harvard Business Review, *Sept. 2007.)*

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