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Don’t Leave the Fate of Your Family Business to Chance!

Strategies to help you pass the torch on your terms

Key points

- When it comes to managing a successful family business, the head of the family is often reluctant to share control and involve other family members in the process
- Every business needs two plans: a short-term plan—in case you become incapacitated or die suddenly—and a long-term plan that addresses your retirement
- Those parents that are most successful at passing the torch are the ones who have created a culture in which transition is welcomed and encouraged

When it comes to managing a successful family business, the head of the family is often reluctant to share control and involve other family members in the process. Perhaps it's a matter of pride, control, or a combination of factors, but this mindset is common among modern-day family business owners.

But do you know what would happen to your business if you became incapacitated or died, unexpectedly? Who would step in to manage day-to-day operations? Even if you have a successor in mind, is that successor even capable of running the business? Many business owners have no idea.

Consider the hypothetical case of Jack and Karen Parker, who own a family business. Jack, 55, runs the business while Karen, 53, is busy with the social work career she resumed after raising the couple's three children. Jack dies suddenly leaving Karen—who has never been involved in the business—as its sole owner. A daughter who works in the business wants to take over but has no ownership or control or the experience to run the business. The children who don't work in the business want their mother to sell, but its value has declined rapidly since Jack has died without a named successor. The value of the business will erode more if it loses key customers.

This less than ideal scenario is quite common. Many business owners put so much energy into operating their businesses—while also attending to their family lives—that they have little time or energy left to think about much else. They are busy doing what they do best: running a successful business.

That may be part of the reason only 30 percent of family businesses survive into a second generation of family leadership and just 12 percent are still operating into the third generation, according to The Family Business Institute.[1]

Ideally, succession planning should begin the day you take over a business. Of course, that isn't always realistic given the amount of work it takes to operate a family business, but succession planning should be a top priority for every business owner.

A business should essentially have two plans: a short-term plan—in case you become incapacitated or die suddenly—and a long-term plan that addresses your retirement.

Sudden transition

When designing your short-term or emergency plan, you should first implement a management succession plan, the most important component of which is naming a successor who has the knowledge and authority to lead your business in a time of crisis. This will help reassure customers, family members, and other interested parties that business will go on as usual.

[1] familybusinessinstitute.com

TOP LEFT: Bruce's Drug Store, 1908.
Shirley Dorrier Collection. Scottsville Museum, Scottsville, Virginia.

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It’s important to carefully weigh the different strengths and weaknesses of each of your children as you consider the future of your business.

After that, you will need to decide how to transfer ownership. You might wish to give or sell the business to children who work in the business. In some cases, it might make sense to sell to a group of employees or even a competitor. This helps to ensure that your family will not be forced to keep the business or to sell it cheaply.

Planning for retirement

Once your emergency plan is in place, you can begin to think about your long-term vision for your retirement and how your business fits into it. Most importantly, you will need to decide if you want to keep the business in the family or sell it.

To make that decision, you have to think about how you envision your retirement. For example, you might think a retirement playing golf sounds great, but you need to consider if you can be happy without engaging in any work at all. To get started, you might ask yourself:

- *Do I want to be actively involved in the business in some capacity until I die?*
- *Do I want to be “chairman of the board” and collect the income?*
- *Will the business generate sufficient cash flow to support my family and me?*

Keeping the business in the family

If you are like many business owners, you may want to keep your business in the family. If this is the case, you will need to identify a successor from within your family or the ranks of your employees who is capable of running the business for your family. To do this, you will need to decide what qualities you are looking for in your next leader.

For example, how much experience in, and knowledge of, the business do you think is necessary and what decision-making and leadership styles do you prefer? Since you won’t necessarily find everything you are looking for in one person, you will also need to think about which qualities are most important to you. You might need a management team for the business to succeed.

You will also need to assess the interest of your children in becoming successors to the family business. Do they have the drive and desire to lead your business in the future? Or do they have other career interests that they wish to pursue? It’s important to carefully weigh the different strengths and weaknesses of each of your children as you consider the future of your business.

Identifying a successor

The size of your business will likely affect how you go about identifying a possible successor. In a smaller family business, you can see if younger family members are interested in the business and give them small jobs when they are younger. Perhaps they can help with basic bookkeeping and eventually move up the ranks. In some cases, a natural successor emerges.

If your business is larger and more complex, you will need to provide opportunities for family members who want to be in the business to become exposed to its many different parts. You may also want to send your children out into the world to have other experiences, which may help them decide if they want to be part of the family business. A management consultant can help you determine which members of the next generation are best qualified to lead. Ideally, you want someone who has both the skills and passion to take your family business where you want it to go.

Grooming your successor

After you identify a successor, you will need to groom this person so he or she is ready to take the helm when you step down. How do you do this? First, provide training within the company or send children off to get relevant experience elsewhere, which they can then bring back to the family business. This will give them a larger perspective and an idea of how things are done elsewhere, which can be valuable.

Though this may seem counterintuitive, it is also important to give your successor the opportunity to fail on a small scale and learn from his or her mistakes. Only then will this person be ready to tackle the unique challenges of running your business.

Selling the business

In some cases, it may make sense to sell your family business. This might be the case if your children have other interests or you need proceeds from the sale to generate sufficient income for retirement.

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If you choose to sell, you will need to think about how to maximize the value of your business. This might mean making capital improvements or maximizing earnings, rather than minimizing them for tax purposes. It could also mean diversifying your client base, strengthening your management team, or upgrading information technology systems, for example.

Then you will have to decide how to structure the sale. As an example, do you want to sell the entire business or sell only a portion of the company and draw income from your remaining interest? If you don't mind retaining an interest in the business, you can also sell in a way that allows you to retain a degree of control. Some common strategies used to structure a sale or monetize an interest include:

- *Debt/dividend recapitalization*
- *Equity recapitalization to create nonvoting interests*
- *Sale of majority interest to a private equity firm*
- *Sale of 100% interest to a strategic buyer*

Succession planning strategies

There are a few succession planning strategies that remain consistently popular with family business owners to identify and retain a willing buyer and to fund the business during the transition. They include:

Buy sell agreements

These agreements provide the legal documentation and financing to effectuate the sale of the business. The agreement is a legally binding contract that obligates one party to buy and another to sell some or all of a business when a triggering event—such as death, disability, or retirement—occurs. In the case of an insured buy sell agreement, the buyout is often funded with life insurance proceeds on the business owner's life.

Minority sale of ownership interests

The business owner may begin to give or sell minority interests to family members in the business or to key employees to provide them with an incentive to stay in the business after the business owner retires or dies.

"Key man" life insurance strategies

The business may purchase life insurance on the life of the business owner to provide adequate funds to find a replacement manager or to retain key employees to run the business after the death of the business owner.

Transition planning always begins with the parents

Years before any transition, it can be beneficial to tell your children who you want to run the family business and why. While this may be a difficult discussion if only one child has been chosen over other family members, it can help reduce the tension between the children after you are gone. Those parents who are most successful at passing the torch are the ones who have created a culture in which transition is welcomed and encouraged.

Additionally, these parents foster a culture of trust, communication, and transparency within their families. This includes being clear with the family about important issues such as the size of each family member's equity stake as well as who has voting rights, veto rights, and the power to fire.