Selling/Exiting Your Business

Your Business Succession: How To Plan For It

You have spent a great deal of your lifetime building a business. Now you are ready to transfer the business to a younger generation. This Financial Guide discusses some of the unique issues in planning for and implementing the transfer of the family-owned business.

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In a small business the owner(s) typically develops a unique bond to the business, unlike the typical corporation/employee relationship. The owner is often interested in ensuring that the business remains intact after his or her retirement or death. Perhaps the business owner would like to pass the business on to family members or sell the business to valued employees.

At any given time, close to half of U.S. small businesses are facing the transfer-of-ownership issue. Founders are trying to decide what to do with their businesses; however, the options are few. The following is a list of options to consider:

- Retain family ownership and management control.
- Retain ownership but hire outside management.
- Sell to an outsider or employee.
- Close the doors.

To be one of the few family businesses that survive a transfer of ownership requires a good understanding of your business and your family. There are four basic reasons why family firms fail to transfer the business successfully from generation to generation:

- Lack of viability of the business.
- Lack of planning.
- Little desire on the owner's part to transfer the firm.
- Reluctance of offspring to join the firm.

These factors, alone or in combination, make transferring a family business difficult, if not impossible. The primary cause for failure, however, is the lack of planning. With the right plan in place, the business, in most cases, will remain healthy.

The family/business strategic plan is needed to maintain a healthy, viable business. This plan establishes policies for the family's role in the business. For example, it may include an entry and exit policy that outlines the criteria for working in the business. It should include the creed or mission statement that spells out your family's values and basic policies for the business. The family strategic plan will address other issues that are important to your family. By implementing this plan, you may avoid later conflicts about compensation, sibling rivalry, ownership and management control.

A succession plan will ease the founding or current generation's concerns about transferring the firm. It outlines how succession will occur and how to know when the successor is ready. Many founders do not want to let go of the company because they are afraid the successors are not prepared, or they are afraid to be without a job. Often, heirs sense this reluctance and plan an alternative career. If, however, the heirs see a plan in place that outlines the succession process, they may be more apt to continue in the family business.

An estate plan is critical for the family and the business. Without it, you will pay higher estate taxes than necessary. Taking the time to develop an estate plan ensures that your estate goes primarily to your heirs rather than to taxes.

Although it is not easy, the commitment made by all family members during the planning process is the key ingredient for business continuity and success. The first rule for successfully operating and transferring the family firm is: Share information with all family members, active and non-active. By doing this, you will eliminate problems that arise when decisions are made and implemented without the knowledge and counsel of all family members.

This Financial Guide will help you plan for a successful transfer of ownership and avoid many of the problems family businesses face when a transfer of ownership occurs. The Guide discusses each of the planning areas listed above, gives an overview of methods for implementing the transfer and provides a planning checklist.

What Makes The Family Business Unique?

This section will explore the nature of the family business as a dual operating system and will identify issues of greatest concern to family business owners, as identified by family business owners across the United States. As you review these issues, you will see that, although you and your family are unique, the challenges you face are not, because almost every family business shares the same problems.

Also, perspectives of the individuals involved in a family business will be presented. We tend to confuse personality with perspective-understanding the viewpoints of the different actors involved in the family business (active and non-active) can help alleviate conflicts that may arise.

What Is a Family Business?

Defined simply, a family business is any business in which a majority of the ownership or control lies within a family and in which two or more family members are directly involved.

It is also a complex, dual system consisting of the family and the business. Family members involved in the business are part of a task system (the business) and part of a family system. This is where conflict may occur because each system has its own rules, roles, and requirements. For example, the family system is an emotional one, stressing relationships and rewarding loyalty with love and with care. Entry into this system is by birth, and membership is permanent.

The role you have in the family-husband/father, wife/mother, child/brother/sister-carries with it certain responsibilities and expectations. In addition, families have their own style of communicating and resolving conflicts, which they have spent years perfecting. These styles may be good for family situations but may not be the best ways to resolve business conflicts.

Conversely, the business system is unemotional and contractually based. Entry is based on experience, expertise, and potential. Membership is contingent upon performance, and performance is rewarded materially. Like the family system, roles in the business, such as president, manager, employee and stockholder/owner, carry specific responsibilities and expectations. And like the home environment, businesses have their own communication, conflict resolution, and decision-making styles.

Conflicts arise when roles assumed in one system intrude on roles in the other, when communication patterns used in one system are used in the other or when there are conflicts of interest between the two systems. For example, a conflict may arise between parent and child, between siblings or between a husband and wife when roles assumed in the business system carry over to the family system.

The boss and employee roles a husband and wife might assume at work most likely will not be appropriate as at-home roles. Alternatively, a role assumed in the family may not work well in the business. For instance, offspring who are the peacemakers at home may find themselves mediating management conflicts between family members whether or not they have the desire or qualifications to do so.

A special case of role carryover may occur when an individual is continually cast in a particular role. This happens primarily to children. Everyone grows up with a label: the good one, the black sheep, the smart one. While a person may outgrow a label, the family often perceives that person as still carrying the attribute. This perception may affect the way that person operates in the business.

Family communication patterns don't always affect the business, but when they do it can be very embarrassing. Family members often say things to each other in a way that they wouldn't speak to employees or even friends. This problem is compounded when communication is misread by the family member(s). Parents might be surprised by a son or daughter's negative reaction to a business directive or performance evaluation despite the fact that it is perceived as criticism from Dad or Mom, not from the boss.

System overlap is apparent when conflicts of interest arise between the family and the business. Some families put personal concerns before business concerns instead of trying to achieve a balance between the two. It is important to understand that the family's strong emotional attachments and an overriding sense of loyalty to each other create unique management situations. For example, solving a family problem, such as giving an unemployable or incompetent relative a position in the firm, ignores the company's personnel needs but meets the needs of family loyalty.

Another example of conflict of interest occurs when business owners feel that giving children equal salaries is fair. Siblings who have more responsibility but receive the same pay as those with less responsibility usually resent it. In cases of sibling rivalry, it isn't unusual for one sibling to withhold information from another or try to engage in power plays, i.e., behaviors that can be detrimental to the firm.

Much of this behavior can be eliminated or managed by devising policies that meet the needs of both the family and the business. Developing these policies is part of the family strategic planning process. Before discussing them, you should make sure you have identified all the issues that need to be addressed.

Issues in the Family Business

The list below contains the issues that most family businesses face:

- Participation-who can participate in the family business and under what circumstances.
- Leadership and ownership-how to prepare the next generation to assume responsibility for the business.
- Letting go-how to help the entrepreneur let go of the family business.
- Liquidity and estate taxes.
- Attracting and retaining non-family executives.
- Compensation of family members-equality versus merit.
- Successors-who chooses and how to choose among multiple successors.
- Strengthening family harmony.

All of these issues and the others you include in the Family Business Assessment Inventory can potentially cause business conflict and family stress. But there are three steps you can take to manage conflict and stress in a family business:

- Identify issues that may cause conflict and stress.
- Discuss these issues with the family.
- Devise a policy to address them.

A discussion of policy making, as well as establishing a forum conducive to it, will be addressed later, in the section Family Retreat.

Who Are the Actors?

The next consideration in understanding the family business is to understand the perspectives of those involved. Without this understanding, managing a family business will be difficult. The actors in the family business can be divided into two groups: (1) family members and (2) non-family members. Each group has its own perspective and set of concerns and is capable of exerting pressures within the family and the firm.

Family Members - neither an Employee nor an Owner: Children and in-laws are usually in this group. Although they may not be part of the business operations, they can exert pressure within the family that affects the business. For example, children may resent the time a parent spends in the business. This creates a problem because parents usually develop guilt feelings as a result of their neglect and the resentment expressed by the children. In-laws, on the other hand, are viewed either as outsiders and intruders or as allies and therefore are usually ignored or misunderstood. For example, a daughter-in-law is usually expected to support her husband's efforts in the business without a clear understanding of family or business dynamics. She may contribute to family problems or find herself in the middle of a family struggle. The son-in-law faces similar, if not worse, problems. He may be placed in a competitive situation with his wife's brothers. If he isn't involved in the family business, he can still exert pressure on the business in his role as his wife's confidant.

Family Members - an Employee but not an Owner: This family member works in the business but does not have an ownership position. For this individual, conflict may arise for a number of reasons. For example, if he or she compares himself or herself to the family member who has an ownership position but is not an employee, a sense of inequity may result. The member may voice his or her resentment: I'm doing all the work, and they just sit back and get all the profits. Or resentment may occur when decisions are made by owners alone. Here, he or she may feel: I'm working here every day. I know how decisions are going to affect the company. Why didn't they ask me? Family members employed in or associated with a family business generally expect to be treated differently from non-family employees.

Family Members - an Employee and an Owner: This individual may have the most difficult position. He or she must effectively handle all the actors in both systems. As an owner, he or she is responsible for the well-being and continuance of the business, as well as the daily business operations. He or she must deal with the concerns of both family and non-family employees. Often, the founder, as the sole owner and chief executive, fails in this category.

Family Members - not an Employee but an Owner: This group usually consists of siblings and retired relatives. Their major concern usually is the income provided by the business; thus, anything that threatens their security may cause conflict. For example, if the managing owners want to pursue a growth strategy that will consume cash and has an element of risk, they may face resistance from retired relatives who are concerned primarily about dividend payments.

Non-family Members - an Employee but not an Owner: This group deals with the issues of nepotism and coalition building and the effects of family conflicts on daily operations. Owners' concerns for non-owner employees usually involve recruiting and motivating non-family employees and non-family owner-managers who will have little or no opportunity for advancement, accepting children of non-family managers into the business and minimizing political moves that support family members over non-owner employees.

Non-family Members - an Employee and an Owner: With the emergence of stock-option plans, this group has become more important. Employees may become owners during a succession. In companies where a successor has been chosen, partial ownership of the company by its employees can foster cooperation with the new management because the employees will personally share the benefits and responsibilities of the company. In cases where there is no successor, selling the company to the employees who have helped build it makes good business sense. Employees who own the company will want to be treated like owners, which may be difficult for family members to understand and accept. A thorough understanding of the behavioral consequences of an employee stock ownership program (ESOP) should be grasped before a family implements such a program. Understanding the perspective of the individuals around you, both family and non-family will make communicating and decision making easier.

Strategic Planning

When conflict occurs in the family business, it can be traced to a disparity in the goals of the individuals, the family or the business. Perhaps a family member works in the business out of economic necessity, not because he or she wants to. Or perhaps the potential successor has plans for the business that differ from current management plans-different generations usually have different goals. Whatever the cause, the conflict must be addressed and resolved to avoid and prevent more serious problems later.

One way to define and align family and business goals is through business and family strategic planning. In these plans, you will create a mission statement for the business and for the family that allows each element to complement the other. Once you have completed this task, set goals for the family business that will allow the family and business to prosper. Next, develop a strategy to accomplish these goals and, finally, formulate policies and procedures that control the family's involvement in the business.

Business Strategic Planning

Strategic planning for family-owned businesses requires that you integrate family issues, such as:

- What are the long-term personal and professional goals of family members?
- What is the family mission? Why are you committed to establishing and operating the business?

- How do you envision the firm in the future?
- Will family members be active in management or will they be passive members?
- How will issues such as compensation, benefits and performance evaluation be handled?

The answers to these questions will affect the business strategy and should be resolved before strategic planning begins.

Strategic planning involves analyzing the business in its environment and devising a process for guiding its development and success in the future. This process involves assessing the internal operations and the current external environment (i.e., economic, technological, social and political forces) that affect the business. To begin this process, identify internal strengths and weaknesses that may constrain or support a strategy. Components of this assessment include (1) the organizational structure, (2) the culture and (3) the resources.

Make a list of the opportunities available (growth, new markets, a change in regulations) and the threats (increased competition, shortage of raw materials, price cutting) to your business. This should give you some insight into the current situation and provide a strategic direction.

Next, list the objectives of you and your family, identifying personal needs and risk orientation. Many of these objectives and goals will be addressed in your family strategic plan. Also, you will find that your personal objectives will affect the strategy you choose. For example, if there is a great opportunity for growth in your market but you have a low-risk orientation and a high personal need for security, you probably should not pursue high growth. It would be not only risky but also expensive. Growth consumes cash, and cash must be generated internally or financed externally. Your personal objectives should mesh with your strategy.

Once you have identified opportunities in the industry, assessed the strengths and weaknesses of the firm and listed your personal objectives, you can proceed with the strategic plan. This will involve:

1. Developing a mission statement
2. Setting objectives
3. Developing strategies to meet objectives
4. Developing action steps to implement the strategy.

Let's consider each of these four elements in greater detail:

1. *Mission Statement:* The mission statement answers the question "What business are you in?" It defines your customers and explains why you are in business. The mission statement

embodies the heart of the business and gives direction to every facet of the business. To be effective, it should:

- Include specifications that allow measurement
- Establish the individuality of the firm
- Define the business in which the firm wants to be involved
- Be relevant to all with a stake in the firm
- Be exciting and inspiring.

2. *Objectives:* You should set reasonable objectives for the firm, based on the mission statement, to ensure accomplishment of the firm's mission. Objectives should be clearly stated, realistic, measurable, time specific and challenging. Objectives can be created for

- Revenue growth
- Earnings growth
- Sales and market share growth
- New plants or stores
- Product/service quality or corporate image.

3. *Strategies:* Strategies are determined by your answer to the earlier question: "What will the firm be like in the future?" Your strategic options include the following:

- Stability-success is derived from little change (rare).
- Profit strategy-sacrifice future growth for profits today.
- Growth strategy-growth may be achieved through vertical integration (expansion from within), horizontal integration (buy a competitor), diversification, merger or retrenchment (turnaround or divestment).

4. *Action Steps:* Once the strategy is selected, action steps should be specified that will guide the firm's daily activities. An example of an action step is creating a budget to project the costs of a strategy. This process also is known as tactical planning. The steps in tactical planning should be practical and easy to implement and account for; their purpose is to convert goals into manageable, realistic steps that can be individually implemented.

Family Strategic Planning

The entire family should develop a mission statement or creed that defines why it is committed to the business. By sharing priorities, strengths and weaknesses, and the contribution each member can make to the business, the family will begin to create a unified vision of the firm. This vision will include personal goals and career objectives.

An important issue to consider is how to set priorities for the family and the business, i.e., decide which will come first, the family or the business. How you answer this question will influence your planning. Some family members will opt for the business first, reasoning that, without a business, there will be no financial security for the family. Others will opt for the family first, reasoning that no business is worth the loss of family harmony. A third alternative is to serve both family and business perhaps not equally, but as fairly as possible. Under this alternative, all decisions are made to satisfy both family and business objectives. For example, a family may have a policy that any family member may join the business, but he or she must meet the requirements of the job. You may find this is the best alternative because it forces a commitment to both the family and the business.

The Family Retreat

Trying to plan a business strategy during normal office hours is almost impossible. Plan a family business retreat to discuss the goals of the individual family members and the goals of the business. The first retreat should focus on reviewing the firm's history, defining family and business values and missions, creating a statement about the future of the business and reviewing areas that need more attention.

The purpose of the retreat is to provide a forum for introspection, problem-solving and policy-making. For some participants, this will be their first opportunity to talk about their concerns in a non-confrontational atmosphere. It is also a time to celebrate the family and enhance its inner strength.

A retreat usually lasts two days and is held far enough away so you won't be disturbed or tempted to go to the office. Every member of the family, including in-laws, should be invited. Begin planning your retreat about six weeks in advance.

Your actual agenda will be tailored to meet the unique needs of your family and business. Usually, families will identify some of the following issues for discussion at their first retreat:

- A family creed or mission statement.
- Management succession.
- Estate planning.
- Strategic business planning.
- The reward system.
- Performance evaluation.
- Communication within the family.
- Preparing adult children to enter the business.
- Transition timing.
- Exit and entry policies.

A series of questions that can be used to identify topics for discussion is included below. You may consider using a retreat facilitator, a professional experienced in helping family-owned businesses. The facilitator helps identify issues for discussion before the retreat and keeps the atmosphere non-confrontational during the retreat. The facilitator does not solve the family's problems but guides the family in doing so.

The retreat is the beginning of a process. When a consensus is reached by the participants, policies should be set, courses of action planned and responsibility for implementation assigned. When agreement cannot be reached, further discussions should be planned, possibly with the continued assistance of the facilitator.

One important outcome of the retreat should be making plans for periodic family meetings and retreats in the future, so the dialogue will continue.

Open communications will enable the family to come to grips with problems and issues while they are fairly easy to solve. Once family members have reached a consensus on the continuity of the firm and their roles in it, you can begin planning for succession.

Succession Planning

Succession is the transferring of leadership to the next generation. It is a process rather than an event. While there is a time frame within which the transition will occur, the actual amount of time taken for the process is arbitrary. It will depend on you, your family and the type of business you are in. This is a difficult process for most family businesses. The failure to face and plan for succession is an all-too-common problem. There are a number of forces that act against succession planning:

For the Founder:

- Fear of death.
- Reluctance to let go of power and control.
- Personal loss of identity.
- Fear of losing work activity.
- Feelings of jealousy and rivalry toward successor.

For the Family:

- Founder's spouse's reluctance to let go of role in firm.
- Norms against discussing family's future beyond lifetime of parents.
- Norms against "favoring" siblings.

- Fear of parents' death.

For Employees:

- Reluctance to let go of personal relationship with founder.
- Fears of differentiating among key managers.
- Reluctance to establish formal controls.
- Fear of change

Environmental:

- Founder's colleagues and friends continue to work.
- Dependence of clients on founder.
- Cultural values that discourage succession planning.

Overcoming the forces against succession planning requires the commitment of the family and employees of the business. Succession occurs in four phases:

1. Initiation,
2. Selection
3. Education
4. Transition

Let's now consider each of these phase in further depth:

1. Initiation

The initiation phase is that period of time when the children learn about the family business. It occurs from the time the children are born. A child can receive either a positive or a negative impression of the family business. If parents bring home the negative aspects of the business, complaining about it and about employees and relatives, the children will view the business in a very poor light. Other ways to destroy children's interest in the business is to be secretive about it or to convey an unwelcome or a hands-off attitude. There are families in which children are welcome to join the family business, but no one has told them so.

Owners are often cautious about systematically conditioning their children to enter the family business, an attitude that stems primarily from their awareness of individual differences and their belief that their children should be free to select a career path. If you do want your children to enter the business, or at least have that as a career alternative, there are some steps you can take to initiate them into the firm. The first step in motivating your children is to be certain that is what you want. Your lack of conviction about their involvement will be communicated to them. This may be interpreted as doubt about their ability, about the viability of the business or about the potential of the parent-child relationship to survive the strain of succession. Any of these situations can cause your child to lose interest in the business.

Assuming your children know that you want them to enter the business, you should talk with them often and openly about it. Be realistic, but stress the positive aspects. Your business provides you with many positive experiences to share with your children. Your children should learn what values the business represents, what the business culture represents and where the business is headed.

2. Selection

Selection is the process of choosing who will be the firm's leader in the next generation. Of the entire transition process, this can be the most difficult step, especially if you must choose among a number of children. Selecting a successor may be viewed by siblings as favoring one child over the others, a perception that can be disastrous to family well-being and sibling harmony.

Owners select successors on the basis of age, sex, qualifications or performance. Because of the potential for emotional upheaval, some owners avoid the issue entirely, adopting an attitude of "Let them figure it out when I'm gone." Nevertheless, there are several solutions to this dilemma. Assuming you have more than one child who is or can become qualified for the position of president, you can select your successor based on age. For example, the oldest child becomes the successor. Unfortunately, the oldest may not be the best qualified. Placing age or sex restrictions on succession is not a good idea. Alternatively, you could have a "horse race." Let the candidates fight it out, and the "best person" wins. While this is the style in some major corporations, it is not the best option for all family businesses.

Family business owners may want to take advantage of a successor selection model developed for corporate executive succession. In this model, family members, using the strategic business plan, develop specific company objectives and goals for the future president or chief executive officer.

The job description includes the requirements for the position such as skills, experience and possibly personality attributes. For example, if a firm plans to pursue growth in the next five years, the potential successor would be required to have a thorough understanding of business valuations and financial statements, the ability to negotiate and a good relationship with local financial institutions.

Designing such job descriptions provides a number of benefits. First, it removes the emotional aspect from successor selection. If necessary, the successor can acquire any special training the job description outlines. Second, it provides the business with a set of future goals and objectives that have been developed by the whole family. Finally, the founder may feel more comfortable knowing objectives are in place that will ensure a growing, healthy business. If you have an outside board of directors, you may want to solicit their input regarding successor selection.

3. Education

Training or educating the successor in the firm is a delicate process. Many times a parent finds it difficult to train a child to be a successor. If so, an alternative trainer may be found within the firm. A successful trainer will be logical, committed to the task, credible and action-oriented. These attributes, when tied into a program that is mission-aligned, results-oriented, reality-driven, learner-centered and risk sensitive, will produce a well-trained beneficiary. All of this, of course, is easier stated than accomplished. A training variant of the Management by Objectives (MBO) concept is the training by objectives (TBO) concept. This concept can be an effective method for providing both the training for and the evaluation of successors.

In the TBO process, both the trainer (you or a non-family manager) and the trainee (potential successor) work together to define what the trainee will do, the time period for action and the evaluation process to be used. This system allows the successor to be placed in a useful, responsible position with well-delineated objectives. It also provides for steps of increased responsibility as goals are met and new, more rigorous goals are established. It is important that the successor enter the firm in a well-defined position. Instead of entering the company as "assistant to the president," which requires that he or she follow the president around all day, the successor (or any other child) should enter with a specific job description. In a small business, this is very difficult because everyone is usually responsible for all tasks. Nevertheless, the successor cannot be evaluated effectively if he or she is not given responsibility and authority for certain tasks.

Your business will enable you to determine which criteria are necessary for good training. Usually, an owner wants to assess a successor in the following areas:

- Decision-making process.
- Leadership abilities.
- Risk orientation.
- Interpersonal skills.
- Temperament under stress.

An excellent way to assess these skills is to let the successor give his or her insight on a current problem or situation. This is not a test and should not be confrontational. Instead, solicit advice and try to determine the thinking process that is generating your successor's suggestions. For example, you may be faced with a pricing decision. Give the successor all the information needed to determine whether or not to raise prices, then sit back and listen. Ask questions when appropriate these should be "Why?" and "What if?" After the successor is finished, say "I was considering. . . ." This way each of you can learn how the other thinks and makes decisions.

It is possible that your leadership style differs from that of your successor. Your employees are used to your style. If your successor's style is very autocratic and uncaring, your company is going to experience problems.

Potential successors should be introduced into your outside network (e.g., customers, bankers, and business associates), something many managers neglect. This will give everyone time to get to know your successor and allow the successor to work with business associates and bankers and to get acquainted with customers.

4. Transition

The actual transfer of control to the successor occurs when you retire. Research indicates that transitions are smoothest when:

- They are timely.
- They are final and do not include the entrepreneur's participation in daily activities.
- The entrepreneur is publicly committed to an orderly succession plan.
- The entrepreneur has articulated and supervised the formulation of company principles regarding management accountability, policies, objectives and strategies.

The transition can be effected gradually by relinquishing more and more responsibility to the successor. One expert advises the entrepreneur to take a number of planned absences before actually relinquishing control. Let the successor see what it is like to manage the business alone.

Also, this allows you to see that the business is not going to fall apart without you.

Once you announce your retirement date, do not rescind it. There is no such thing as semi-retirement. By the time your children are in their 40s, they expect leadership roles in the firm. If you refuse to let go, they may leave.

Letting Go

There are many reasons why entrepreneurs cannot let go of the family business. Primary among these are financial ones. As a business owner, you may be used to a large salary and benefits, such as a car or insurance. After working hard in the business most of your life, you want your retirement years to be comfortable, not filled with financial anxieties. There are several ways to ensure your financial security after retirement. Business owners usually consider either taking what they need from the company after they retire or arranging a buy-out that will give them the needed liquidity without placing an undue financial burden on the company. If you don't sell the company and your financial security is contingent on its daily operations, you will be less likely to retire completely.

Your successor needs full control, and you probably won't let that happen. Also, the company may not be able to support you and the successor and still pursue the strategy you have set for it. Finally, you may not be able to meet your financial goals from income generated by the company.

To avoid these problems, consult with a financial planner or an attorney to determine the method of transfer that is best for you. There are tax consequences to the outright sale of the business to your children. Also, an outright sale may burden the company with too much debt. Other alternatives include an installment sale or private annuity or funding a buy-sell with insurance proceeds. To provide effectively for your retirement, seek professional assistance in this area.

There are other reasons why the entrepreneur doesn't want to let go. One of the primary reasons is the fear of retirement. To understand this fear, it is necessary to appreciate the relationship between work, the meaning of life and social evaluation. For many founders, work and the business are synonymous with a meaningful life. The intense involvement the entrepreneur has with the business increases the importance of the job and his or her identity. Removal from work is like losing a part of oneself.

Work is important to the entrepreneur because it provides economic returns, opportunities to contribute to society, status and self-respect. It also provides social interaction, personal identity, structured time, escape from loneliness and isolation, and personal achievement.

That's a lot to ask someone to give up. Especially important is the loss of status and social power. The leader of a firm wields a great deal of influence and enjoys public impact and public exposure. Retirement means giving up this power.

Because this loss is unpleasant, it is not uncommon for a founder to give a successor the responsibility for running a firm and still try to retain power and privileges from a position on the board of directors.

The entrepreneur who successfully lets go has:

- A sound financial plan for retirement
- Activities outside the business that can provide social contact and power
- Confidence in the successor
- A willingness to listen to outside advisors.

Consider a Board of Directors

Most small businesses do not have a board of directors, but a board can be invaluable during the succession process. A board can help management determine objectives and strategies, provide specialized expertise and even arbitrate feuds among family members.

The board is usually composed of both insiders and outsiders. Although family businesses usually are operated in a very private manner, there are benefits to making outsiders board members. They come with different backgrounds and perspectives and provide checks and balances. Outside directors don't work out well if they lack knowledge about the firm and its environment, or if they are uncommitted to board responsibilities.

The first step would be to establish goals and objectives for the board. You should set these objectives before you recruit or make a commitment to any members. Boards can expand your network, provide input into the succession process, judge the successor's progress or help determine a transition date. But boards should not get overly involved in operational or day-to-day issues.

The second step is recruiting. A board should have five to seven members, including three or four outsiders. Select them carefully. You can find them in civic and charitable organizations, among acquaintances and at local universities.

You should know and have a good rapport with prospective members, and you should determine their ability to provide concrete advice and direction for the business. The following are a few good questions to ask:

- What is their background?
- How are they thought of in the community?
- What do your present directors think of them?
- Do they have the qualifications to help realize the goals and objectives you have set?

The remainder of the board is composed of top insiders. Your potential successor may be invited to attend the meetings, or you may choose to make him or her a member of the board.

Making Succession Work

To make succession work, you must communicate. This is the key ingredient. Use the family retreat as well as family meetings. Family meetings can educate the family in discussions about the nature of the firm, the kinds of leadership skills needed, entry and exit conditions, decision-making policies and conflict resolution procedures. Casual conversations about these issues can contribute to your formal planning later on.

Family meetings do not have to be formal affairs, but they should occur regularly and have an agenda. Parents don't have to lead the meeting; have the offspring organize and conduct a portion of the meeting. Use the meetings to defuse any potential time bombs.

Anticipate problems. Will there be any problems with non-family members? If so, which ones? How will they be a problem, and what can you do (short of firing them) to handle it?

Sibling rivalry is another problem to consider. Does it exist? If so, how will you resolve it? It may not be a problem until the successor is named. Develop a code of conduct for sibling relations. This code will outline how siblings must act toward each other (i.e., in a way conducive to a healthy business), including how to work together, how to play together and how to keep spouses informed about what's going on. Anticipate problems that may arise and meet them head-on.

Estate Planning

In the family business, the bulk of your assets are often tied up in the business. This can not only create a large estate tax bill, but it also means that the estate may not have sufficient liquidity to pay those taxes. Estate tax laws are continuously changing. It is critical that you discuss your estate with your financial advisors to assess the adequacy of your current estate plan.

A key objective of estate planning is to pay the least amount of estate tax possible under the law, though this may be subordinate to your decisions about who and how much- to benefit with your assets. A rule in tax law called "unified credit exemption equivalent" exempts a certain amount of your assets from estate tax. This is in addition to the blanket exemption for assets left to charity and the general exemption for assets left one's surviving spouse. In 2022, the exemption equivalent exempts up to $12.06 million ($11.70 million for persons dying 2021). This means that you can pass $12.06 million in assets to your heirs free of estate taxes in 2022.

Estate plans typically make use of legal devices such as living trusts, marital deduction trusts, the unified credit/exemption equivalent trust, the dynastic trust, annual exclusion gifts, unified credit/exemption equivalent gifts, and the statutory grantor retained interest trust. You should contact your advisor regarding the applicability of these tools to your situation under the current estate tax laws.

The tax code also makes available a tool for deferring the estate tax the installment payment of the federal estate tax that is attributable to the value of a family business. The provision allows an extended payout of the estate tax.

The annual exclusion gift consists of gifts of cash or other property of $16,000 in 2022 ($15,000 in 2021) or less per recipient per year. These gifts are free of federal gift taxation. Such gifts, as well as their appreciation in value and future income from them, are also excluded from federal estate and generation-skipping transfer taxation. This provision can be used to transfer portions of your business to your beneficiaries over your lifetime, reducing the amount of your estate that is subject to taxation.

It cannot be emphasized enough that it is important to seek professional guidance when planning your estate.

Implementation

There are a variety of techniques which can be used to transfer your family business to relatives, partners, employees or others. The technique which is best for you will vary depending upon the structural form of your business, your intentions and the nature of the transfer (e.g., sale or gift). Here are some of the techniques developed before the recent estate and gift tax changes:

- Outright gift - transfer ownership of all or a portion of your business to your heirs with no compensation.
- Annual gifting - transfer a portion of your business annually to take advantage of the gift tax rules. A family limited partnership or corporation is often used in this situation.
- Outright sale - sell ownership in your business for cash or other assets (e.g. stock swap).
- Installment sale - sell ownership in the business in exchange for future interest and principal payments. A self canceling installment note may even be used in a sale to family members, where the balance of the note is cancelled in the event of your death.
- Combination gift/sale - a combination of the above which can be used in the case of transfers to heirs.
- Buy/Sell agreement - an agreement, typically between co-owners, where one agrees to buy the business from another for a set amount. Such agreements are often funded with life insurance.

- Employee Stock Ownership Plan - establish a tax advantaged plan which can transfer ownership of the business to your employees over time as your sell your business interest to the ESOP.

Planning Checklist

Transferring the family business requires the family to make a determined effort to do the following:

- Communicate.
- Create a business strategic plan, including (1) business mission, (2) business goals, and (3) a strategy to achieve goals.
- Create a family strategic plan, including (1) a unified vision of the family's role in the business, (2) a code of conduct for family members, (3) joint operating policies that serve the family and business, and (4) a family creed.
- Prepare a Succession Plan, including arranging for successor training and setting a retirement date.
- Prepare an Estate Plan.
- Championing your successor.

There are many organizations, books, and magazines that can help you plan and manage a successful family business. Gather as much information and read as many references as possible before you devise a plan for managing and transferring the family business. You will find that following the guidelines discussed in this Financial Guide will make the process easier and more successful.

Summary

Succession is a process that may extend from three to six years, or longer depending on your age and on your successor's age. It occurs in phases. Over a period of time, you initiate or educate your children to the family business. After determining a successor, you develop a plan to transfer leadership in the family business. The decision to announce who the successor is and when the transition will occur depends on the family.

There are benefits to making an early announcement, including (1) reassuring employees, suppliers, and customers, (2) allowing siblings time to adjust to the decision and to make alternative career decisions, if necessary, and (3) enabling the entrepreneur to plan for retirement.

The fundamental goal should be to pass the family business successfully to the next generation. To do this you must feel financially secure, secure with the company's future goals and plans and secure with your successor.

Strategic Plan Checklist

<u>Answer Yes or No to the following:</u>

1. Have I listed the emerging opportunities in my industry?	______________________________
2. Have I listed the environmental threats to my firm?	______________________________
3. Have I listed the internal strengths of my firm?	______________________________
4. Have I listed the internal weaknesses of my firm?	______________________________

5. Have my family and I listed our personal goals and objectives? ______________________________

6. Do I have a mission statement? ______________________________

7. Have I listed goals (objectives) for the firm? ______________________________

8. Are the objectives for my firm in line with my family's personal goals? ______________________________

9. Are the objectives for my firm in line with the analysis of my firm's strengths and weaknesses? ______________________________

10. Have I written a strategy to meet my objectives?	______________________________
11. Are my actions manageable (one year or less)?	______________________________
12. Are my actions accountable (someone is responsible)?	______________________________
13. Are my actions reasonable?	______________________________

Pre-Retreat Planning Checklist

Determine which questions would be most beneficial to address at your retreat and have everyone answer them.

Personal Questions:

1. Do you have a desire to be the successor in	______________________________________

the family business?

2. What are your reasons for wanting to be the successor? ______________________________

3. Have you signed a letter of commitment? ______________________________

4. Do you intend to work outside the family business? ______________________________

5. Do you have the necessary education to handle the job? ______________________________

6. Are your values comparable to the founder's values? ______________________________

7. What strengths do you have that can benefit the organization?	______________________________
8. Do you have a vision for the company?	______________________________
9. Are you willing to make sacrifices (such as your family time) for the business?	______________________________
10. Is your choice to become successor your own, or is it expected by the family?	______________________________

Questions Dealing with the Family:

1. What are the reasons for perpetuating the family business? ______________________________

2. Are you aware that the odds are not in favor of the survival of the business? ______________________________

3. What is the history of the family business? ______________________________

4. How does the family get along? ______________________________

5. Is anyone qualified to be the successor? ______________________________

6. Who will choose the successor? ______________________________

7. How will the ______________________________

successor be chosen?

8. At what age will potential successors be allowed to work in the family business? ______________________________

9. Is there a minimum education level required to become the successor? ______________________________

10. Will there be a position in the family business for all interested relatives? ______________________________

11. Are there any special conditions for entering the family business? ______________________________

12. Who will determine salaries? ______________________________

13. Will salaries be paid evenly across the board or by performance? ______________________________

14. Will a mentor be assigned? ______________________________

15. Will the successor be accepted by the family? ______________________________

16. Is anyone in the family eligible to become the successor? ______________________________

17 .How will conflict among relatives be resolved? ______________________________

18. Will the successor start in an entry-level or management position?	______________________________
19. At approximately what age will the successor take control?	______________________________
20. Will a spouse be allowed to work in the family business?	______________________________
21. How long will the potential successor remain in control?	______________________________
22. Is there a procedure for filing grievances in the business?	______________________________

23. Is there a code of conduct? ______________________________

24. Will all potential successors work at the headquarters or at different divisions? ______________________________

25. Are the successor's suggestions taken seriously? ______________________________

Questions Relating to the Business:

1. In what stage of the industry life cycle is the family business? ______________________________

2. What is the company's mission statement? ______________________________

3. Can the business support another executive? ______________________________

4. What are the company's strengths and weaknesses? ______________________________

5. Who are the firm's competitors? ______________________________

6. Are there any barriers to entry? ______________________________

7. What are the competitors' strengths and weaknesses? ______________________________

8. What is the business's current market share? ______________________________

9. Has the founder told employees the business will stay in the family? ______________________________

10. Do employees hear news directly or through the grapevine? ______________________________

11. How does the family business compare with other companies in the same industry? ____________________

12. Is there a manager in place capable of running the business if something should happen to the founder and the successor is not ready? ____________________

13. Will current employees stay when the power changes hands? ____________________

14. Are the company's goals shared by the employees? ____________________

15. Is the family business ahead or behind technologically? ________________________________

16. Does the interest of the family or at the business come first? ________________________________

17. Is the family willing to sacrifice today to prosper later? ________________________________

18. Will the employees accept the successor? ________________________________

19. Is the timing right to announce the successor? ________________________________

20. Is there fresh talent in senior level positions? ________________________________

21. Is there an established budget? ________________________________

22. Is reinvesting in the family business a priority? ____________________________________

Successfully Pass On Your Family Business To Next Generation

Starting a family business is a difficult adventure, especially when day-to-day tasks can overshadow your goals. We know your business is something you want to last, and planning ahead will help you achieve that success.

Old wisdom is clear: The critical issue concerning succession was to identify, develop, and install the successor to the business's top executive. That seems simple, but most people don't consider all the other elements like non-family executives and advisors.

The predominant family business statistic has been that only 30 percent of family businesses survive the second generation. The need for succession planning to avoid becoming a victim of that dismal statistic was the reason for developing the family business field.

But family business experts have come to realize that a 30 percent "survival" rate rather than being a symbol of failure is actually a phenomenal success achieved by the advantages that family strength brings to business enterprises.

We now know that the analogy of "passing the baton" is terribly inadequate. We now understand that succession rarely involves an incumbent and a successor. Instead, the process involves all of the key players, including family members, executives, and advisors.

Not just a matter of successor development and the incumbent's preparedness to let go, the process is a complex stew of social, cultural, financial, legal, strategic, moral, and other dimensions that resist logical, "business-like" thinking.

Success, we came to recognize, depends on being able to combine and balance businesslike thinking with family-like thinking. Clearly, "succession" is inadequate to describe the process. Among the many categories of planning - besides succession - too often neglected in family business were strategic, estate, operational, and governance.

Failure to plan in any of these areas can be fatal. In many instances, the issue was not "how to" but "why not?" What would keep a family business from doing what it should and could to achieve its goal of self-preservation?

The need to develop processes dealing with the massive complexity of changes relating to personal, family, and corporate finances (including the effort to deal with the estate-tax issue) is key. This includes issues of strategy and structure in the business, family values in relationships and structure, governance and accountability, and each of the key players' personal journeys.

If you run a family business it's extremely important to start the planning process now.

Please call us and we'd be happy to talk to you about how to get started.

Maximize Your Wealth With a Winning Exit Plan

Selecting your business successor is a fundamental objective of planning an exit strategy and requires a careful assessment of what you want from the sale of your business and who can best give it to you.

There are only four ways to leave your business: transfer ownership to family members, Employee Stock Option Plan (ESOP), sale to a third party, and liquidation. The more you understand about each one, the better the chance is that you will leave your business on your terms and under the conditions you want. With that in mind, here's what you need to know about each one.

1. Transfer Ownership to Your Children

Transferring a business within the family fulfills many people's personal goals of keeping their business and family together, but while most business owners want to transfer their business to their children, few end up doing so for various reasons. As such, it's necessary to develop a contingency plan to convey your business to another type of buyer.

Transferring your business to your children can provide financial well-being for younger family members unable to earn comparable income from outside employment, as well as allow you to stay actively involved in the business with your children until you choose your departure date.

It also affords you the luxury of selling the business for whatever amount of money you need to live on, even if the value of the business does not justify that sum of money.

On the other hand, this option also holds the potential to increase family friction, discord, and feelings of unequal treatment among siblings. Parents often feel the need to treat all of their children equally. In reality, this is difficult to achieve. In most cases, one child will probably run or own the business at the perceived expense of the others.

At the same time, financial security also may be diminished, rather than enhanced, and the very existence of the business is at risk if it's transferred to a family member who can't or won't run it properly. In addition, family dynamics, in general, may also significantly diminish your control over the business and its operations.

2. Employee Stock Option Plans (ESOP)

If your children have no interest or are unable to take over your business, there is another option to ensure the continued success of your business: the Employee Stock Ownership Plan (ESOP).

ESOPs are qualified retirement plans subject to the regulatory requirements of the Employee Retirement Income Security Act of 1974 (ERISA). There's one important difference, however; the majority (more than half) of their investment must be derived from their own company stock.

Whether it's due to lack of interest from your children, an economic downturn or a high asking price that no one is willing to pay, what an ESOP does is create a third-party buyer (your employees) where none previously existed. After all, who more than your employees has a vested interest in your company?

ESOPs are set up as a trust (complete with trustees) into which either cash to buy company stock or newly issued stock is placed. Contributions the company makes to the trust are generally tax deductible, subject to certain limitations and because transactions are considered stock sales, the owner who is selling (you) can avoid paying capital gains. Shares are then distributed to employees (typically based on compensation levels) and grow tax-free until distribution.

If your company is a stable, well-established one with steady, consistent earnings, then an ESOP might be just the ticket to creating a winning exit plan from your business.

If you have any questions about setting up an ESOP for your business, give us a call today.

3. Sale to a Third Party

In a retirement situation, a sale to a third party too often becomes a bargain sale--and the only alternative to liquidation. But if the business is well prepared for sale this option just might be your best way to cash out. In fact, you may find that this so-called "last resort" strategy just happens to land you at the resort of your choice.

Although many owners don't realize it, most or all of your money should come from the business at closing. Therefore, the fundamental advantage of a third party sale is immediate cash or at least a substantial upfront portion of the selling price. This ensures that you obtain your fundamental objectives of financial security and, perhaps, avoid risk as well.

If you do not receive the bulk of the purchase price in cash, at closing, however, your risk will suddenly become immense. You will place a substantial amount of the money you counted on receiving in the unpredictable hands of fate. The best way to avoid this risk is to get all of the money you are going to need at closing. This way any outstanding balance payable to you is "icing on the cake."

4. Liquidation

If there is no one to buy your business, you shut it down. In liquidation, the owners sell off their assets, collect outstanding accounts receivable, pay off their bills, and keep what's left, if anything, for themselves.

The primary reason liquidation is considered as an exit plan is that a business lacks sufficient income-producing capacity apart from the owner's direct efforts and apart from the value of the assets themselves. For example, if the business can produce only $75,000 per year and the assets themselves are worth $1 million, no one would pay more for the business than the value of the assets.

Service businesses, in particular, are thought to have little value when the owner leaves the business. Since most service businesses have little "hard value" other than accounts receivable, liquidation produces the smallest return for the owner's lifelong commitment to the business. Smart owners guard against this. They plan ahead to ensure that they do not have to rely on this last ditch method to fund their retirement.

If you need assistance figuring out which exit strategy is best for you and your business, please don't hesitate to contact the office. The sooner you start planning, the easier it will be.