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Family Business Transition Planning

Abstract
This white paper examines the process of transitioning the ownership and management of a family business. It discusses pre-transition planning, considers the challenges of intergenerational ownership transfers versus third-party sales, and proposes a framework for meeting family and business goals throughout the process.

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'Defer no time, delays have dangerous ends.' *Shakespeare*, Henry VI

Overview

Transition planning is one of the most important issues facing any business--and one of the most commonly avoided. Preparing the business for succession and successfully completing a transfer is often more difficult than building the business itself. However, an exit is inevitable, years away or in the near future. Few business owners want to continue operating a company for the rest of their lives. Every owner faces an eventual challenge: control his business transition or be controlled by the situation.

Life planning is equally important for business owners. What will the owner do after he retires? How will he find fulfillment? How can he ensure that he will have the financial resources he needs to enjoy that reward? Despite the difficulty in tackling these issues, having a strategy for continuing a meaningful and satisfying life, and maintaining the resources to live that life, must be addressed.

Learning from Experience

Over the past year Harvest Capital partners have conducted a wide-ranging survey of business owners, accountants, corporate, estate, and M&A attorneys, and investment bankers to compile data on how business owners approach transitions and their goals for the transition process. We confirmed what challenges typically arise, why they occur, and how they can be avoided or overcome.

The data compiled through our surveys, complemented by industry research, provides valuable insight into how families typically approach succession planning, how common challenges impact business transitions, and which approaches to transition plans succeed and why. Through these surveys, and by studying the results of similar surveys conducted by academic and industry organizations, a series of 'best practices' have emerged for developing and implementing a successful family business transition plan.

Executive Summary

We have developed a framework to guide the successful transition of a family business to new owners and management. These steps accommodate either the sale to a third party or transfer to a new generation of family members. Taken in total, they offer an orderly process for reaching and executing the decisions necessary to balance both family and business transition goals.

The principal conclusions we explore in this paper include:

1. Successful transition planning can be divided into five inter-related steps which we outline.
2. Planning for transition is the culmination of an owner's stewardship over the family business.
3. There are four types of succession planning which occur in a transition:
    a. Management - determining who will take over the day-to-day operations, or in the case of a sale, putting the right management team in place to carry forward under new ownership
    b. Ownership - while straightforward in a sale, determining the fair allocation of ownership and control in future generations is complex
    c. Operational - preparing the business, management and staff to operate successfully during the transition
    d. Emergency - preparing the company and family for succession of management, ownership and operations in an emergency

Planning for transition is the culmination of an owner's stewardship over the family business.

4. The biggest challenges for a successful transition are:

    a. Proper planning far enough in advance
    b. Getting the transaction structure right in a sale
    c. Getting the intersection of management and ownership right when the business stays in the family (differentiating family member roles as owners versus employees)

5. How a family defines success is rooted in its family values.

6. A family constitution, cooperatively created, provides a touchstone for balancing family and business needs.

7. The succeeding generation needs a seat at the planning table: a successful transition plan is everyone's business, as they will live with the consequences for years.

8. Planning the owner's life after transition is often inadequately addressed.

While it is true that every family business transition is unique, there are similarities among all family businesses:

- In a family business, ownership succession is inevitable. Ideally, business owners would begin thinking about succession from the company's earliest days and would continue to refine their plans throughout their careers. Unfortunately, most owners wait far too long to begin planning a transition.

- A family's values define success for its business. Every family hopes to derive slightly different benefits from the company. Some may want to earn as much wealth as possible, while others may wish to balance charitable endeavors with profits. Still others may be more concerned with creating a rewarding environment for future generations and employees. These values must be considered in its succession plan.

- Relationships between family members always impact intergenerational transitions. It is vital to address the needs and desires of all affected family members when planning an intergenerational transfer.

The five steps for successful transition planning are Goal Setting and the Family Constitution, Preparing for the Transition, selecting one of two options for Transition, planning for Life After the Transition, and establishing Lifestyle Balance.

STEP 1: GOAL SETTING AND THE FAMILY CONSTITUTION

The first consideration for succession of ownership and management is to formulate realistic objectives. This process will reveal the family's core values and goals.

Our research demonstrates that among business transition objectives, three stand out as being most important to the owners of family businesses:

1. Asset protection and preservation of wealth
2. Being fair and equitable to their extended family
3. Financial independence to maintain the lifestyle for the owner and his immediate family

Not surprisingly, continuity of the family and finances are foremost among the concerns of business owners who are considering succession. For many, the ultimate goal is to complete a transition that creates sufficient wealth for the owner to retire comfortably while at the same time taking care of their spouse and children.

Similarly, research at Baylor University of over 600 family businesses in the United States also found that family and finances are among the most important transition goals among owners[1]. In addition, the study's results expanded upon this theme, identifying relational and organizational concerns that are common among business owners. The Baylor University research demonstrated the following ranking of owner objectives and values:

1. Family relationships
2. Preservation of wealth and its transfer to succeeding generations
3. Well-being, independence, and development of the retiree
4. Continuity of the enterprise
5. Leadership development and subsequent succession
6. Ownership transfer and organizational governance

Many of these findings support those of earlier (and subsequent) research. One outcome of this research is that it identifies broad averages for identified goals, though it can't take into account what individual families determine to be their own values: this needs to come from the family itself.

1.1 Set goals

In the goal-setting process, the determination of values is important. At the outset of the goal-setting stage the owner and her family should:

1. *Determine their own core values and goals.* Does the family or the business come first? Owners should ask themselves which statement rings more true: "Family issues are the biggest challenge in running this business." or "The business is the biggest challenge to our being a family." At the same time, they should decide which of the values and goals from the research above are the family's own. Are there other values not included on the list? Understanding the answers to these questions and their implications affects multiple phases of transition planning.

   The majority owner / CEO who has initiated the transition planning starts to answer these goal questions. However, it is vital to consider whether other family members have additional or different answers. The owner should discuss the option between continuing the family business or monetizing the family investment to pursue other dreams.

   Once a list of the owner's and family's values is made, it is important to prioritize them. This prioritized list of values will determine how the planning will proceed. Each step can then be measured by whether or not it meets these values and goals.

2. *Reconcile family visions.* When owners include a variety of family members in the goal-setting process, they typically find a diversity of opinion. Owners must be prepared to reconcile these varied opinions to create a unified family and company vision.

   During this reconciliation phase, owners should be thinking about how this unified vision will impact the company over the long haul. What is the owner's vision for the family 10, 15, 50 years following, disregarding the skills and capital which may be necessary to continue the business? What would succeeding generations want for the family? Does the business have to be a central part of that vision or might it be the creator of wealth to be managed and deployed for other purposes?

   This reconciliation process directs the role the company will play in the family's long-term happiness and success. It is a vital element of the planning stage, helping to determine the direction of the transition.

3. *Define success for the family: create a Mission Statement.* Through the reconciliation of family visions, owners will decide where the company fits into the family dynamic and learn how each major stakeholder envisions a favorable transition. This will determine what mission unites the family and gives it purpose and will help establish benchmarks for demonstrating a successful outcome.

4. *Decide how they want the family to be remembered.* The final step of the goal-setting stage is to determine what type of legacy the owner and his family want to create and what needs to be done to achieve this legacy.

   When each of these goals is identified, the owner and his family must consider how the contemplated transition will support these goals.

1.2 Establish a family constitution

Because family relationships are a primary concern of business owners, it is helpful for a document outlining the family's beliefs and goals to be developed during the first phase of the transition process. Determining whether the family or business is most important to the owner will influence which path is chosen.

It is here that the tension between management succession and ownership succession comes to the front. In a company's first generation, management and ownership

are usually the same. If there is more than one child when the business is passed to the second generation, family branches develop. The first time the challenge of separating management and ownership typically arises is with the third generation. By then multiple branches of the family can exist and it is unlikely all will make, or can make, equal contributions to the business. If the business is the central identity of the family, unequal participation can lead to value distinctions between family members and branches. After the third generation, real chaos can occur if careful thought hasn't been given to how the family will function.

A process that identifies the family's beliefs, goals and governance structure is useful in dealing with these realities. When written down it becomes a family constitution. Whether taken as a whole or built in parts the process should:

- *Include input from all family members.* A collective constitution has strength while one imposed on the family doesn't work.

- *Incorporate the family vision, mission and values from the goal-setting exercise.* This anchors the family and unites them with a common purpose. If everyone had a say in articulating the family values, and the transition steps are consistent to these values, the sense of family membership and of protecting the family legacy will be enhanced.

- *Build a family team of owners.* In a 2007 American Family Business survey the authors found 'Unity of the ownership group is significantly associated with... predictions of sales growth and demonstrations of past growth; the more family unity, the more they grew in the last three years and the more they expect to grow in the future.[2]" Simply having a family constitution cooperatively adopted and respected by the family is a unifying practice.

- *Create the new ownership and governance structure.* Nothing will have greater positive impact on future generations than constructing this carefully. There are two broad categories of ownership for participation in a family business: 1) Active (Operating / Governing) and 2) Passive (Interested owners, Investors). An operating owner has an active management position in the business. A governing owner may not work in the business but may participate in its governance through board membership. Passive owners don't have any employment, management, or governance responsibilities, but may take an active interest in the business's success and be reliable supporters, or may simply be disinterested other than in the investment value of their ownership. Another possibility is that a family member or entire branch of the family has no ownership at all, but receives appropriate compensation for the family wealth by other means. This becomes more common as future generations develop.

- *Address control and fairness.* A key goal of ownership succession planning is allocating ownership across the family in ways that preserve family unity while ensuring control is transferred in a way that best meets the long-term interests of both the family and the business. A properly drafted family constitution goes a long way toward addressing the fairness of how members will be treated and ownership interests will be balanced. Those who are risk averse and not entrepreneurial may prefer the relative certainty of assets other than stock in an enterprise that is fraught with future risk. The family must be disciplined about diversifying its enterprise wealth to reflect the interest of all involved members.

It is crucial to encourage full participation of the entire family, or representatives of family branches able to speak on others' behalf, in creating the Family Constitution.

- *Promote communication and trust through family meetings.* The family is a living entity and the need for communication and trust is ongoing. Family meetings are a productive way to institutionalize communication around the central pillar of the family constitution, and they are the cornerstone of avoiding conflict or managing it successfully. Research and experience both indicate that family meetings aren't typically held often enough and, if started only in the context of a business transition, are not as successful. Family meetings should be conducted at least annually (more often during transitions) and provide for ample recreation time to assure that relationships don't revolve solely around the business.

- *Establish a code of conduct.* One way to promote respect for all members of the family, even those on the margins due to lack of ownership in the family business or distance from the family center, is to establish a code of conduct to govern family interactions. Even in close families with strong connections this affirmation of how each member will be treated strengthens bonds and serves as an example for newcomers to the family. This code should be broad enough that behavior isn't micro-managed, but specific enough to give guidance of family expectations. This also becomes an excellent example for young family members as they grow into areas of responsibility. A code of conduct decreases the tendency of family branches to develop into clans.

- *Create an outside board of advisors for the family.* A board including trusted and experienced outsiders is imperative to balance the interests of the family and the business. Its advisory mandate should be broad to be effective and should deal with any topic that threatens the stability of the family or its business. There is no standard makeup of such a board, but expertise in law, finance, taxes, conflict resolution, governance and communication are common examples. More important than expertise, however, is independence. Diversity is particularly important to gain the trust of all family members.

- *Provide for the education of all family members.* The family constitution should be the reference point for educating new and emerging members on family issues. It should formalize how family spouses and step-children will be brought onboard. In many families, anyone who marries into a multi-generational business family starts as an outsider because they lack the single element the rest of the family has in common. Spouses may be treated cordially but they remain apart and their ideas and contributions relating to the family business are rarely sought out. However, spouses can provide important skills and experience, and should be treated as valuable resources. This is a two-way street: while spouses should be educated about the family, its constitution and its business, the family also needs to be educated about the spouse, his or her background, accomplishments, interests, and value as a family member.

- *Establish privacy limits for children.* In this age of social media, the line between what should be confidential and what is appropriate to share with friends (and strangers) depends on the age of who draws it. As children learn more about the business, its value, their prospective future, and the family interactions around the business, the difference between private and public information needs to be clear and the children held accountable to distinguish between the two.

- *Incorporate a family participation plan.* As the family grows, not everyone will have an active role in the business. Therefore, criteria for family participation must be set. Many families require a certain level of education and outside experience before joining the family business and also require working in many different areas of the business before earning promotions to areas of increased responsibility. The most successful families actively support alternatives to joining the family business and reinforce the value of each individual regardless of his or her association with it.

- *Promote stewardship.* The longer a family business survives, the more likely its owners will develop a sense of stewardship over its existence. They inherited the benefit of prior generations' efforts and feel a strong responsibility to pass on that legacy, not only intact but having developed it further. Sometimes the next generation isn't able to continue the business, however. When this is the case, stewardship requires that the business and the family part in order to preserve the value built by previous generations. A new direction can be forged that builds and diversifies the family legacy for the future. This often opens up opportunities for family members previously not involved in the family business to become contributing members of this new direction.

- *Create an exit strategy for owners.* One measure of good family governance is the existence of a fair and updated shareholder buy/sell agreement allowing members to relinquish their portion of the company. Sometimes called 'pruning the family tree', this allows natural selection to work within the family. It is the most direct way to deal with family members who become detached from the business and potentially disruptive to its success. These agreements should be customized around a family's particular circumstances, drafted early in a business's history, and updated as circumstances change.

  It is crucial to encourage full participation of the entire family, or representatives of family branches able to speak on others' behalf, in creating the Family Constitution. While this doesn't guarantee that future conflict will be avoided, it does significantly reduce the likelihood of acrimony if younger generations feel they were part of the goal and value-setting process.

STEP 2: PREPARING FOR TRANSITION

Upon completion of goal setting and the family constitution process, it may seem clear whether or not the family hopes to retain ownership and management of the business. However, before committing to any path, owners should engage in an objective and thorough internal and external analysis of the business. Only through such analysis can owners know whether the family's strategic goals can be achieved through a transition and, if so, what type of transition should be pursued.

An effective analysis differentiates between the internal factors the family can control and external factors to which they react. Sometimes referred to as a SWOT analysis, the strengths and weaknesses of a company are internal aspects that can be enhanced or corrected, while opportunities and threats are external aspects which may be seized or must be defended against.

Key areas of the internal analysis include the company's structure, culture, staff, capacity, profitability and access to finance. External forces which will impact the company include competition, changes in market demand, vendors, technology and public policy. This analysis may produce different results based on the strategic alternative being tested: the operating, financial, and leadership needs of the business will vary based on the transition option under consideration. Since the skills required by future management may be different from what currently exists (leading a mature company is not the same as building a new company), the analysis will help identify whether the family has the human and financial capital to keep the business in the family. To be effective the analysis should have multiple points of input and not rely on a single viewpoint. Participants might include the CEO, non-family management, suppliers, customers and important partners (CPA, bankers, etc.).

Decision point: In conjunction with the results from goal setting, the SWOT analysis will help determine whether retaining the business in the family or selling it to owners outside the family best meets the future needs of the business. Once the answer to this question is clear, management can set out in a strategic plan the broad steps and benchmarks to accomplish the transition and operate the business effectively throughout the process. These steps include:

2.1 Retain appropriate advisors

Once the sale or transition decision is reached, it will be clear what types of advisors will be needed to achieve the owner's and family's goals. Every advisor's principal

role is to provide guidance to the family toward achieving its goals in a prompt and cost-effective manner while identifying risks and challenges the family may not have considered. In the Baylor University study, different types of advisors chose different "top priorities" for family businesses. For instance, technical advisors felt structural and financial goals were most important, while the families themselves selected family relationships. A strong team will identify issues in all areas but respect the client's objectives.

Certain advisors should be part of any transition, including an experienced corporate attorney and knowledgeable CPA. The owner's most trusted advisor (typically one of these two) will take a lead role coordinating the efforts of the team.

If pursuing a sale, the attorney should have experience in mergers and acquisitions to better protect the family's interests and provide a wider range of structuring ideas. These lawyers are specialists and can complement the family's and company's existing attorney if necessary. The same standard of experience is necessary with CPAs. Those accustomed to the purchase or sale of businesses are familiar with how buyers evaluate financial statements and will help build enterprise value.

Sellers often benefit from engaging an investment banking firm to market the business, screen for viable purchasers, and provide market knowledge on similar transactions. Investment bankers may have a principal role in negotiating the sale depending on the industry, the size of the transaction, and whether sale prospects have already been identified. They are capable of opening doors to suitors outside the target industry, resulting in a higher transaction value.

Intergenerational transfers require an experienced trust and estate attorney to recommend deal structures that are responsive to the family's objectives while maneuvering within the existing gift and estate tax framework.

A wealth advisor will help the family identify its values, prioritize its goals, align the transition or sale with its mission, and ensure the owner's personal financial planning will preserve and protect the wealth created by the transaction, assuring them financial independence after the transition is complete.

2.2 Prepare a personal financial plan for departing owners

Harvest's research found that a principal factor in delaying transition planning is owners' uncertainty regarding the conversion of their equity capital into financial capital and sufficient income to sustain their lifestyle. Successful business owners have mastered the risk of running a business: they have control over their cash flow and are confident in their ability to manage through unforeseen challenges. However, a business transition changes the character of their enterprise. The succeeding business is essentially a financial management company whose inventory is stocks, bonds, commodities and other investments that are often unfamiliar to them. The financial business presents new risks that they must rely on others to manage.

A personal financial plan is the owner's strategic retirement plan, preparing them to successfully manage the future. The scope of plans will vary based on individual circumstances, but common to all plans are:

- Identify and prioritize personal goals
- Determine the owner's definition and tolerance for different types of risk
- Develop an appropriate investment strategy
- Prepare the owner for retiring into a balanced and productive lifestyle

Constructing a personal financial plan prior to the transition gives the owner a high degree of confidence in the outcome and helps determine what structure and business value will best meet his needs.

A personal financial plan is the owner's strategic retirement plan, preparing them to successfully manage the future.

Case Study

Dietrich and Hans are brothers and second generation owners of a wholesale distribution business. Both are married and have adult children active in the business. The firm recently was valued at $30 million and their advisors have alerted them to their growing estate tax exposure. The brothers are intent on passing the business on to future generations but not until they are ready to retire.

The advisors propose establishing irrevocable trusts for each child now into which non-voting shares of the business can be gifted. Under existing tax law, discounts for lack of marketability and control are still available, allowing for a greater percentage of the business to be transferred into the trusts. As the business continues to grow, part of the appreciation of value will occur in the trusts and not in the brothers' estates, substantially reducing their future estate taxes. The brothers retain complete control of the business and can pursue additional strategies for transferring the balance of the company in the future. An added benefit includes asset protection for the property held by the trusts. Even when the children are married, transfers into the trusts can be protected from a divorcing spouse or other creditors. With the proper provisions and gifts the trusts can also benefit the brothers' grandchildren while reducing the future estate taxes for their own children.

2.3 Intergenerational estate planning

Most estate planning occasioned by a business transition concerns itself with tax minimization strategies and transfer options for the departing owners. Where significant wealth is present this planning should be multi-generational and consider the estate tax, asset protection, and gifting requirements of future generations as well. Started early enough, this planning can have huge benefits measured in the amount of wealth retained by the family over generations. When a business is being kept in the family, this planning will drive the transition. It is also valuable when a sale is pursued, the principal difference being the character of the wealth that will be transferred to future generations.

Specific strategies will be determined by the family goals, demographics, existing tax law, timing of the proposed transition, and how early in the process planning has started. This is an area in which all advisors may have relevant input as it touches on law, taxes, and family wealth management.

2.4 Charitable planning in transaction structure

Charitable giving is rarely part of the discussion during the early phase of the transition. However, if the personal financial plan has identified charitable intent as a family goal, and the transition will create significant excess capital beyond the needs of the owners to meet their personal goals, building charitable planning into the transition structure can have attractive tax benefits. More importantly, it supports causes important to the family and sets an example for future generations of the responsibility that comes with success. Several charitable structures are possible that provide both immediate and long-term tax benefits and, if this is a goal, analysis of charitable giving options should be undertaken early.

2.5 Prepare the business for change

Succession of a business involves both ownership and management and can occur as part of a careful plan or be forced upon the company by unexpected events. When part of an orderly transaction, either through a sale or intergenerational transfer, effectively managing

the business through the changeover demands careful attention.

The value of the business is a reflection of how successful management has been at increasing revenues, managing margins, developing new products, controlling inventory, production and distribution, vendor relationships, employee relations, and financial management. A transition to new owners and the planned exit of executive management creates the risk that attention will be diverted from these building blocks of value. From the time the framework for a deal is negotiated to when the transaction is closed, much can happen that will affect the final price. Losing a major customer, flat or declining orders, an erosion of margins or the loss of key employees all can have significant impact on the transaction value; in extreme cases they can derail the deal entirely. This is an area experienced M&A attorneys emphasize: the non-family management team must be engaged in the transition planning and provided incentive to stay loyal to the company and family throughout and after the transition. By keeping management and employees focused on these priorities, the ongoing, orderly operation of the business continues so momentum is not lost, employee cohesion is maintained, and enterprise value is preserved or increased during the transaction.

There are three steps we recommend to prepare the business for change:

1. A specific leader should be selected to oversee business management during this phase and it need not be the existing CEO. The COO or other senior level manager with the broad operational experience and authority to handle the day-to-day operations is a good choice. It should not be the person primarily tasked with completing the transition of ownership.

2. Develop a clear plan for how the responsibilities of the current CEO will shift during or at the conclusion of the transition. When the business is staying in the family it is particularly important that the current CEO stick with the plan supporting, not undermining, the transition. This is a key area of potential friction and the most common source for a succession plan running into trouble.

Case Study

Steve and Hannah own 60% of a manufacturing business that has been in Hannah's family for three generations. Both are active in the community and have many charitable interests. Though they have two children, neither is active in the business and its sale now seems likely in the next five years. There is very little cost basis in the company stock and there will be a substantial tax burden when the company is sold. Interested in a dependable income in retirement and mitigating the impact of taxes, they wonder what steps they can take now in anticipation of a future sale.

Their advisor suggests part of the answer may be in establishing a charitable remainder trust. Since the business is a C corporation, part of the stock they own can be gifted into the CRT for which an immediate tax deduction is available. The portion of the business gifted to the CRT is also outside of their estate upon their death. When the business is sold, the CRT will pay Steve and Hannah an income stream for the balance of their lives. Any value left in the CRT upon their deaths will pass to a charity they selected when the CRT was established or be directed to another charity through a testamentary power of appointment left to their heirs.

This technique must be set up before a sale of the company is undertaken. Whatever is placed in the CRT escapes capital gain taxation completely but is also not available to their children. Steve and Hannah can determine how much of a legacy they want to leave to their children and retain that amount of stock or, if gifted to a CRT to increase their income or benefit to charity, replace the gift value with a permanent life insurance policy partially funded by the income they receive. This in turn can be placed in a wealth replacement trust so its value also escapes taxation upon their deaths.

3. Mindful of necessary confidentiality, communicate the plan to all constituencies consistently, including:
   - Family members
   - Management and employees
   - Customers
   - Key vendors
   - Banks

Everyone needs to be on the same page to have faith in the transition plan. Be alert to distractions caused by the anxiety of an uncertain future. The better the communication during the transaction planning, the healthier the company will be upon its conclusion.

2.6 Business contingency plan

Sometimes unexpected events create the need for an immediate change in management and ownership. An orderly succession of ownership and management is difficult enough under ideal circumstances when there are years to prepare. The unexpected and sudden loss of a CEO never occurs at an ideal time and is always a shock to the business. It is possible, however, to lessen the impact by planning for the 'what if' scenario. A business contingency plan should address:

- Who is best qualified to fill positions on a temporary basis?
- What outside help will be necessary to?
  - Meet the needs of the business
  - Instill confidence in the customers, employees and vendors that the necessary resources are available to meet the business needs
  - Help the family deal with the crisis
- What will be the mechanism for filling positions permanently?
- Who in the family will assume a leadership role during the crisis?
- How will ownership and control of the business ultimately be changed?

STEP 3: TRANSITION

The planning steps we have outlined apply whether the business will be sold or kept in the family. Similarly, business valuation is required regardless of whether the transition involves an intergenerational transfer or sale. Some owners resist this step if a sale is contemplated, believing the market is a more realistic measure of a company's value. However, a valuation has several further benefits:

- It establishes a reference point for negotiation with potential buyers.
- It validates an owner's perception of value or identifies a mismatch in expectations.
- It can inform the timing of a transition, moving it forward if the numbers work or delaying it while additional value is built.
- It helps reconcile divergent views of value held within the family and becomes the basis for wealth transfer planning before the sale.

3.1 Intergenerational transfers

Intergenerational transfers present special challenges because business considerations must be balanced against the family's needs. The larger the family, the more difficult these issues can be. There are a number of actions that can mitigate these challenges.

1. *Address ownership succession.* The family constitution establishes the framework for thinking about ownership of the family business. When the decision is finally made to either sell or keep the business within the family, ideas may have already formed about how ownership and management will be divided. Though these decisions are often made in concert with each other, different considerations are in play.

   Decision point: The question of ownership is one of dividing economic value amongst the family. Control is a related but different issue because it is possible that control can rest with minority owners as long as they own the majority of voting stock. This is particularly useful as the size of the family grows since it may not be economically feasible for a majority of enterprise value to be held in just a few hands. The art of

this decision is to fairly distribute the investment value of ownership in the family business while placing management and control in the hands of those best able to build business value for the family.

In practice, the ownership structure already in place will influence how much flexibility there is to make changes. However, how the family enterprise value is shared will have a major impact on family relationships for generations to come, so it must be considered carefully. The advice of corporate legal counsel is invaluable here.

2. *Select/Prepare a successor CEO and management team.* Selecting the future management team requires meeting several important objectives:

   - *Support of owner team.* The next generation of owners may identify leaders of the family differently than the current owners. The next generation's understanding may not reasonably reflect who has the skill set for best managing the business. Leadership of the business and the family can be separated, or at least effectively shared, to minimize future conflict.

   - *Support of non-family management team.* The professional managers of the business who don't have family ties must embrace the new order and have confidence in the management succession plan. They need to see a healthy and functional family dynamic that will support the business and their careers or the business will lose valuable managers.

   - *Development plan for chosen CEO.* Once the new executive is chosen, she must be well prepared for the task. Following the family participation plan (see page 6) will have provided her adequate experience within the industry, but an individual plan is also required to fully develop the specific skills she needs to be an effective leader and successfully assume a CEO's responsibility. The departing CEO's exit and the new executive's development should be carefully coordinated and formalized as part of the transition plan.

   - *New CEO performance evaluation and process for further succession.* The selection of a new executive should not create a lifetime position by default, particularly in a thriving and healthy family of owners. The CEO must be accountable for his performance, and a mechanism should be established for preparing a future replacement.

3.2 Third party sales

Sales to a third party are less complicated than intergenerational sales. There are a number of steps owners can take to assure the smooth transition to a new owner:

1. *Maximize the company's value.* Some family businesses are well prepared to be sold. Financial accounting systems are in good order, family expenses are not run through the business, there are no unusual accounting practices, and full audits of financial statements are completed annually. Other indicators of sale readiness include expanding sales growth, diversification in the customer base, a stable pool of employees, strong relationships with those employees or related unions, and an absence of pending regulatory actions, including environmental liability.

   Perhaps most importantly, prospective buyers value an experienced management team that will stay in place after the sale to continue operating the company and serving the clients, protecting the business revenues and cash flow. If the SWOT analysis identified any weaknesses or threats in these areas, they will be important to address before the company can receive its highest value in the marketplace.

2. *Identify prospects.* Many business owners have already identified a selection of potential purchasers to acquire their business, and their inclination may be to work with their existing advisors to contact these prospects and negotiate a sale. Many successful transactions are concluded this way if the advisors are well experienced in performing this role. Where access to a broader market of potential buyers is

desired, an investment banker can be added to the team. Investment bankers provide market perspective on the shape and value of similar transactions, and may be able to develop alternative sale options that help meet the seller's long-term objectives. Where a sale to a competitor is thought to be the best solution, they can develop competing proposals before contacting the competition, protecting the seller's market and perhaps pushing the competition into a higher bid. Their role as a professional intermediary between the buyer and seller also allows the family's other advisors to support the sales process more efficiently.

3. *Negotiate the structure of the sale.* The structure of the transaction will significantly affect its value to the owner. The nominal price of a deal is reduced by its tax impact, both present and in the future (e.g., a stock versus asset transfer or installment sale). If an earn-out is involved, the price is not set and a lower price without that contingency may be more valuable. Any liability retained by the seller clouds the eventual value of the deal. There may be additional benefit or cost to the seller if the structure requires him to stay involved for a period of time. The family may have identified other non-financial objectives which will determine if the deal is right such as the structure's impact on employees and the community.

STEP 4: LIFE AFTER THE TRANSITION

Whether the business has been sold or passed on to the next generation, a lifetime of work has now taken on a new form. If the process was well-planned, the previous owner now has financial independence. However, that wealth is often in a new and largely foreign form: cash and liquid investments versus closely held and illiquid private equity.

In one sense, the owner has exchanged an operating company for a financial company. It still must be managed, and the business goals are similar: risks must be understood and addressed; business affairs must be handled with consideration for their tax impact; and another succession plan must be put in place for the resulting financial enterprise or capital. There are five major concepts that should be considered in this new stage.

4.1 Family wealth protection and preservation

Most business owners only have one chance to create wealth or to build upon the efforts of previous generations to enhance their wealth. Once that enterprise value has been passed on, the wealth that was generated must be preserved and protected for the lives of the owner's family and/or for future generations as well. In an intergenerational transfer, much of wealth preservation will have been addressed in the transfer structure: the goal of wealth protection becomes directed at the capital pool that sustains the prior owner's lifestyle. When a sale has occurred, the preservation, protection, and growth of the sale proceeds are principal goals of the family that must be managed continually.

4.2 Risk management and investment strategy

Owners often take risks in their business, though few appreciate the severity of those risks. This changes once business equity is exchanged for financial assets. After stepping aside, an owner's typical view of acceptable risk is different, and appropriately so. The retired owner's understanding of the financial markets is rarely equivalent to his understanding of the business and industry he left, so he is inclined to be much more conservative with his capital. An investment strategy should incorporate this new risk limitation and deliver a sustainable cash flow while protecting the capital with few surprises. As the newly retired owner develops trust in the investment approach and expertise of the investment manager, the strategy can evolve. Managing the risk to which investment capital is exposed and preserving it for a lifetime are primary objectives of an appropriate investment strategy.

4.3 Tax management

A thorough understanding of an investor's overall tax position is necessary to maximize the sustainable value of his investments while managing when and at what rates taxes are paid. Close coordination with the family's CPA is required to make this effective. The following are examples of decisions which impact the level of annual income tax liability, either for the existing investor or heirs:

- The division of investments between taxable and tax-deferred accounts
- Timing of portfolio reallocations
- Retirement plan distribution methods
- Beneficiary designations on retirement plans
- Source and selection of assets for charitable giving
- Lifetime gifting options to heirs
- Trust structures used during life or in estate planning

4.4 Charitable giving

Successful families often turn to philanthropy to further the family legacy, particularly after a liquidity event and the realization that capital exists beyond their needs or that of their families. Charitable interests help build the bridge between an active life in business and one in retirement. However, strategic philanthropy operates quite differently from check book charity. When pursuing strategic philanthropy, a family should develop a charter to guide its giving, identifying the broad and then narrow areas of particular interest to support. Depending on the allocation to charitable giving, three options are most often used:

- Create an annual gifting budget with contributions coming from general family assets, though structured for maximum tax benefit.

- Establish a donor-advised fund with an initial irrevocable gift and adding to the fund from time to time as resources allow.

- Create a family foundation which is also funded with seed capital and expanded as resources permit.

These options are listed in ascending order of complexity and cost, and the charitable deductions available will vary. Many families see great value in establishing a charitable example for the next generation, and all three alternatives provide the opportunity to engage several generations of family members in the gifting decisions. This connects children and grandchildren, not only with each other, but with the family and a world beyond themselves. These options are essentially lifetime giving opportunities, though charitable bequests upon death also provide means for achieving philanthropic goals. If philanthropy is important to the family and was identified as part of the legacy it hoped to leave, planning for it should be incorporated into the business transition and not left until the transition is complete.

4.5 Wealth transfer

This is the succession plan for the financial enterprise that was formed after the family business has been passed on or sold. Prior to the business transition, intergenerational estate planning should have taken place and the broad outlines established for how the final wealth of the senior generation would be passed on. Perhaps charitable interests that were not achieved during lifetime are set up as bequests upon death. As years pass after the business transition, adjustments might be appropriate to achieve fairness through passing on wealth the senior generation still controls. Frequently, the family tree has undergone changes, marriages have occurred or been dissolved, children have come back into the fold or been estranged. This is an opportunity to correct part of the plan that might not have worked as expected. Tax planning is part of this process, though not necessarily the most important one. Coordination of advice from advisors is important in establishing this succession plan to maximize its effectiveness and efficiency.

As one client told us, "I used to matter. When I walked into a room people noticed. Now conversations go on without me."

STEP 5: LIFESTYLE BALANCE

Insufficient attention is often devoted to planning for lifestyle balance and building a new identity after the business owner has moved on. Only in hindsight do most owners come to grips with the impact such a change creates. As one client told us, "I used to matter. When I walked into a room people noticed. Now conversations go on without me." One client became so agitated with his seeming irrelevance that he spent hours in front of the computer each day watching the minute-by-minute change in his portfolio value and exchanging instant messages with a friend who was doing the same with hers. Some owners haunt the halls of their former business, never quite yielding control even though their presence may actually disrupt the careful succession planning they orchestrated.

Another common problem is with family relationships, most often with a spouse. A household accustomed to schedules built around work and outside responsibilities suddenly changes when there is no longer an office. Few things generate more domestic upheaval than when management skills honed at the office are suddenly attempted at home.

Case Study

Warren Stone was a Dr.'s doctor; his practice was meticulously run, his bedside manners impeccable and nearly every mother in southern New Hampshire knew him because he had delivered her babies. He loved to practice medicine and he loved the affection from all of his happy patients. He had a satisfying professional life.

However, thirty years of delivering babies were beginning to wear Warren down. Retirement would mean becoming less important to patients and his community; while he wanted a break from the constant demands, he didn't want to slip into obscurity. Warren struggled with what to do.

Reflecting on where he found enjoyment in life, Warren knew that he felt comfortable speaking to groups and that he liked to be respected as an authority. He also loved to read, especially historical novels. Finally, he thought about his fascination with wine and vineyards. He loved to visit vineyards whenever he could.

His wife had the answer. "Teach about wine, teach history; share what you already know and love!" she said. "Wow", Warren thought. That's what I can "retire to".

Now retired for five years, Warren and his wife sold their home and moved to a college town for the summers. There he teaches "Twentieth Century Leaders", picking a different character from his list of favorite historical figures each semester. In the autumn they head for Arizona, visiting vineyards along the way. Once in Arizona he teaches a wine class, introducing his students to the art and science of wine and the best vineyards and wine makers across America. Warren takes great pride in his new "career" as a teacher and never regrets "retiring" from medicine.

These may seem like minor and transitory issues, but an encore career can last 30 years, and that's a long time to struggle. That's why it's vital for former owners to have a well-balanced life plan that includes each of the following:

- Secure lifetime income: This allows the retiree freedom to pursue all his other goals.

- Purposeful living: Finding a direction that absorbs the considerable energy a successful business owner has will create a new identity. Becoming a mentor, angel investor, SCORE or other volunteer, board member or advisor to another business can provide new meaning to a person whose life was previously defined by their business accomplishments.

- New family relationships: Many retired business owners find satisfaction developing deeper and broader communication links with family members. This is often necessary given the owner's changing role within the family.

- Health and long-term care planning: This becomes an evolving focus of life as we age and our health inevitably deteriorates. Maintaining healthy habits and activity levels improves and extends quality of life. A long-term care plan should go beyond having the assets to pay for long-term care or buying long-term care insurance. It should include the source for funding care, the preferred provider for that care, the location where that care can easily be provided, and preferences for medical intervention at the end of life: the latter are included in Advance Directives which are customarily prepared as part of estate planning. It is also important to thoughtfully communicate these wishes to the family.

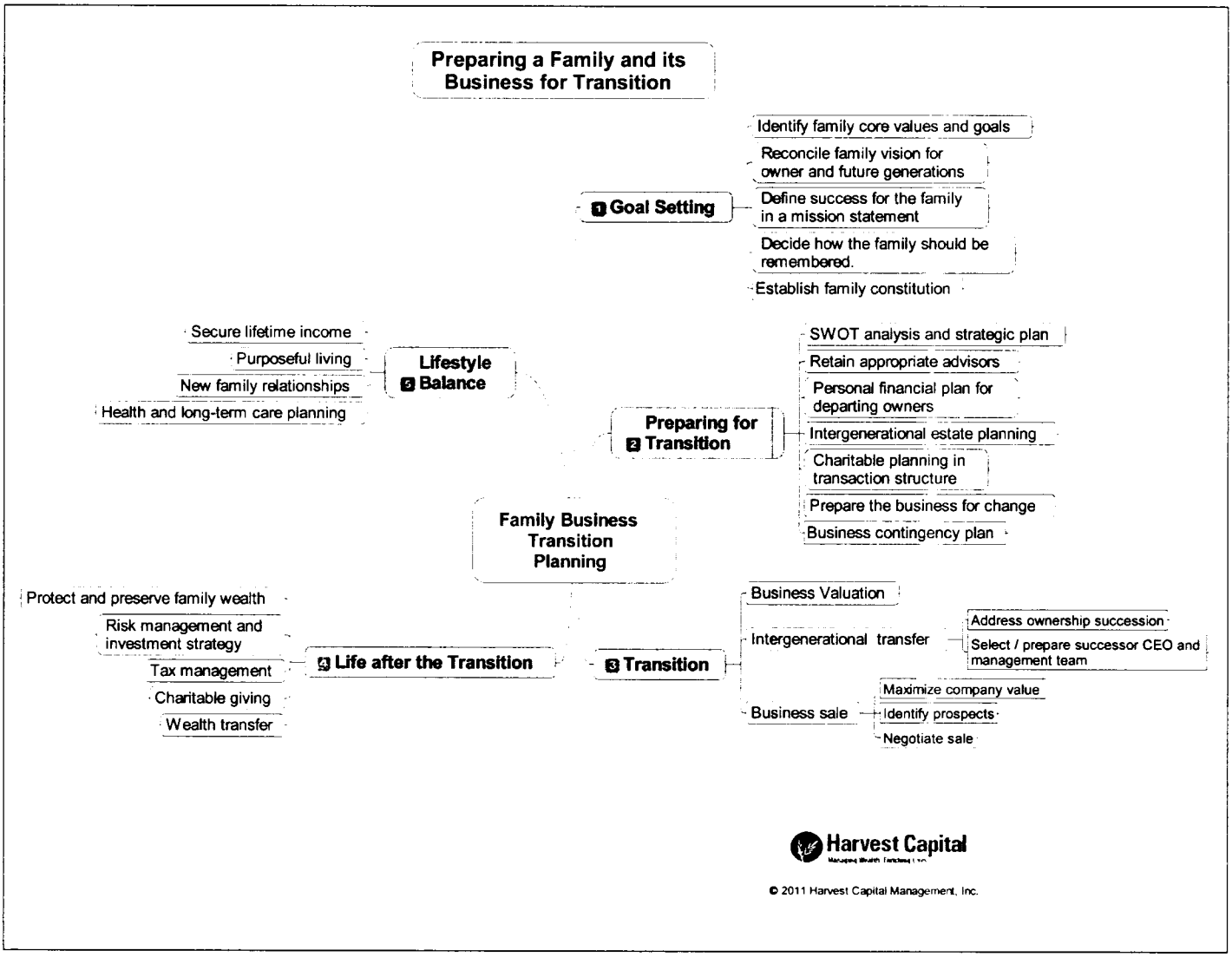
Ultimately, for the retiring business owner, an ongoing productive and happy life is the real goal of the transition planning process.

The five principal concerns of successful business owners are:

- ***Preservation of wealth***
- ***Mitigation of income taxes***
- ***Taking care of heirs***
- ***Protection of wealth from loss due to theft and fraud***
- ***Charitable giving***

TOWARDS A SUCCESSFUL TRANSITION--AND BEYOND

A successful transition of a family owned business requires a multi-step process. These steps are grouped into the five major categories we have discussed, as illustrated in the following graphic:



The cornerstone of stewardship is planning for succession. There are four types of succession planning, including management (preparing the CEO), ownership (preparing the family), transition (preparing the business), and contingency (preparing for emergencies).

The most successful transitions begin by planning years in advance. This gives the business and family time to understand their true goals and implement the structures which will best serve them. A family constitution is a foundational practice that will support this effort.

Maintaining healthy family relationships will reduce the emotional resistance that always accompanies change. A business succession is always challenging, more so when family discord is added to the mix. Healthy family relationships also provide a happier retirement for the owner after the transition is consummated.

Ultimately, the success of any business transition is determined by the extent to which it reflects the family's values, includes everyone with a stake in the transition, and provides a rewarding life to the owners and their loved ones after the transition is completed.

Final thoughts:

Every business must go through a transition and it is never too early to start planning. In addition to the steps outlined here, meet with owners of similar businesses who have gone through a transition and ask them what they did well and what they might have done differently. Assemble the best possible team to help you. There is also much written on this subject so seek out publications on ownership and management succession planning for family-owned businesses.

Most importantly, make the commitment to get started.

In the coming months we will publish more in-depth articles on components of this process introduced here. If you would like to receive notification when these articles are available please contact us at info@harvestcap.com.

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Other resources

UNH Center for Family Business www.familybusiness.unh.edu

Family Firm Institute www.ffi.org

Family Business Magazine www.familybusinessmagazine.com

New Hampshire Charitable Foundation www.nhcf.org

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