

FINANCE

Passing the Baton How to Keep the Business in the Family

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For many entrepreneurs the family business is the definition of the American Dream. Like the Rockefeller or DuPont families, we all savor the idea of the "family name" on the business passing from generation to generation. Yet studies indicate that only about 30 percent of family-owned businesses survive to the second generation, with only 10 percent passing on to a third generation.

Passing the baton is a planning process, and the sooner it is begun the better are the chances for a successful continuation. Business succession involves emotion as well as finance, love and sibling rivalry, and fairness versus equality. Since there will be some difficult choices, many owners may simply defer making the necessary decisions. In our experience, this delay in decision making is the number one reason for the failure of the family business.

Planners sometimes refer to the parent-owner in terms of the "Founder's Syndrome," conjuring up visions of the family patriarch who is proud, successful, a little over-bearing and patronizing toward the adult child who is trying to break into the business. Frequently, the parent-owner is extremely reluctant to let go of the reins. Other parent-owners desperately want to relinquish control but experience difficulty because of a number of thorny questions.

Perhaps the most common of all scenarios is this: The key family asset is the business. One of the children has made it his or her life's work, while the other siblings have taken on other pursuits. The parent-owner wants to be sure that the one child gets the business and still treats the others "equally." Even if the dollar value of the owner's assets can be mathematically distributed in equal shares, will the distribution be a "fair" one where one child gets a business and the others get cash or assets?

Sometimes, for lack of a better solution, a parent-owner decides to leave the business in fractional shares to all of the children, without regard for the fact that one is managing it while the others are not. This is usually disastrous to family harmony as well as the long-term health of the business. Such a situation tends to breed resentment—the two classes of siblings will likely view each other as the parasites or the plunderer.

The death of the parent-owner can lead to an even worse disaster unless a plan is established specifically for this situation. A few years ago, one of California's largest wineries was in the news when the company president was fired by his mother (the firm's majority stockholder) and replaced by his brother. The father had been the majority stockholder until his death, at which point his will stipulated that his wife receive his stock holdings. His son, however, was his successor as the top manager for the business. The seeds for dissension were plain to see. One family member, who was inactive in the business, held the power of ownership, while another managed the enterprise, and yet a third was waiting in the wings.

While a separation of management from ownership may be normal, even essential, in large, public corporations, it can be the cause of fatal controversy in the smaller, family-owned business. It is imperative that ownership control and management be united in the same person.

The potential for conflict is high if long-term, non-family key employees come to resent the idea that their next boss might be that "spoiled college brat." Can there be an accommodation between a parent's desire to keep the business in the family with that of an employee who has all the prerequisites to take over the business himself? Part of the answer may be to develop an outside Board of Directors to

provide a kind of advisory group during the transition years.

It's also quite possible to keep a key employee happy and still accomplish a transition to the child coming into the business. A valued employee must *feel* as though he were an owner, even though he has no legal ownership. The way to do this is to tie compensation to the firm's earnings, such as through a retirement plan technique referred to as "phantom stock." The key employee earns some form of retirement credits that are tied to increases in the value of the firm's stock. This helps create an ownership interest in the employee, which will ultimately be translated into dollars at retirement.

Often, the business is the only income-producing asset for the family. The parent-owners have enjoyed a comfortable standard of living from the firm's earnings, and somehow, they expect to maintain a stable income even after they retire. In order to assure enough cash flow to step down, it's essential that some kind of retirement planning be set in motion far enough in advance. Sad to say, but in our experience, the parent-owner will often be ready to step down and turn over the business, but there is no way he or she can *both* fund a comfortable retirement and relinquish control.

One option frequently used is the family buy-sell agreement. A legally binding contract is made between the parent-owner and the adult child, which provides for the purchase of the parent's interest in the business at an agreed-on price. The "trigger date" for the purchase is normally the parent's death or retirement, whichever comes sooner. If such a plan is properly funded in advance, the child will have the money to buy the business, and the parent-owner, or his estate, will receive cash. Now the funds are available to provide for retirement and/or the equitable distribution of the estate to the other members of the family.

Just as every family business is unique, there will never be one solution to fit all circumstances, and an experienced planner will have a number of options to address varying issues. The most important thing to note is that planning for the future disposition of a family business has extremely important benefits. Without the proper preparation for succession, a business may be lost and the family fortune extinguished. •

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