FAMILY BUSINESS TRANSITIONS: RISING TO THE CHALLENGE

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The seeds of family businesses are sown from the rich soil of dreams and nourished by hard work, risk-taking, economy and diligence. Indeed, much of the wealth in America today has come from family-owned businesses.[1] It is no surprise, then, that business-owning families would like to see their businesses — and the wealth from their businesses — flourish across multiple generations.

Unfortunately, there is often a rub: The likelihood of successful transitions of family businesses to the third generation and beyond is distressingly low. Less than 12% of businesses survive to the third generation.[2] This sobering statistic raises a number of important questions: Why does succession planning for family businesses often yield such dismal results? And how does a business-owning family make the right transition decision and prepare the family for its implementation?

This *Wealth Planning Insights* is the first of a two-part series exploring such questions. In this initial discussion, we look at reasons for the high failure rate — as well as how families can defy the odds. In the second part of the series, we will explore how families can determine whether to keep or sell a family business and best practices around implementing the decision in order to increase the chances of a successful transition.

1 "Family Business Facts." *Conway Center for Family Business*, June 2014, www.familybusinesscenter.com/resources/family-business-facts.

2 *Ibid.*

WHY DOES FAMILY BUSINESS SUCCESSION FAIL?

There are multiple reasons the failure rate is so high for family business succession, and many authorities have articulated and explored these reasons.[3] Northern Trust itself has roots that go back to a business-owning family over 130 years ago. Since that time, we have worked with many business owners and have observed some commonly held family experiences. Two particular themes have emerged as the primary reasons family business succession often fails:

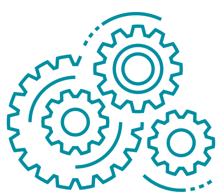
- The next generation is not interested or prepared to lead the business.
- The leadership has not thoughtfully planned or prepared for leadership transition.

FIRST CHALLENGE:

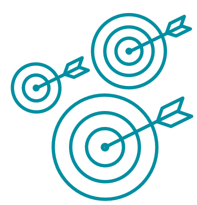
THE NEXT GENERATION IS NOT INTERESTED OR PREPARED TO LEAD THE BUSINESS

Wealth creators are a different breed, and starting and sustaining a business is not for the faint of heart. Traits of successful entrepreneurs often include:[4]

PASSION



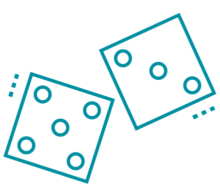
DRIVE



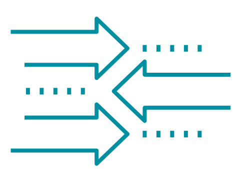
GOAL-ORIENTATION

SELF-CONFIDENCE

INTERNAL LOCUS OF CONTROL



RISK-TAKING



RESILIENCE

3 Williams, Roy O., and Vic Preisser. *Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values*. Robert D. Reed Publishers, 2015.

4 Kerr, Sari Pekkala, et al. *Personality Traits of Entrepreneurs: A Review of Recent Literature*. Harvard Business School, 2017, *Personality Traits of Entrepreneurs: A Review of Recent Literature.*; Zhao, Hao, and Scott E. Seibert. "The Big Five Personality Dimensions and Entrepreneurial Status: A Meta-Analytical Review." *Journal of Applied Psychology*, vol. 91, no. 2, 2006, pp. 259–271.; Robinson, Joe. "The 7 Traits of Successful Entrepreneurs." Entrepreneur Magazine, Jan. 2014.

When you consider these characteristics, it is easy to see how they might create a larger-than-life persona that is hard to duplicate in the rising generation — at least without a great deal of effort spent developing talent. The rising generation might feel unable to replicate the success of the founder, creating a sense of inadequacy that devolves into diminished self-confidence, risk tolerance, resilience, passion and drive — the very traits needed to sustain the business over time.

Additionally, it is not uncommon for a founder to have worked long hours away from the family in order to build the business. This absence has the potential to build resentment from the next generation toward the business, as heirs believe the founder was willing to sacrifice family life for wealth creation. This dynamic can squelch any desire to interact with the business other than to reap economic benefits.

Without a systematic process to prepare the rising generation, it is difficult to find competent managers and executive leadership. To begin developing such a process, there are several initial steps we recommend family business owners consider.

- **Cultivate pride of ownership: tell both the family and business stories**
- **Expose the rising generation to what the family business does and how it works**
- **Define roles in the family business, and educate family members about the roles**
- **Determine and communicate family employment parameters**
- **Provide education on financial and business fundamentals**

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1 CULTIVATE PRIDE OF OWNERSHIP: TELL BOTH THE FAMILY AND BUSINESS STORIES

Storytelling is an effective tool for instilling a sense of pride in the next generation. Tell the story of the business creation, the founder's vision, the values demonstrated in sustaining the business for future generations, and its community impact. Storytelling can be a connective tissue between generations, and keeping these stories alive in the minds of each family member is a reminder that the business has a heritage worth preserving.

It can also be beneficial to document the story of the family and business stories for posterity. Authors Phyllis M. Cowan and Paul D. Milne articulate the case for doing so:

> **[Family business histories] should be written for many reasons — to reveal to today's generation the values of earlier generations, to inspire, to inform, as a source of pride for the family and employees of the business, and most importantly as a diagnostic tool… A business history, like a medical history, assesses current status as well as past experiences and places this information within a family context by which symptoms can be interpreted, conditions diagnosed and solutions developed.[5]**

Additionally, Cowan and Milne go on to say:

> **[A family business history is] extremely useful in the succession planning process. As well as being a diagnostic tool, it is also an assessment tool for identification of critical success factors for the family business. For example, as a business history unfolds it can help family members and consultants determine core values, leadership and management styles, conflict resolution, decision-making processes, and external relationships such as those with customers, professional advisors and business relationships.**

Family businesses rarely enjoy a straight line to success. Documenting failures as well as successes — the high and low moments in the timeline — is a way to communicate to upcoming generations that success comes in fits and starts. Honest narratives normalize the business cycle and provide a strong message that perfection is not possible, while also illustrating how the business evolved to meet challenges.[6]

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5 Cowan, Phyllis M., and Paul D. Milne. "The Family Business History—A Catalyst to a Successful Succession Plan." *Simpson Wigle*, 1997.

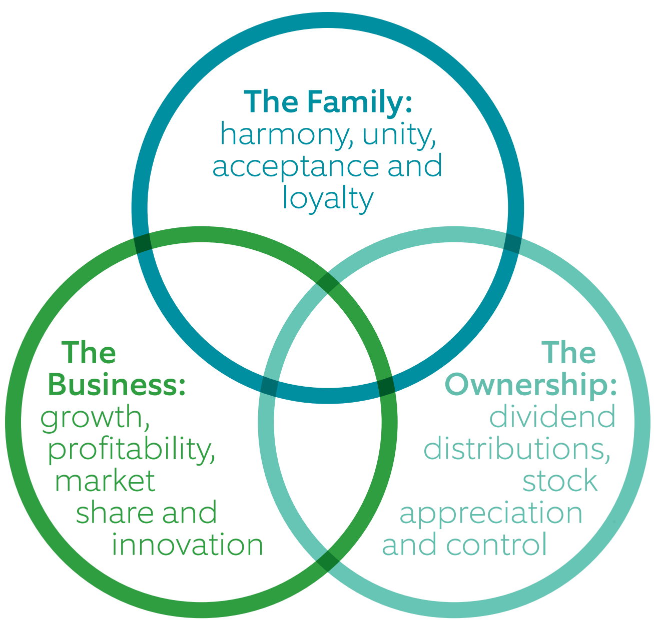
6 *Ibid. 6.*

2 EXPOSE THE RISING GENERATION TO WHAT THE FAMILY BUSINESS DOES AND HOW IT WORKS

Another best practice is to create opportunities for the rising generation to learn about the business. Touring the facilities, shadowing executives, mentorship programs, summer jobs and internship opportunities are all learning experiences that can help determine who is interested in and wants to someday enter the business.[7] Emphasizing legacy and cultivating interest from the rising generation allows for a pipeline of future leaders and a greater appreciation of the benefits and responsibilities that come with being a business-owning family.

3 DEFINE ROLES WITHIN THE FAMILY BUSINESS AND EDUCATE FAMILY MEMBERS ABOUT THE ROLES

Not every family member will serve as management or an employee in a family business, but that does not mean other family members do not have a role. Harvard University professors Renato Tagiuri and John Davis created the Three-Circle Model of the Family Business system in the late '70s. We have found that priorities in each area include:



These separate, and sometimes competing, priorities can create tensions for all of the stakeholders. And those problems can be complicated by generational differences and different life experiences. Understanding these systems, and clarifying the roles and responsibilities of family members who are part of the model, can help alleviate tension.

7 Schuman, Amy. "Successful Ownership Transitions Rest on Strong, Knowledgeable Shareholders." *The Family Business Consulting Group*, www.thefbcg.com/.

Family members should determine and advance their shared values and vision and be aware of how the values and vision are reflected in the family business. It is also important to **understand the importance of communication**, **know how to positively resolve conflict** and create a framework for **decision-making — or family governance**. Effective decisions will have to be made to successfully navigate both the family and the business over multiple generations.

Business roles and responsibilities need to be clearly defined. What are the roles and responsibilities of management? Are there job descriptions and policies for employment? What kind of reporting does management provide to owners and family members, and how often? Is there a liaison between management and the family? These are important questions to ask and resolve if there is to be sufficient transparency to ward off concerns about trust.

Owners need to know their rights and responsibilities. Responsibilities include preparing for and attending shareholder/owner meetings; reading financial statements; understanding the challenges of business management; and familiarizing oneself with the duties of management. If the family member's only interest as an owner is economic benefit, issues around compensation can create division between those family members working in the business and those who do not work in the business.

Similarly, it is important to educate family members who are not working or managing the business about what it means to be an owner. As Craig E. Aronoff, Ph.D. and John L. Ward, Ph.D. state in *Family Business Ownership: How to Be an Effective Shareholder*:

> **When you prepare yourself to be a good owner, you are creating the opportunity for yourself to contribute. You are finding the way to earn what you own by being a good steward of it — preserving and building it for the next generation, for employees, and for the community.**[8]

Family, Business and **Owners** need to coordinate and collaborate. Does the family business have a governing board? If so, it will be important to educate the family about how directors are appointed, who is eligible to serve, and what qualifications are required to be on the board. What are the duties of the board members, and what kind of accountability will be required of a board member? How will the board communicate with owners and the family? Understanding how the board works and who can serve is another way to increase transparency and trust within family systems.

The bottom line is that **role clarity**, **transparency**, **communication** and **education** are key ingredients for transition success.

8 Aronoff, Craig E., and John L. Ward. *Family Business Ownership: How to Be an Effective Shareholder*. Palgrave Macmillan, 2011. Entrepreneur Magazine, Jan. 2014.

4 DETERMINE AND COMMUNICATE FAMILY EMPLOYMENT PARAMETERS

Not every family member who has an interest in the business is competent to work in the business. Nor does every family business have the right employment opportunity for the skill set of the family applicant. Early on, families need to determine if every family member is entitled to a place in the family business or if the business will only hire family members when the business has a position that needs filling for its benefit. Is this a "family first" business, a "business first" business, or something in-between? Most families with whom we have worked do not make employment decisions solely on the basis of the family name. Instead, they make it clear that the business will hire based on its business needs. Additionally, they often clarify family employment expectations by creating a family employment policy. This type of policy can help make it clear that there are objective criteria for applicants to meet. It can also mitigate some of the intense emotions that swirl around family members with unrealistic assessments of their progeny's competence relating to specific jobs.

5 EDUCATE ON FINANCIAL AND BUSINESS FUNDAMENTALS

It is also critical that family members understand financial and business fundamental concepts. Financial literacy in the United States today is abysmal.[9] But understanding basic financial concepts is necessary for both personal and business-owning families' financial decision-making. Family members need this knowledge to understand the financial history of the business, its current health, and its potential for future growth. Failure to educate family members on business fundamentals can lead to misunderstandings about dividend distributions, compensation, operating reserves, valuations and more. A knowledgeable shareholder/owner is far less likely to disrupt a family business with unrealistic expectations about the economic benefits associated with ownership.

Spending time educating the next generation about financial and business concepts does not have to be a mere information session. Developing money managing skills can begin early with piggy banks that have dividers for spending, saving and sharing. Providing opportunities to learn experientially — even the old-fashioned lemonade stand — can be a creative way to teach concepts such as cost of goods sold, marketing, sales, revenue, and expenses and profit.

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9 Pelletier, John. 2017 *National Report Card on State Efforts to Improve Financial Literacy in High Schools*. Champlain College, *2017, 2017 National Report Card on State Efforts to Improve Financial Literacy in High Schools*.; "2017 Consumer Financial Literacy Survey." NFCC, BECU, 2017, www.nfcc.org/clientimpact/2017-financial-literacy-survey/.

EXPERIENTIAL LEARNING

In this example of experiential learning under Dr. Charlotte Lamp's Eddy Academy education program, one family draws from the Junior Achievement idea of starting a company in order to understand business concepts. The family has started a refrigerator magnet company, built birdhouses, and painted canvas bags.

Before the annual family gathering, the four oldest members of Eddy Academy are deemed CEO, CFO, COO and HRO. During their meeting time, the four adolescent officers guide a discussion, lead a vote for their company name and divide up the younger children into production and sales teams. Under the watchful eyes of the company officers (and adult supervisors), production occurs. That evening, the young company officers oversee their teams as they either sell or auction off their wares. The next morning, Eddy Academy meets to count their earnings, figure out their profit and choose the charity that will receive it. They then prepare a presentation to their stakeholders (the adults of the family).[10]

As the next generation ages, they should take opportunities to attend seminars or camps on entrepreneurship, or short-term university programs tailored to family businesses. There are many resources for families to create an education program that spans age groups, from the very young to young adults. It just takes intentionality and commitment.[11]

10 Lamp, Charlotte E. "Building a Family Curriculum." *Family Business Magazine*, 2012.

11 Godfrey, Joline. *Raising Financially Fit Kids.* Ten Speed Press, 2013.; *Financial Education Ages 5 to 8*. Northern Trust, 2018, *Financial Education Ages 5 to 8*.; *Financial Education Ages 9 to 12*. Northern Trust, 2018, *Financial Education Ages 9 to 12*.; *Financial Education Ages 13 to 16*. Northern Trust, 2018, *Financial Education Ages 13 to 16*.

SECOND CHALLENGE:
LEADERSHIP HAS NOT THOUGHTFULLY PLANNED OR PREPARED FOR THE LEADERSHIP TRANSITION

Most family business owners would agree that succession planning is a top priority, yet only about 40% of family businesses actually have a succession plan in place.[12] There are often multiple reasons that plans are not created:

- **It is hard for the founder to even contemplate letting go and leaving the business**
- **The founder is unclear of what their next life chapter will be**
- **No qualified successor has been identified and prepared**

1 IT IS HARD FOR THE FOUNDER TO EVEN CONTEMPLATE LETTING GO AND LEAVING THE BUSINESS

If this is a transition from the founding generation (G1) to the next generation (G2), it is not unusual for the founder to find it difficult to let go. After all, this is their creation, and it has consumed their time and energy for many years. Oftentimes, the family business is the alter ego of its founder — and without it, the founder is set adrift without a focus or alternative passion to occupy their time. "Who will I be without the business?" or "Will I become obsolete or not needed?" are common refrains for transitioning founders. Fear about what stepping down will mean — what the next chapter of life will hold — could cause the founder to avoid addressing succession at all, or cling to the belief that the business cannot be sustained without their leadership.

Suggestion: When considering the impact of not letting go, founders should think about succession planning from the perspective of the next generation. A relay race metaphor can prove instructive. It may be that the race has been well-rehearsed and well-planned, but as the next generation reaches out to receive the baton, the other runner won't let go. Or think about the same relay race in which the baton is handed off — but after receiving the baton, the runner finds it too difficult to maintain control and the baton is dropped. Consequently, they are never able to establish control, and they simply quit the race. In either case, the race is lost. Letting go and ensuring control is handed to the next generation is not easy, but it is necessary to ensure a successful transition.

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12 "Perspectives on Family-Owned Businesses Governance and Succession Planning." *Deloitte*, 2013, www2.deloitte.com.

2 THE FOUNDER IS UNCLEAR OF WHAT THEIR NEXT LIFE CHAPTER WILL BE

Most family business leaders like what they do. They enjoy the prestige and perks that come with the job. With lifespans increasing, many family business leaders realize that the old paradigm of retiring at 60 or 65 is changing. They may live well into their 90s, so the push to step down does not seem as pressing.

But what about the next generation? If the retirement age is extended even further, what is the incentive for the next generation, who may be in their 60s, to wait for the baton pass? As Dennis Jaffe notes in his article, *Stepping Up: What Family Business Leaders Can Do After They Step Down*:

> **Witness the painful place in the family hierarchy of Prince Charles as his mother continues to serve the U.K. admirably and his children come into their own. This middle-generation dilemma of endless waiting arises in too many family businesses. The rising generation is ready with new ideas and youthful energy. If they have to wait too long, the most talented will seek opportunities elsewhere.**[13]

Suggestion: The business leader will need to reflect on what the next chapter of life will look like if there is to be a stepping down to allow the next generation to step up. It is doubtful that the next chapter is only spent on a golf course, in a spa, or in travel. On the contrary, most retiring executives will want to occupy their minds and use their energy, talents, skills and experience in some new endeavor, whether it is in working with the family investments, family philanthropy, mentoring of next generation members, serving on other boards, or even starting another business. Surfacing this important aspect of succession — what comes next — is an important issue to address if succession is to succeed.

3 NO SUCCESSOR IDENTIFIED OR QUALIFIED

Even if the founder is ready to step down, it is sometimes difficult to find a qualified family successor. Or, the founder may not believe that there *is* a qualified successor. Sometimes, the question of whether or not there is an appropriate successor is impacted by the founder not being willing to recognize management potential because it would mean letting go.

Regardless of the reasons, failure to plan is a plan to fail. Successors are not born; they are made. As business journalist Leah Golob writes:

> **In successful transition cases, the next generation is not parachuted into a top position. It's important for successors to learn the ropes and learn all aspects of the business. The business should create guiding principles outlining requisite education and experience before making offers of employment.**[14]

13 Jaffe, Dennis. "Stepping Up: What Family Business Leaders Can Do After They Step Down." *Forbes*, Forbes Magazine, 15 Nov. 2018, www.forbes.com.

14 Golob, Leah. "Ten Reasons Why Family Businesses Fail." *The Globe and Mail*, 20 July 2012, www.theglobeandmail.com. Updated 3 March 2018

Suggestion: A succession plan is a roadmap for identifying and selecting a successor, mentoring, and allowing practice opportunities to lead. It is a process that is multi-layered and requires input not just from the controlling generation but from the other stakeholders in the business — family, shareholders/owners and board members. Taking the time to delineate how the successor will be chosen is a process that builds buy-in and better, healthier relationships. In the event that such a process is not practical, then transparency as to why a particular individual is tapped for leadership is critical for acceptance. Often, for example, siblings may at first be disgruntled or envious of another sibling who is chosen to lead. But after receiving further information and reflection about the reasons, they may be mollified or even relieved that their sibling is willing to act in a leadership role.

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The process of developing talent for the future is a task that, left undone, can lead to adverse consequences for the business and family. This is particularly true if the transition occurs suddenly due to death or disability of the business leader. When a leader unexpectedly dies or becomes disabled, decisions are made in crisis, which can lead to serious business disruption and family disharmony. Being proactive about creating a process to identify future leaders — and preparing for transition long before the event — can mitigate negative results. Business leaders can take comfort in recognizing that transition planning is a process and not an event. Remember: Just because you are engaged in the planning does not mean the implementation occurs immediately.

CONCLUSION

Creating and sustaining a family business over multiple generations is not an easy task. The family has to recognize daunting statistics that indicate a high failure rate in transitioning the family business to the third generation — again, a mere 12% successfully make the transition. Certainly, family dynamics, challenges specific to the business, market conditions and many other factors can make it difficult to effectively transition. However challenging it is to continue a family business, though, there are ways to best position the family and the business for ongoing success. Embarking on an intentional process of preparing the heirs, and creating a roadmap for succession, will increase the chances of the family and the business continuing to succeed in the years — and generations — to come.

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