WILL YOUR FAMILY BUSINESS SURVIVE THE NEXT GENERATION?

Did you know that only one-in-four family businesses make it to the second generation, and only one-in-eighteen make it to the third generation?[1.] Those are not very high odds. So, why is the failure rate so high, and what can be done to increase your chances of success?

Admittedly, within those failure rates is the general failure rate for small businesses. 62.7% of small businesses fail within six years.[2.] The number of businesses failing increased by 61.3% from 1990 through 1991 alone.[3] Most family-owned businesses can be grouped as either small or medium-sized businesses, say from $1 million to $80 million in annual sales.

As with small business failures in general, family-owned businesses that do not survive the next generation fail because of poor planning, poor preparation, and a lack of separation between ownership and management. As an example, a family owned business I have known had always made a profit. The business had 16 million in annual sales and was the dominant California company in its market that was and still is growing. The company had been passed down from the father to his two sons. This company should have been an excellent prospect for a new banking relationship. However, the firm was not considered a good risk. Why? Because the father had neglected the sons' two very different personalities and competency levels, and he had not separated their ownership from management. Each son managed a different part of the company. Both were in total disagreement and did not cooperate with each other, and each respective department actually worked against the other. The firm still made a profit! Banks seeing the internal management conflicts between the two brothers/owners feared the eventual undermining of the company and refused to extend any credit to the firm.

Transition questions can be summarized as how to plan, when to plan, and how to divide the firm among several heirs. Transition planning consists of clarifying and documenting the company's mission; choosing and working with an outside, neutral consultant; developing a written business plan; training any prospective management heirs; and tax planning. This type of planning will greatly increase the company's chances of successfully passing into the next generation. It is important that such planning work be done long before it is expected to be needed. If the current owner is in poor or deteriorating health, such planning should be done as soon as possible. If a scheduled retirement is a factor, beginning such planning ten years before such retirement is not too early. Some family business owners have a concern about doing transition planning early for fear that such plans will be outdated when used. All plans are subject to change, but the basic work necessary to create the plan in the first place will have been done. It is much easier to change or modify an existing plan than to create one. Planning early also allows for a testing or trial period, when appropriate, for potential management heirs within the company.

The first step in the transition planning process is choosing an outside advisor or consultant who can help organize the process, brainstorm with the owner, research needed information, give anobjective viewpoint, and help family members reach agreement and avoid anticipated or real conflicts.

The next step is writing a formal Mission Statement for the firm and having the heirs sign it. The owner may already be quite clear on the mission of the firm, but the heirs may not be and may not be in agreement with each other. The success and strategy of other planning will depend on this step.

Developing a formal Business Plan is the third step. The process of developing a business plan forces the company to organize work flow and information tools and clarify each key functional position within the firm. The financial, equipment, inventory, and people needs necessary for the firm to grow and change successfully over the next several years will also be identified. Small Business Administration data clearly indicate that businesses that do not grow fail at a much higher rate than those that do.

The fourth step involves identifying who will inherit the business and what role, if any, they will play in its management. Only those family members who show strong maturity, judgment, and leadership qualities should be planned for management. They should be brought into the business at an early date to be trained and tested. If a family member doesn't work out, there is then still time for change. It is possible that no family members are qualified for future management. In that case, outside professional management can be sought and hired and the family members can still retain control and maximize benefits through stock ownership. Some family members, while not qualified for management, may wish to work in some non management function within the firm. Family members who are to inherit the firm can receive money in ways other than working for a salary in the firm or participating in active control over the firm (officer, board of directors). Such other means of compensation will depend on how the firm is organized: as a corporation or partnership if more than one owner.

The last step is tax planning. For this step, the business owner should consult a good tax attorney. It may be to the tax advantage of the family for heirs to acquire ownership stock through gifts over a period of years or for the business owner to lend the heirs the money to buy stock. It may be important for heirs to specifically limit spousal ownership through legal agreements. Incorporation for purposes of stock as well as protection from liabilities of the company may be advantageous.

Perhaps the most important immediate benefit from careful business transition planning is the owner's piece of mind in knowing important issues have been settled and everything has been done to ensure the successful continuance of the business.

1. Recent interview on CNBC (the television business channel)
2. Small Business Administration (SBA)
3. SBA

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