Steve Leimberg's Business Entities Email Newsletter - Archive Message #148

Date: **12-Nov-14**
From: **Steve Leimberg's Business Entities Newsletter**
Subject: **Avi Z. Kestenbaum & the Family Business Succession Planning Crisis: A Call to Action**

"We all know about it. We all read about it. Yet, are we as estate planners really aware of the true reasons that the vast majority of family businesses do not successfully transition through the generations and why the few that have effectively transitioned were able to defy the odds?

The statistics are shocking and sobering. Very few family businesses successfully transition to the next generations. Estate planners may be unaware of the true reasons for this and therefore may be unable to properly help our clients. What good is our planning and documents if the family business fails?

We need to understand the reasons for the dismal statistics and learn from the family businesses that have flourished through more than one generation. There should also be much more learning and education on this subject especially as over the next several years many businesses are being transitioned. This commentary is an important call to action in a complicated and critical area that hasn't received enough of our focus."

Avi Z. Kestenbaum provides members with commentary he refers to as "a call to action" in a complicated and critical area that he believes hasn't received sufficient attention.

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Martha Hurtado Oliveros provided invaluable research and writing assistance and this article would not have been completed without her contribution. Martha graduated from Marquette University with a B.A. in International Affairs. Martha is originally from Peru and is currently in her third year of law school at the Benjamin N. Cardozo School of Law. She worked as summer associate at **Meltzer Lippe** this past summer and her interests include corporate law, intellectual property, business immigration, and international law.

Before we get to Avi's commentary, members should take note of the fact that a new **60 Second Planner** by **Bob Keebler** was recently posted to the **LISI** home page. In his commentary, Bob reports on the approaching deadline for late portability filings under Rev. Proc. 2014-18. To obtain relief under the Rev. Proc., Form 706 must be filed by December 31, 2014. You don't need any special equipment to listen - just click on this link.

Now, here is Avi Z. Kestenbaum's commentary:

EXECUTIVE SUMMARY:

The statistics are shocking and sobering. Very few family businesses successfully transition to the next generations. Estate planners may be unaware of the true reasons for this and therefore may be unable to properly help our clients. What good is our planning and documents if the family business fails?

We need to understand the reasons for the dismal statistics and learn from the family businesses that have flourished through more than one generation. There should also be much more learning and education on this subject especially as over the next several years many businesses are being transitioned. This commentary is an important call to action in a complicated and critical area that hasn't received enough of our focus.

COMMENT:

We all know about it. We all read about it. Yet, are we as estate planners really aware of the true reasons that the vast majority of family businesses do not successfully transition through the generations and why the few that have effectively transitioned were able to defy the odds? Put more directly, what good are our sophisticated planning and technical documents if the very source of the family's wealth (which often times is also the family symbol, pride and legacy) disintegrates?

Only 30% of family businesses successfully pass to the 2nd generation, 12% to the 3rd generation, and 3% to the 4th generation.[1] In almost all instances this failure is not due to lack of tax planning or imposition of taxes. The analysis of family business succession failures indicate that of typical breakdowns of family businesses: 1) 60% arise from relationship issues (how they get along); 2) 25% from lack of competence and being unprepared; and 3) only 10% due to tax and traditional estate planning issues.[2] If our role as estate planners is to help our clients protect and preserve their assets, we must ask ourselves why are the statistics so dismal and what are the possible solutions?

There are natural and inherent conflicts between family and business. They include:

- families value tradition and resist change while businesses succeed and grow during changing times;
- families are emotional while businesses are logical;
- families seek equal treatment and rewards while businesses reward based on performance and responsibility; and
- families accept members unconditionally while businesses rank employees and fire those who are not productive.[3]

The senior generation often times must balance the competing goals of securing the future success of the family business with family unity and well-being and often times trying to accomplish both objectives leads to worse results and neither goal being fulfilled. This is a very difficult and emotional decision and many of our clients are torn between doing what is best for the future of the business and upsetting some or all of their family members. Is the senior generation most concerned about the business, a specific child, doing what is best majority of his children, the children in the business, the employees, or following his morals and beliefs? What about grandchildren, future generations, charities, social good, and his or her legacy? There are no simple answers, and with many competing interests some family members will inevitably be distraught no matter the ultimate decision and a family war may ensue. This issue is so critical that 85% of the crisis faced by family businesses focus around the issue of succession.[4]

The succession crisis not only impacts families and companies, but also the national economy. More than 90% of all U.S. businesses are considered family businesses.[5] Over 150 of Fortune 500 companies are family businesses.[6] In the United States alone, family owned businesses are responsible for 60% of total employment and generate 78% of all new jobs. [7]

To further complicate matters and highlight the current crisis, according to a 2007 survey, 40.3% of business owners expected to retire in 10 years. Of the business owners expecting to retire in 5 years, less than half (45%) had selected a successor. For those expecting to retire in 6-11 years, only 29% had selected a successor and 30.5% of business owners had no plans to ever retire (essentially planning to die in office!).[8]

Most of the succession issues are unique to family businesses and have little application to other assets. Cash and brokerage accounts are easy to divide among the heirs or in trusts for their benefit. Real estate can sometimes be divided through different parcels, or as a mostly passive asset, can sometimes (albeit with difficulty and often times there are also major family disputes) be held together many years for the family's benefit through a family management committee or with outside management companies. In contrast, operating businesses cannot generally be divided and must be very actively managed to stay current and profitable.

Successful Family Businesses

Estate planners can learn valuable information and lessons from family businesses that have successfully transitioned through the generations. While this knowledge is generally outside the purview of most estate planners, it must become part of our studies and education or else we will inevitably fall short in helping business owners.

Outlined below are the most common characteristics shared by family businesses that have been successfully passed down more than one generation:

- Positive Family Business Image[9]
- Code of Shared Values[10]
- Entrepreneurial Risk Taking Through the Generations[11]
- Investment in Human Capital[12]
- Market Niches[13]
- Self-imposed Capital Restraint in Second and Third Generations[14]
- Commitment to Charity and Community Development[15]
- Family Unity[16]
- Commitment to Legacy [17]
- Written System of Governance and Conflict Management[18]

Positive Family Business Image

A family run business image gives an identity to the business that sets it apart from corporate conglomerates. Most successful family businesses use their image and reputation as a "family-firm" to gain a competitive advantage and exploit an established position in the market. A positive family image may be portrayed through the use of the family name as the business name, the maintenance of a coherent brand, and the advertisement of consistency through the generations.[19] In fact, a recent study has found a direct correlation between a positive family business image and the business' performance.[20] A family business image also incentivizes future generations to uphold the "good name" of the family through the success of the company.[21] Furthermore, a positive image and reputation in the market allows the business to charge premium prices, attract better job applicants, and provide better access to capital markets.[22] Examples of multi-generational American family businesses that have named the company after the family's name include Perdue Farms, founded by Arthur Perdue in 1920, S.C. Johnson, founded by Samuel Curtis Johnson in 1886, the Kohler Company, founded by John Michael Kohler in 1873, and Mars, Inc, founded by Frank C. Mars in 1920.

Code of Shared Values

The successful family business tends to adopt the family's values as the business's values. An interview with the CEOs of some of the oldest and most successful family businesses in America revealed that at the core of their business is upholding a particular family value.[23] Among those interviewed were Thomas M. Belk Jr., CEO and Chairman of Belk, which was founded by his grandfather in 1888, Tom Gilbane, CEO of Gilbane Construction Company, founded by his great grandfather in 1873 and Jim Perdue, CEO and Chairman of Perdue, founded by his grandfather in 1920. The most common values at the core of these businesses are a commitment to the quality of their products, the good treatment of their employees and customers, and the commitment to act with integrity above all.[24]

Entrepreneurial Risk Taking Through the Generations

Family businesses are generally thought to be risk adverse organizations in terms of their strategy for financial investment and business expansion because most aim to protect their legacy for future generations and share a strong sense of commitment to their employees.[25] However, among the oldest and most successful family businesses, higher levels of risk taking behaviors are positively related to business growth. [26] In fact, approximately 42% of second generation family businesses agree that they take on more risks than non-family businesses.[27] Nevertheless, the way family businesses approach risks differs from how non-family businesses approach risks as family businesses are less concerned with short term gains and quarterly earnings and have a more far sighted vision taking on risks that aim to achieve long-term goals.[28]

Unfortunately, it is not always common for second and third generation successors to have the same risk taking behaviors or to share the entrepreneurial spirit of the founding generation. Whether potential successors will have the required entrepreneurial instincts and "knack for innovation" is one of the top concerns of the senior generation.[29] This is one of the reasons that family businesses are increasingly hiring outside management. A recent survey of American family businesses that expect to pass on the ownership of the businesses to the next generation revealed that 24% of them plan to hire outside management to run the company and to only pass ownership of the company to the next generation.[30] Many of the oldest family businesses tend to take on a combined approach not only investing in their heirs' human capital, but also incorporating non-family leaders in top management positions when appropriate.[31]

Investment in Human Capital

Successful family businesses share a commitment to investing in future family member successors from very early on through lessons taught at the kitchen table and work experience within the family business, as well as through university and outside professional experience.[32] Approximately 76% of current family business owners intend to pass on their family business to the next generation. [33] Therefore, it is not surprising that successful family businesses usually train their successors from an early age and in all areas of the business. Family business successors also tend to work longer at the companies before becoming the leaders there.[34] The tenure for family business leaders ranges from a decade to 30 or 40 years, significantly longer than leaders in non-family businesses.[35] Further, studies have shown that family business transitions are smoother when heirs are well-prepared, although it is interesting to note that smoother transitions do not necessarily result in better post-transition performance. [36]

Market Niches

Approximately 20% of family businesses that have survived beyond 60 years were able to do so in large part because they were in a protected market niche, where they were relatively unaffected by rapid changes of technology and where the consumers and competitors did not change.[37] A study showed that family businesses around the world that have survived for over 200 years share the fact that their products were all connected to basic needs, such as food items and products relating to house cleaning and maintenance.[38] The success of these family businesses is not based solely on the fact that they provide basic products; it is because in those niche markets, family businesses are able to take advantage of their unique characteristics including their long established industry relations.[39] Further, the ability to build specialized knowledge or collective memory of the market is most valuable in these niche markets.[40]

Self-Imposed Capital Restraint in Second and Third Generations

It is usual for businesses to be capitally constrained at its initial stages, but these constraints tend to lessen as the business matures. In contrast, most successful family businesses continue to operate under a self-imposed capital restraint during the second and sometimes third generations. They tend to grow at a slow pace for long periods of time with little external capital and high debt aversion.[41] For non-family businesses slower growth puts the business at a disadvantage with their competition. However, in the case of family businesses, many case studies show that the discipline involved in operating while capitally constrained is a great source of business focus, motivation, and creative strategy selection.[42] Thus, in the second and third generations, family businesses tend to invest in less-capital intensive strategies, with lower risks and often based on intangible elements such as reputation, quality, and brand recognition.[43] Approximately, 82% of U.S. family businesses aim for steady growth while only 11% expect to grow quickly and aggressively over the next five years.[44] Similarly, long established family businesses often have experience with financial cycles and tend to maintain optimal investment levels rather than cut back during industry downturns, giving them a strategic advantage over their non-family business competitors.

Commitment to Charity

The most successful multi-generational family businesses share a commitment to charity and community development.[45] Interviews with the CEO's of H.J. Heinz and S.C. Johnson - two of the most famous American family businesses that have been successfully passed down through the generations - revealed that both of their current CEOs continue a "legacy of philanthropic activism" and "commitment to both the products sold and their community."[46] Since 1915, the Heinz Company has founded and contributed to different foundations, notably one of them devoted to after-school activities for children,[47] and since inception, S.C. Johnson has committed to community development programs focused primarily on programs that help young people.[48]

Family Unity

Family unity is one of the most essential traits in successful family businesses.[49] Unity in the family is achieved through a combination of several possible means, including: having a shared vision and expectation for the family and the family business; cooperation in regular family meetings; commitment to continuing the family business legacy; and the desire to portray a positive family business image. While plans for succession and business strategy are important, successful family businesses are able to survive only if there is continuity in the family's vision and mission for the business. Successful family businesses "not only have to perpetuate a strong business over a long period of time, but have to keep the family strong and solid over a long period of time as well."[50] Adopting company and family mission statements can also help with family unity.

Commitment to Legacy

79% of senior generation business owners want their families to retain the family business and 70% of the next generation has the same hope.[51] A key factor to the success of multi-generational family businesses is a strong commitment to the family's purpose, future, the business, and the continuity of business ownership in the family.[52] This is highly related to investing in human capital and preparing the family member successors from early on.

Written System of Governance and Conflict Management

Studies indicate that 60% of failed family business successions arise from relationship issues.[53] Two of the most prevalent and effective ways to deal with communication problems in long-lasting family businesses are the formation of an independent board of directors and having regular family meetings.[54]

Family businesses that have independent boards tend to grow faster.[55] Independent boards may be comprised of family members, key non-family employees and non-family directors with no vested capital interest in the company.[56] This type of independent board allows directors (both family and non-family) to meet and discuss important business aspects for the future of the business.

Similarly, regular family meetings allow family members to create processes, policies and share expectations for the family, as well as for the business. While some policies might be liberal (e.g., leeway with charitable and social causes) and others restrictive (e.g., limiting management positions for family members only to those with years of outside experience and an MBA or equivalent degree), regular family meetings allow families to work on policies, reach consensus and articulate rules by which to deal with conflicts within the family.[57] This is also related to implementing a family code of shared values, which tends to minimize family conflicts because it provides a shared vision of business goals and implied rules concerning how to achieve those goals.[58]

The results of a 2012 survey of 1000 corporate directors around the globe by Harvard Business Review found that 75% of family owned businesses' directors held advanced degrees, which was approximately the same percentage (77%) as non-family owned businesses.[59] Family and non-family business directors had also served on an almost identical number of boards in their careers (5.8 and 6.0, respectively) and were currently serving on the same number of boards (3.1). [60]

Monarchy or Shared Leadership

Historically, long lasting family businesses have passed down leadership of the company to only one individual in each generation similar to a monarchy.[61] However, today, approximately, one-quarter of the family businesses in the United

States that are expected to pass to the next generation will bring in outside management to run the company, though the family (or trusts for their benefit) will still own the company.[62] Studies also show that sibling rivalry is a common and serious problem in succession planning for the family business and the parent/owner may even delay planning to avoid favoring one child over the other.[63] Further, sibling teams in shared CEO positions do not tend to work as well as a single CEO.[64] In fact, it is rare for teams of sibling or cousins to share the position of CEO and more often, they function as part of a top-management team under the leadership of a Chief Operating Officer or CEO.[65] For example, at the J.M. Smucker Company, which has been successfully passed down through five generations, Mark Smucker and his cousin Paul Smucker manage different departments, and then report to a non-family COO, who then reports to the family CEO.[66] There are also various other structures that encompass two management boards - family and non-family. The non-family board manages the company (though a deserving family member may be permitted on this board depending on the system of governance) and the family board may have an input with major decisions and with social and charitable causes.

Conclusion

As estate planners, we must wake up and do a better job of becoming educated on the subject of business succession planning to understand what works and what doesn't and why. The tax structuring and trust planning has little value if the business fails.

To accomplish this, there must be much more emphasis, instruction and seminars in our field in conjunction with outside experts and increased learning on these topics. Without this focus, the strong likelihood is that our clients' businesses, which they worked so tirelessly and passionately to start and grow, will be included in the sobering statistics of failures. Let's please unite as estate planners, problem solvers and legal caregivers to our clients and to their businesses, and figure out how to better address these important issues as there seems to be a substantial gap in our knowledge and effectiveness in this area.

Note that the author is now working on a follow-up newsletter, which will provide helpful and practical tips and tools to practitioners on how to guide their business owners' clients who are confronted and struggling with the sensitive and emotional issues of passing their businesses to the next generations. That commentary will be completed in a few months. Stay tuned.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Avi Z. Kestenbaum

CITE AS:

CITATIONS:

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[3] Gerald LeVan, *Keeping the Family in the Business: Estate Planning May Not Be Enough*, Prob. & Prop., vol. 2 at 28-31 (1988).

[4] Fox, *supra* note 1, at 2011.

[5] *Id*. at 2012.

[6] *Id*.

[7] Boris Groysberg and Deborah Bell, *Generation to Generation: How to Save the Family Business*, Harv. Bus. Rev. Blog (April 10, 2014; 10:00 AM), http://blogs.hbr.org/2014/04/generation-to-generation-how-to-save-the-family-business/.

[8] Fox, *supra* note 1, at 2011-12.

[9] Esra Memili, et al., *The Importance of Looking Toward the Future and Building on the Past: Entrepreneurial Risk Taking and Image in Family Firms, in* Entrepreneurship and Family Businesses 3, 4-5 (Alex Stewart et al. eds., 2010).

[10] Randell S. Carlock & John L. Ward, When Families are Best: The Parallel Planning Process for Family Harmony and Business Success 81-82 (Palgrave Macmillan, 2010).

[11] Memili, et al., *supra* note 8, at 17.

[12] Carlock, *supra* note 9, at 123-127.

[13] John Ward, Perpetuating the Family Business: 50 Lessons learned from Long Lasting Successful Families in Business 6-7 (2004).

[14]John Ward, *Unconventional Strategy: Why Family Firms Outperform*, Unconventional Wisdom: Counterintuitive insights for family business success 13, 20-21 (John Ward ed., 2005).

[15] William T. O'Hara, Centuries of Success: Lessons from the World's Most Enduring Family Businesses 318 (Adams Media Corp., 2003).

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *See* Memili, et al., *supra* note 8, at 7-8.

[20] *Id.* at 17.

[21] *Id.* at 8.

[22] *Id*.

[23] *See* Sean Eichenberger, *The Best Family Businesses*, Forbes, (June 17, 2011, 03:00 PM), http://www.forbes.com/2011/06/17/best-family-businesses.html.

[24] *Id.*

[25] Powerhouse Coopers LLP, *PwC Family Businesses Survey 2012/2013*, at 4, http://www.pwc.com/us/en/private-company-services/publications/assets/pwc-family-business-survey-us-report.pdf (last visited Oct.15, 2014).

[26] Memili, et al., *supra* note 8, at 17.

[27] Powerhouse, *supra* note 24, at 4.

[28] *Id.* at 4-5.

[29] *Id.* at 3.

[30] *Id.* at 17.

[31] *See* Stacy Perman, *Centuries-Old Family Business Share Their Secrets*, Bloomberg Businessweek (May 14, 2008), http://www.businessweek.com/stories/2008-05-14/centuries-old-family-businesses-share-their-secretsbusinessweek-business-news-stock-market-and-financial-advice.

[32] Carlock, *supra* note 9, at 123-127.

[33] Powerhouse, *supra* note 24, at 17.

[34] Joachim Schwass, *Understanding the Successor's Challenges,* Unconventional Wisdom: Counterintuitive Insights for Family Business Success 77, 80 (John Ward ed., 2005).

[35] *Id*.

[36] Alfredo De Massis et al., Family Business Studies: An Annotated Bibliography 30 (Edward Elgar Publishing 2012).

[37] Ward, *supra* note 12, at 6-7.

[38] O'Hara, *supra* note 14, at 318-319.

[39] *See* Ward, *supra* note 13, at 26-27.

[40] *Id.*

[41] *Id.* at 20.

[42] *Id.* at 21.

[43] *Id.*

[44] Powerhouse, *supra* note 24, at 7.

[45] O'Hara, *supra* note 14, at 318, 320.

[46] Stephanie Morrow, *Famous Family Businesses that have been Passed Down*, Legalzoom, Feb. 2011, https://www.legalzoom.com/articles/famous-family-businesses-that-have-been-passed-down. (Last visited Oct 16, 2014).

[47] *Id.*

[48] *Id.*

[49] O'Hara, *supra* note 14, at 318.

[50] Ward, *supra*, note 12, at 8.

[51] Allen, *supra* note 2, at 7.

[52] Ward, *supra* note 12, at 20-21.

[53] Allen, *supra* note 2, at 8.

[54] Ward, *supra* note 12, at 16.

[55] *Id.*

[56] *Id.*

[57] *Id.* at 26-27.

[58] *See* Carlock, *supra* note 9, at 208-210, 215.

[59] Groysberg, *supra* note 6.

[60] *Id*.

[61] Ward, *supra* note 12, page 7.

[62] Powerhouse, *supra* note 24, at 17.

[63] Fox, *supra* note 1, at 2019-20.

[64] Ernesto Poza & Mary S. Daugherty, Family Business 110 (4th ed. 2013).

[65] *Id.* at 156.

[66] *Id.*