COMMITTEE REPORT:
THE MODERN PRACTICE

By **Avi Z. Kestenbaum** & **Christine K. Knox**

Navigating the Discussion of Business Succession Planning

How to better address this sensitive issue with our clients

As indicated by the alarming statistics referenced later in this article, most family businesses don't successfully transition past the first generation. (See "Baby Boomer Business Owners," p. 19.) To implement the strategies used by successful businesses, we must better address how to communicate the sensitive issues involving family business succession planning in discussions with our clients.[1]

Why Family Businesses Fail

An analysis of family business succession failures reveals that the source of typical breakdowns are: (1) relationship issues (60 percent); (2) lack of competence and being unprepared (25 percent); and (3) tax and traditional estate-planning issues (only 10 percent).[2] The remaining 5 percent is from miscellaneous sources. There are natural and inherent conflicts between families and businesses. Families are emotional, while businesses are logical. Families value tradition and heritage and resist change, whereas businesses succeed during changing times by adapting and growing.[3] Generally, families accept family members unconditionally, while businesses rank employees and fire those who aren't productive. Families seek to treat and reward everyone equally, yet businesses reward employees for performance and achievement.[4] Family business succession planning is especially difficult because of the emotional and psychological complexity of family dynamics, most notably the relationship among siblings. When siblings work within the family business, sibling rivalry and jealously are heightened, particularly if one sibling reports to another sibling or if one sibling is chosen for a leadership position over another. Other times, there's conflict between siblings who work for the family business and siblings who don't. The "insider" siblings often resent the "outsider" siblings for not working in the family business (yet still being supported from the business or inheriting a piece of it), while the outsider siblings often feel left out from the working relationship the insider siblings share with their parents (and perhaps feel that the insiders received an unmerited silver spoon).

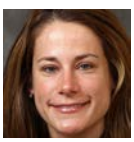
The family business owner must balance the competing goals of securing the future success of the business with family unity and happiness. In his dual role as business owner and parent, he may feel torn between doing what's best for the future of the business and upsetting some or all of his family members. Is he most concerned about the business, a specific child, doing what's best for the 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 legacy? There are no easy or simple solutions, but ignoring the issues and dismal statistics dooms planners to keep adding to the list of family business failures.

Key Characteristics

Here's a brief summary of some of the most common characteristics shared by family businesses that have been successfully passed down more than one generation:[5]

1. **Positive family business image.** Most successful family businesses use their images and reputations as "family firms" to gain competitive advantages and exploit an established position in the market.[6] A family firm image also incentivizes future generations to uphold the "good name" of the family

Avi Z. Kestenbaum is a partner, and **Christine K. Knox** is an associate, at Meltzer, Lippe, Goldstein & Breitstone, P.C., with offices on Long Island, N.Y. and in New York City. Avi is also an adjunct professor at Hofstra University School of Law in Hempstead, N.Y.



through the success of the company.[7] Examples of multi-generational American family businesses that have named the company after the family 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).

2. **Code of shared values.** Successful family businesses tend to adopt the families' values.[8] The most common values at the core of these successful businesses are a commitment to the quality of their products, the fair treatment of their employees and customers and the commitment to act with integrity, above all.[9]
3. **Entrepreneurial risk taking through the generations.** Among the oldest and most successful family businesses, higher levels of risk-taking behaviors are positively related to business growth.[10] Whereas non-family businesses take risks to achieve short-term gains and quarterly earnings, family businesses have a more far-sighted vision, taking on risks that aim to achieve long-term goals.[11] However, the second and third generations may not share the first's risk-taking behaviors, entrepreneurial spirit or knack for innovation, which is the reason family businesses are increasingly incorporating non-family leaders in top management positions when appropriate.[12]

The most successful multi-generational family businesses share a commitment to charity and community development.

4. **Investment in human capital.** Successful family businesses share a commitment to investing in future family members 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.[13]
5. **Market niches.** According to one study, two-thirds of successful family businesses that have survived beyond 60 years are in a protected market niche, where they're relatively unaffected by rapid changes in technology and consumers, and competitors don't change.[14] In these market niches, family businesses are able to take advantage of their long-established industry relations, ability to build specialized knowledge and collective memory of the market.[15]
6. **Self-imposed capital restraint in second and third generations.** Most successful family businesses operate under a self-imposed capital restraint during the second and sometimes third generations and tend to grow at a slow pace for long periods of time with little external capital and high debt aversion.[16] Thus, in 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.[17]
7. **Commitment to charity and community development.** The most successful multi-generational family businesses share a commitment to charity and community development.[18] Interviews with the CEOs 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."[19]
8. **Family unity.** While plans for succession and business strategy are important, successful family businesses are able to survive only if there's 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."[20]
9. **Commitment to legacy.** Seventy-nine percent of senior generation business owners want their families to retain the family business, and 70 percent of the next generation has the same hope.[21] A key factor to the success of multi-generational family businesses is a strong commitment to the family's purpose and future, the business and the continuity of business ownership in the family.[22]
10. **Written system of governance and conflict management.** Successful, long-lasting family businesses tend to form an independent board of directors and have regular family meetings.[23] An independent board (which may be comprised of family members, key non-family employees and non-family directors with no vested capital interest in the company) allows directors to meet and discuss important aspects for

the future of the business.[24] Regular family meetings allow family members to create processes, policies and shared expectations for the family and the business. Governance is also related to implementing a family code of shared values, which tends to minimize family conflicts by providing a shared vision of business goals and implied rules concerning how to achieve those goals.[25]

Raising Sensitive Issues

While there are no simple answers in this area, as many of us learned in law school, the key is spotting and identifying the issues so the solutions can be more easily achieved. One key concern is how we, as planners, discuss and bring up these sensitive and complicated issues with our clients, who likely aren't aware or are in denial of the poor odds of successfully passing down their businesses. Here are a few practical considerations:

1. **Be candid.** Explain to clients that the vast majority of family businesses fail, and provide literature for them to read on this topic. Also, emphasize that there will be a tremendous amount of thought and planning involved if they're to give their businesses the best chance to succeed for multiple generations. State that the process will be complex and require significant effort and time.
2. **Study and get to know the business.** While every business is unique, certain common characteristics are very helpful to give the business the best chance for long-term success. Planners will have a difficult time properly advising clients if they don't get to know the business intimately, including the key employees and family members involved, as well as the core business components and long-term goals and prospects. While this familiarity is outside the realm of what's generally viewed as "estate planning," it's vitally important. Clients will also have to be educated on the need for their estate-planning attorneys to know and understand their businesses and the additional time and expenses that will be involved.
3. **Create realistic expectations now and for the future.** Our clients might be better off selling their businesses if there's little chance of future success. At least if the business is monetized, the proceeds can be divided and future aggravation and potential family feuds can be avoided. If our clients want their businesses to last multiple generations, there will be a lot of effort and work involved without any guarantee of success, and they must understand this reality.
4. **Understand the family dynamics.** The most prevalent reason a family business fails is a family feud, so clients must open up to us regarding family members' different personalities, prior histories and relationships, as well as individual strengths and weaknesses. We should also get to know all the players personally. We may recommend bringing in a psychologist or other experts with experience handling family dynamics, especially when it comes to active businesses. Also, if the estate planner will play a role in the future, such as trustee, executor or director, it will make the future transition much easier and smoother if the entire family trusts the planner and values his services and opinion.

With business succession planning, there are many components and moving pieces involved, as well as tremendous obstacles.

5. **Learn from similar successfully transitioned businesses.** Estate planners should learn from and study the businesses that have flourished for multiple generations. We should also recommend that our clients, their family members and key employees learn from these examples along with us. In addition to other consultants, we may even invite a family member from a successful multi-generational business to share his experiences with us and our clients.
6. **Work as a team.** Due to all the complexities involved, there are many important players on this team who must work closely and trust each other. These members may include the business owner(s), family members, key employees, directors, accountants, investment and insurance advisors, estate planner, tax and corporate attorneys and, perhaps, outside consultants like business management experts and psychologists. Depending on the specific planning, executors and trustees might also play a pivotal role in the future. It makes sense to appoint a trustworthy quarterback

to coordinate the team now and for the future. Also, some of the team members might be wearing different hats at once (for example, employee, director and trustee) and owe ethical and fiduciary duties to the client, business and trust beneficiaries; it's important for each individual to understand and appreciate his role both from a legal and practical perspective.

7. **Plan early (and often).** The early bird has the greatest chance of success because it will take significant time and effort to get the plan, system of governance for the business, key employees and the family and the legal documents in place and work out any quirks and issues. This isn't deathbed planning or even regular estate planning, which often can be implemented quickly because, typically, that process involves discussions between the estate planner and his client (and perhaps the client's accountant and insurance advisor) and then preparing and signing documents. With business succession planning, there are many components and moving pieces involved, as well as tremendous obstacles.

Goodwill items bind the family and the business for a greater purpose and help with long-term success.

8. **Create mission statements for business and family.** While the tendency might be to overlook these feel-good items, business and family mission statements create and foster an environment of expectations and values. They help both family unity and the longevity of the business.
9. **Start family business meetings.** Family unity is a key ingredient, and it may take time to get the family on board with the planning and structure. Starting regular family meetings while the senior generation is still strong and can exert influence on the family members to attend gets the family meetings going in the right direction from the start and establishes a legacy of importance to these family meetings.
10. **Implement structure while the senior generation is strong and vibrant.** The family is less likely to argue in the future if the structure is already solid and working for many years while the senior generation is strong and vibrant. Once the senior generation is older, they may lack the strength to exert the necessary influence to get the family on board with the planning and structure (that is, the system of governance they're now putting into the business to deal with future issues like two boards, trusts and outside management) or to effectively deal with difficult family members.
11. **Sensitive, yet strong and decisive decisions.** Many of our clients are torn between implementing what gives the business the best chance of long-term success and hurting one or more of their children. This dichotomy is understandable, and we need to be sensitive to our clients regarding this topic, which often prevents them from doing any planning whatsoever. However, if our clients are too wishy-washy when it comes to making family business decisions and choosing future leadership, and they don't put documents into place and impose serious repercussions on family members who create problems, the business will have far less chance of success. Our clients will never be able to make every family member happy.
12. **Focus on unifying social and philanthropic themes.** These goodwill items bind the family and the business for a greater purpose and help with long-term success. Clients should devote a percentage of business profits, time and activities to these social and charitable items. This involvement creates positive feelings among family members, who can get involved at a young age.

Endnotes

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Baby Boomer Business Owners

This segment of our population is retiring. Now what?

Baby boomers (those born in the United States between 1946 and 1964) are in the midst of retiring or will be retiring in the near future. According to the Pew Research Center, the oldest of the baby boomers started turning age 65 on Jan. 1, 2011 at a rate of 10,000 people per day, and this same daily statistic will continue for the next 19 years.[1] Experts estimate that due to the retirement of the baby boomers, businesses with a total aggregate value of over 10 trillion dollars will be passed down by 2025,[2] and an estimated 65 to 75 percent of U.S. family businesses (approximately 10 million in total) will likely be up for sale within the next five years.[3]

In the United States, 80 percent to 90 percent of all business are considered family owned; however, only 30 percent of these businesses survive to the second generation, 12 percent survive to the third generation and just 3 percent survive to the fourth generation.[4] Over 150 of the *Fortune* 500 companies are family businesses.[5] Family-owned businesses are also responsible for 60 percent of total employment and generate 78 percent of all new jobs in the United States.[6] Experts estimate that 85 percent of the problems facing family businesses center around succession.[7] Even though 95 percent of family business owners acknowledge the importance of succession planning, tellingly, only one in eight has a written plan for his exit and succession.[8]

How, if at all, does this critical information about the importance and current shifting of family businesses, as well as the sobering statistics on succession failures, impact our job as estate planners? Is it our role simply to prepare highly technical and effective legal documents for our clients that address tax and traditional estate-planning issues, or should it be our mandate to do everything we possibly can to ensure that a family business not only passes to the next generations, but also flourishes for the benefit of future generations?

Endnotes

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23. *Ibid.*, at p. 16.
24. *Ibid.*
25. *See* Carlock, *supra* note 8, at pp. 208-210, 215.