Wealth Planning **Update**

Five dynamics in family business

Conflict resolution strategies to help ensure the longevity of your business.

If you run a family-owned, private or closely held business, you may find that you spend more time working *in* the business than working *on* it, specifically on ensuring its longevity. This is partly due to the dynamics inherent in family-owned businesses, where you may be required to choose between what's optimal for your business and what's best for your family. These emotional dynamics can devalue or even tear a business apart—preventing you from transferring it to the next generation, whether within your family or outside of it. Understanding the following five dynamics may help you avoid mixing business and family, and run your company in a way that both increases its value and ensures its longevity.

① Financial control vs. human capital

Conflict:

Because so much of your own assets and cash flow is tied to your business, it's only natural for you to want to retain full control. However, human capital is an asset. It may seem counterintuitive but, if you allow others to rise into leadership positions—and make yourself replaceable—the value of your business will increase because its success won't rest entirely on your shoulders. With capable, talented people in your business, it's more likely to grow.

Plus, once your business is transferable, you can start thinking about retirement.

Recommendations:

- Recruit and mentor great managers, then trust them with the authority to fulfill their responsibilities.
- Hold your managers accountable. "Inspect what you expect."
- Keep your business finances separate from personal finances. Don't treat the business as your personal checkbook.

Case study in the value of human capital

Jim was only a few years from retirement. He had built a very successful HVAC installation and servicing business. He knew every customer by name, had an annual Christmas party with his vendors, customers, and employees, and even came in on the weekends to work on scheduling and ordering parts. He knew he had a lean, mean, profitable business. He put two kids through college and belonged to the best country club in town.

When it came time to look for a buyer, Jim went to his trusted advisor. Unfortunately, the advisor said that if Jim were to exit, the business would be worth much less than Jim believed because most buyers would not be able to take over and hit the ground running. There would be significant transition time, and risk in keeping customer, vendor, and even employee relationships. Furthermore, Jim would need to stay on to assist—working to pay himself off. If Jim had allowed others to assume more responsibility within the company, if he had built human capital, his business would have been more valuable to potential buyers.

② Legacy vs. mortality

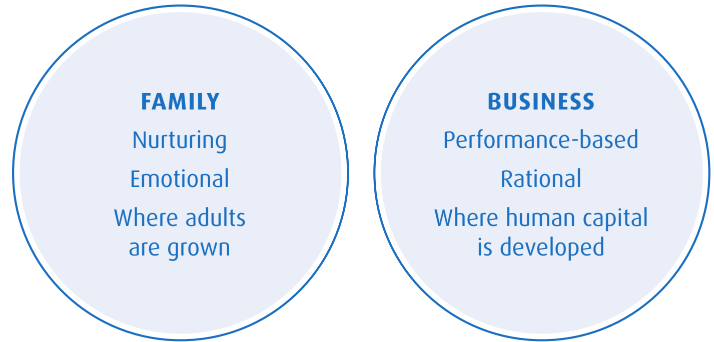
Conflict:
Most business owners understand the rationale behind exit planning but they resist it on an emotional level. It can be hard to face our own mortality. You may get so caught up in steering the ship to make sure it keeps sailing for years that you forget to plan for the inevitable. A well-thought-out plan can protect your business from floundering if the unfortunate occurs.

Recommendations:
- Take the time to create a written transition plan.
- Incorporate measures to allow for a seamless passing on of responsibilities and authority.

③ Business vs. family

Conflict:
You have an allegiance to your family as well as to your business (including employees, customers, and vendors), and often those goals do not align, specifically when it comes to birthright. If your children want to take over the business in the future, it's important to consider whether they have the necessary skills.

Most business owners believe family members will assume control of their business five years from now. Yet, only about 30% of family businesses pass to the next generation and only 10% to the following generation. If you have co-owners who are not family members, they will have different opinions and goals, adding a third layer of complexity.



Family and business goals often clash. Placing your family above the business can impact competitiveness.

Recommendations:
- Communicate with children early (before college) to gauge their interest in the business.
- Help interested children get the proper education, experience, and mentorship. Possibly have them work outside of the company for a time before joining.
- Recognize that the business supports the family and, therefore, the family must abide by business governance and best practices.
- Formalize governance, including a separate family council, management team and board of directors, each with its own "constitution" so they can make decisions independently and then communicate on shared governance matters.
- Instill family philosophies and constitutions in the business mandates. In this way, it's not the business vs. the family, but rather the business *with and for* the family.

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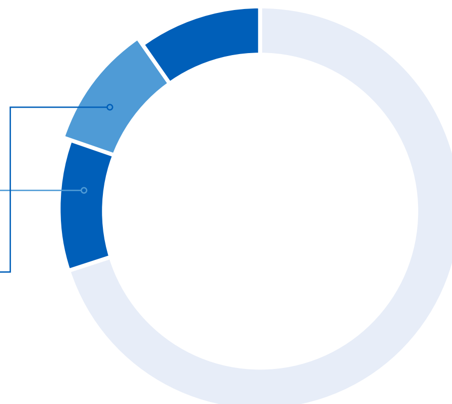

④ Older generation vs. younger generation

Conflict:
The older generation "speaks a different language." Senior business owners may be more conservative in order to protect the company's financial resources. As a result, they may be slower to pursue change. On the other hand, the younger generation typically wants to force faster change, feeling they know the current pulse of the market better than their elders, who they see as behind the times.

Recommendations:
- Have the younger generation get some skin in the game by making them owners. Perhaps they can buy-in using nonvoting shares; even just a small amount at a time will be worthwhile.
- True-up compensation for family members if you're underpaying them, possibly by allocating the difference to a share purchase program. This should help their sense of value and create better morale.

⑤ Business ownership vs. wealth transfer

Conflict:
Some children may be active in the business and others may not. How can you equalize the wealth you transfer to each? Should children who are not part of the business be bequeathed business ownership?

Recommendations:
- Keep in mind, fair does not always mean equal.
- If you desire equality, consider life insurance, although you still may not be able to guarantee equal value.
- If you'd like all children to have some ownership in the business, allow only nonvoting shares in the hands of those who do not work for the company.

Dealing with family-owned business challenges is best handled with the advice of a seasoned advisor who collaborates with a team of relevant experts. Wealth planning, estate planning, exit planning and governance planning all come into play as you document—and over time update—your intentions and expectations. For additional information about family business dynamics, speak with your wealth professional.

Bob, owner of an IT consulting business, had two children, Jim and Kathy.

Kathy was one of Bob's best salespeople and Bob thought she would be ideal to run the company at some point. **Jim** had little involvement with the business. Wanting to treat his children equally, Bob arranged to leave 50% of the business to each child when he passed. Kathy succeeded him as the leader and continued to grow the company. Jim looked forward to the quarterly distributions.

Soon after, Kathy saw the need to divert some of the earnings to the future growth needs of the company (rather than pay out dividends), but Jim was unwilling. He simply did not understand the business need. Since there was no majority owner, the company began to lose sales to competitors and the distributions dwindled.

If Bob had recapitalized the business before his death (giving Kathy voting shares and Jim nonvoting shares), Kathy would have had the ability to move the business forward while Jim would have benefited from its continued growth. If they ever sold the business, both could have shared in the profit. Equal is not always fair (and fair is not always equal).

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