FOUR MISTAKES FAMILY BUSINESSES MIGHT MAKE WHEN PLANNING FOR TRANSITION, AND HOW TO AVOID THEM

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“It is a wise father that knows his own child.” – William Shakespeare, The Merchant of Venice

In the preface to his book Borrowed from Your Grandchildren: The Evolution of 100-Year Family Enterprises, Dennis Jaffe writes, “Family businesses are among the world’s most enduring and ubiquitous economic and social institutions. They are the foundation of social relations and communities; as humans evolved from hunting to agriculture, trading, and industrialization, family business evolved as well to make this possible. … At the core of our economy are living families that seek and stand for so much more than financial profit.”

Studies consistently find that family-controlled businesses (FCBs) are more profitable, more resilient and more likely than their rivals to survive through tough times. It’s worth noting that business bestsellers like *Built to Last* and *In Search of Excellence* feature many FCBs as their star performers.

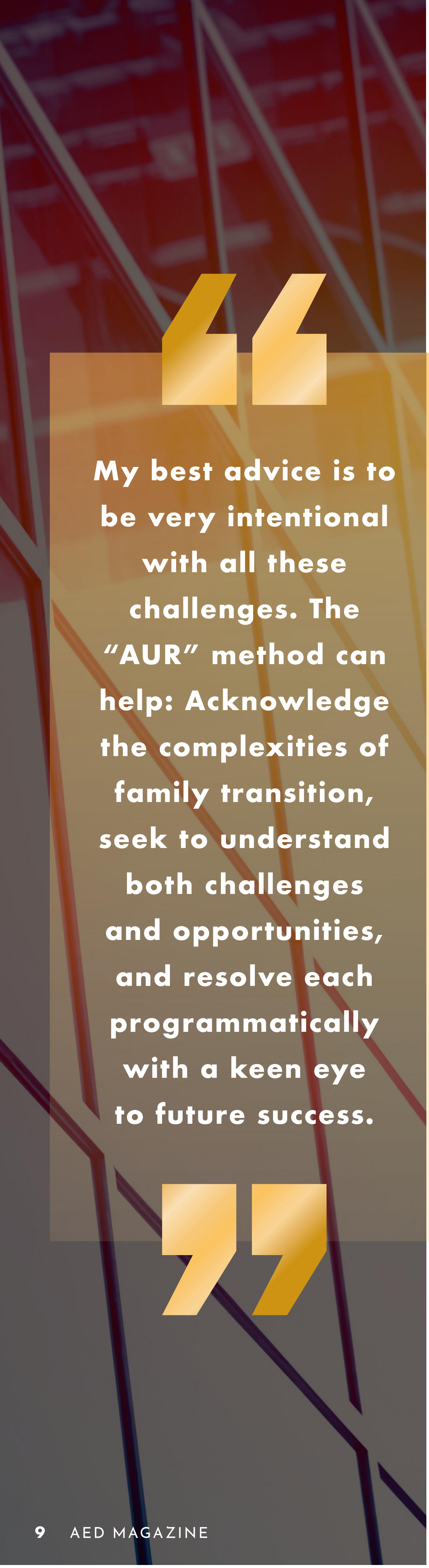
In 2022, Deutsche Bank looked at data from the COVID-19 period on listed businesses having a family as the anchor investor. Notably, compared to those without a family shareholder, the family businesses’ share prices returned to pre-COVID levels three weeks earlier, and they were more profitable overall. Family business return on equity averaged 7% in 2020. For non-family companies, the average RoE was negative 11%.

In other words, families in business have a lot going for them. Then why is the intergenerational transition failure rate so high? Only 30% of family businesses make it to the second generation, 12% to the third, and maybe 4% to the fourth. Despite all the statistics that would suggest otherwise, and notwithstanding deeply consequential family linkages, when it comes to ownership transition, family businesses seem to be as fragile as any other.

An “unstoppable force meeting an immovable object” is a logical paradox and cannot be true. But ownership transition of some kind is unstoppable. (Father Time always wins.) If a business family facing transition proves to be immovable, you can imagine what happens when the two meet. Very little good comes from the impact.

The fact is, with good transition planning, a potentially catastrophic collision can be avoided.

There are four planning mistakes to avoid.



> **My best advice is to be very intentional with all these challenges. The “AUR” method can help: Acknowledge the complexities of family transition, seek to understand both challenges and opportunities, and resolve each programmatically with a keen eye to future success.**

1. ASSUMING THE NEXT GENERATION WANTS TO OWN THE BUSINESS

Predecessor generation owners can easily fall into the trap of thinking that because they know their successors, they also know what they want in life and from the family business. In these instances, years of close relationships may tempt the predecessor to prioritize their understandable desire for an enduring family business legacy over the (perhaps unspoken) life goals of their successors. Instead of just assuming “the kids” want to take over the family business, ask early on if they’re interested in succession, and if they are, create a plan that gives them a chance to develop the skills necessary to carry the business forward using a vision and mission that they can fully own. Conversely, predecessors must intentionally prevent successors from assuming they will inevitably inherit the business one day. Entitlement thinking, especially when it’s enabled, is almost always toxic to business culture. Make education and life experience a requirement by encouraging successors to spend five years in another related business before taking responsibility for the family enterprise.

2. UNDERESTIMATING THE COMPLEXITIES OF INTERGENERATIONAL TRANSITION

Family business transitions may seem simpler than a sale to a third party or management team, but they are not. Understanding and respecting the potential complications, including inevitable emotional responses to the plan (such as sibling rivalries or perceptions of favoritism), can soften these sharper edges. Doing so will involve deep and sometimes awkward conversations, and my experience over 20 years of exit planning has been that most of the more difficult interactions fall into the “missing conversation” category. We tend to avoid them, convinced that the family ties that bind will make up for any differences. When it comes to business, they will not, and unaddressed conflicts or misunderstandings will take their pound of flesh. This is the explicit responsibility of the predecessor generation to get right. If a planned transition gets messy, or the performance of the business suffers in the future, successors are too often unfairly blamed. Sometimes, when a successor takes over the family business prior to an ownership change (or even after), the management transition is complicated by predecessors who have a hard time relinquishing authority. Successors who are truly ready to take over the family business need the authority to make and follow through on their decisions so they don’t end up as inconsequential figureheads. We call this “custodial ownership,” and it is psychologically damaging to successors because they are essentially living someone else’s life. Letting go of the reins is made easier with proper long-term planning, meaning there is a weaning period that may take years. Authority transfer doesn’t have to be like jumping off a cliff – it can be granted intentionally over time. But once given, it should never be taken back unless the successor is for some reason unable to fulfill their role and responsibilities.

3. NOT TESTING TRANSITION PLANS AGAINST THE FINANCIAL REQUIREMENTS OF THE EXITING GENERATION

Family transitions are ideally treated as arm's length even though the arms are typically a bit shorter than with a third-party transaction. The transitioning generation may be in a position to gift all or part of the business to successors, but I do not recommend it because it leans toward entitlement – something to be avoided at all costs. Even if predecessors already enjoy significant wealth prior to transition, they can use additional capital to fund charitable endeavors, to create other business opportunities within the family enterprise (for future generations, or as investors), or to do whatever else they care about. Predecessors' past financial sacrifices are rewarded at exit. Their choice to be entrepreneurs must be recognized as worthwhile. But any family transaction must also respect the need for the business to remain financially viable. The transaction can't decimate the company's balance sheet and impair future growth. Successors deserve enough working capital to carry on the family legacy while still making their own mark on the business.

4. UNDERVALUING FAMILY GOVERNANCE

Every family has a set of values, a kind of family DNA, that develops both organically and intentionally. Whether everyone agrees is another matter. Establishing some sort of family governance system that encourages the alignment of family and business values can be a powerful bulwark against potentially catastrophic fractures that may take years or longer to resolve. I have seen family-owned and -operated businesses fail due to inattention to values and the way they play out over multiple generations. I have also seen businesses thrive beyond the wildest dream when family governance is strong (but not rigid). A family board of directors with multigenerational representation breeds respect and accountability, and allows each generation to learn from the others. To be clear, values enforcement does not equal good governance. Predecessor generations are not endowed with police powers. The role of governance is to continuously develop the family's capacity for compassionate and respectful evolution while simultaneously establishing values-based decision making. Every family changes over time, and it should. The business must evolve as well.

My best advice is to be very intentional with all these challenges. The "AUR" method can help: **A**cknowledge the complexities of family transition, seek to **U**nderstand both challenges and opportunities, and **R**esolve each programmatically with a keen eye to future success. Transitions are not, by their very nature, about the past. Predecessors and successors are ultimately trying to accomplish the same thing – a positive and enduring legacy. •