SOLUTIONS FOR REDUCING CHALLENGES IN FAMILY-OWNED BUSINESSES

Introduction

The family-owned business is often assessed as a difficult structure to move from one generation to the next, and at times, may even be referred to as a breeding ground for political maneuvering and dissension. Notwithstanding, there are more success stories than failures when a new generation takes over a multi-generational business. The ones that succeed were developed with a sound structure.

Although a significant number of family businesses have imploded for a variety of reasons, those that are successful have a significant impact on the economy and society. The business section of the newspaper largely covers public companies; however, it is important to note that family-owned businesses represent an estimated 85% of the world's companies, which means that ensuring their longevity is essential to our economy. According to the advocacy group Family Enterprise USA, there are more than 5.5 million family business operations in the United States, employing almost 62% of the workforce.

The owners of family businesses are the decision-makers and without their approval, there is no investment in resources or manpower. A public company's structure, in contrast, is one in which investors are the owners and decisions are made by a board of directors or officers. In the public setting, the board and management operate the business and make major decisions while the investors' remedy for failure is to vote for change. Ownership of a family business rests with a relatively small number of related people. Their ability to shape the company is significant and, for the most part, dependent upon the relationship by and among the owners, which can also lead to daily highs and lows.

The key principles involved in operating a family-owned business include (i) the type of ownership; (ii) structure and governance policies; (iii) how success is defined; (iv) what and how to communicate; and (v) how will the business be transferred to the next generation. If the founders and successive generations are not in sync with respect to these principles, it can lead to chaos and oftentimes failure.

Challenges Associated with Various Types of Business Structures

Business journals generally pronounce that there are four primary forms of business structures employed by families and understanding the positives and negatives of each is key to succession. The choice of ownership type is not a mere legal formality in that it can define or restrict various members' involvement and sometimes lead to a source of conflict.

The form most recognized by the baker or grocery store owners is that of a sole proprietorship, which is most effective when the business requires decisive leadership and creates enough liquidity to satisfy non-owners. In each generation, one member leads the company, buying out siblings' shares. If there are no siblings or cousins involved, family conflict is rare; however, sole ownership does have its downside. Succession becomes a central issue, which may be decided according to merit that is assessed by the current owner, meaning the owner must wrestle with what benefits to extend to other family members. This model has risk in that the family's capital and talent exit in each generation.

In a partnership form of structure, ownership is restricted to family members actively working in the business, which requires clear rules governing how people can join or leave the ownership group, as well as defining the benefits of non-owners. In this structure, the children of current owners are admitted to the partnership on a competitive basis, requiring evaluation and a period of apprenticeship. Partnerships tend to keep family owners engaged; however, they are vulnerable to the loss of capital and talent. The partnership structure does provide for a more resilient enterprise because they do not rely on just one leader; however, all partnerships are exposed to conflict as new partners are admitted.

Distributing the ownership in a family business from one generation to the other often occurs when most of the family wealth resides in the company or is expected by family culture. In this form of ownership, the family members pass down their shares to the next generation either proportionately or evenly, tying the family capital to the business. In this structure, the owners may vary in engagement and determining decision-making norms will be challenging because there is always the thought that those who are not fully engaged are getting a free ride, which can lead to resentment. If there is a likelihood that certain members will want to be bought out, it is essential to have a well-defined exit strategy in place.

When ownership in a family business is concentrated in one or more groups of family members, the challenge associated with decision-making is somewhat minimized or even eliminated; however, the control issue becomes more challenging with the next generation. The owners may want to strive for consensus, yet the more significant decisions must rest with only a few, which could lead to conflict. Maintaining the engagement of the various levels of ownership is critical to long term success from generation to generation.

Solutions to Reducing Challenges

The decision-making power in a family business must be clearly defined especially if the enterprise is large. What is most often the case is that the early generation owners make decisions easily and without consultation. When the business is transferred to the next generation, if there is no clear decision-making structure, the business will always be at a risk of failure. Some owners exercise too much control, stifling innovation and making it hard to either attract talent or nurture the younger generation. Others step back from major decisions, leaving a vacuum that may be filled by executives looking to their own interests.

Governance in a family business is all about finding a middle ground between micromanaging and abdicating responsibility, and it becomes more challenging as the family and the business grow. A simple framework to guide decision-making will garner support and confidence. Otherwise, decisions may be unnecessarily complicated and stifling. Owners are the visionaries who set high-level goals, while an elected board of directors oversee the business and hire managers, i.e., Presidents or CEOs.

Family businesses can easily become chaotic if good decision-making processes are lacking. If the problem becomes apparent too late, it could destroy what years of collaboration built. Lack of governance can also empower a "cowboy" type attitude that is unchecked and leads to resentment by other family members who might be equal owners. A well-thought out process for decision-making solves problems before they occur.

The owners of a business have a right to the residual value it creates. With that right comes the ability to define success. Public companies aim to maximize shareholder returns, while in a family business, the owners determine what matters most without the outside forces that could influence decision-making. The owners value earnings growth more highly than providing family members with employment or can insist that you pursue opportunities that clash with your beliefs.

Effectively exercising this right can be an incredible advantage in making a business last. It enables a long-term, generational approach that contrasts sharply with public companies' obsession with quarterly results. But not all families are clear about what they value most. That lack of clarity can trigger battles over priorities, missed opportunities, or a failure to retain talented employees. More fundamentally, if you are unclear about your objectives, you risk losing your raison d'être for being in business together, especially as the company grows and transitions to new generations. Your path may become a dead end.

To avoid that fate, it is important to maintain an owner strategy that identifies concrete goals and sets up guardrails to maintain balance. Aligning on priorities is essential; however, without concrete ways of measuring performance, it becomes lip service. Guardrails can help ensure that those running the business day-to-day allow the founder or leader to direct energy and resources toward navigating challenges.

Owners should be concentrating on a small number of financial goals, i.e., minimum levels of return on invested capital or maximum levels of debt—and ensure that the company stays within them. Nonfinancial guidelines define outcomes for which owners are willing to sacrifice financial performance. The values informing them are often part of the glue holding the family together and a means of making the world a better place.

Owners are entitled to know a great deal about their business, including what is in the financial statements, certain organizational records, and ownership documents. Unless they bring in outside investors, lenders, or board members, owners are not obligated to share that information with anyone (other than the government). That means they control communication as nothing of consequence can be shared without their permission. How owners exercise this right significantly affects the business' longevity. Effective communication is critical to building one of a family business' most valuable assets: trusted relationships.

Early in the life of the family business, communication is likely to be informal, perhaps taking place over meals. As things progress, consider what meetings, policies, functions, or technological platforms could improve your dialogues. Start by aligning what you will and will not disclose to each audience. In our experience, owners are often so worried about protecting details regarding their wealth that they fail to think through what they can share to help stakeholders feel connected to the business' long-term success. Such information might include your owner values and strategy, how decisions will be made, how you think about succession, and your passion for the business. If you decide to keep such information private, tell your stakeholders why.

Succession Planning Considerations

The final right of owners is deciding how to exit. You can choose who will own the business next, what form that ownership will take (whether shares or a trust), and when the transition will occur. With this right come complex and difficult decisions. What will you do with the assets you worked so hard to build? How will you let go? What roles should members of the next generation play? How should you prepare them? Are the relationships among them strong enough that they can work through decisions together?

To execute a successful transition in a family business, it is critical for the founders to have developed a formal continuity plan that outlines a path from the current generation of owners to the next. This type of plan would address the type of ownership; how ownership will be transferred and what vehicles will be used to implement the transfer, i.e., trusts and gifting. Additionally, the continuity plan should create a path necessary for the current leaders to step back and allow the next generation to begin making decisions. It should also outline the criteria for selecting successors to ensure a smooth passing of the baton. Finally, the plan should outline how the next generation will develop the skills necessary to take the reins and how the roles to be filled will be identified.

Transition is a process, not an event—and the more the continuity plan resembles a discussion rather than an ultimatum, the greater the chances of success. The plan should not simply dictate the path from one generation to the next, rather the incoming leaders need to be prepared and aligned. The major hurdle in developing the continuity plan is getting started. When facing pressing concerns in the present, it can be tempting to put off cross-generational conversations that may be fraught with issues of mortality and identity. So put those conversations on your agenda and set some deadlines for consideration and implementation.

Conclusion

Without hard and smart work by the owners and other family members and employees, family businesses often implode. Much energy is needed to keep the many competing interests from turning destructive. There is no single way to survive, and there are few universal best practices; however, developing an organized structure that is tested is critical. Collaboration combined with the power of ownership will sustain the family business for generations. If you would like to learn more or have questions about your family business, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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