

# An overview on family business transition<sup>1</sup>

Family advisory and Philanthropy services



A family business transition is not a one-time event. It is an ongoing process that takes place on multiple levels. As such, it requires attention by family members and their advisors not only to the business and its finances, or to the ownership structures and their interplay, but also to the family and its growth and strength.

# The power and challenge of family

Family businesses are among the most widespread and successful business organizations worldwide. They often combine passion, a sense of identity, shared culture and a long-term outlook, as well as nimbleness in making and executing decisions. As a result, family firms account for two-thirds of all businesses around the world, and they create an estimated 70% – 90% of world-wide GDP.<sup>2</sup> Studies have shown that family businesses tend to show higher long-term profitability than their non-family competitors and to be less likely to lay off and more likely to hire employees in the face of an economic downturn.<sup>3</sup> For example, in Europe from 2000 to 2010, businesses with such “committed shareholders” outperformed the broader market by over 16%.<sup>4</sup>

At the same time, like any business, family businesses face challenges in planning transitions of ownership and management. Industry experts estimate that about 30% of family businesses remain active through the second generation of ownership and 10% through the third.<sup>5</sup>

The same passion and committed control that give family businesses an advantage in the marketplace can prove hard to manage, especially when it comes to transitions. Some of the most common conflicts that arise include:

- Conflicts over employment and compensation of family members.
- Parent-child and sibling conflict over control.
- Conflicts over different ownership strategies (e.g., keep vs. sell).
- Conflicts between shareholders who are also managers vs. shareholders who are “outside” the business.
- Tensions between the spouses of family members who are owners or managers in the business.
- Conflicts over strategy and direction.

Given the variety and complexity of these conflicts, it is not surprising that many family business owners put off dealing with transitions—or handle the transition by deciding to sell the business.

For those families who do wish to transition their enterprise from one generation to the next, this overview will lay out some of the most fundamental considerations and strategies.

# The fundamentals of family business transition

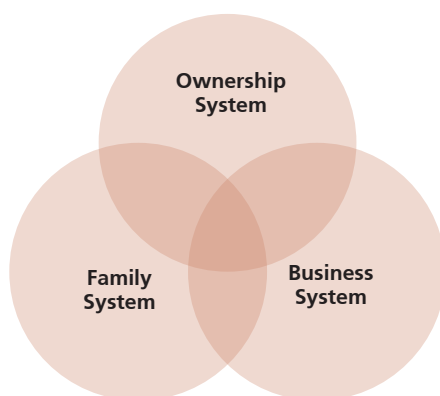
The first key to managing family business transition is to recognize that, as closely connected as they are, the family as a family and the business as a business have different goals. The family system is typically focused on emotional dynamics, family members' personal needs, and the stability of the family. In contrast, the business system must focus on business performance, marketplace demands, and innovation.<sup>6</sup>

Family system	Business system
Emotional dynamics	Business performance
Family members' personal needs	Marketplace demands
Stability of the family	Innovation

As a result, family business transition involves at least four possibly parallel sets of changes:

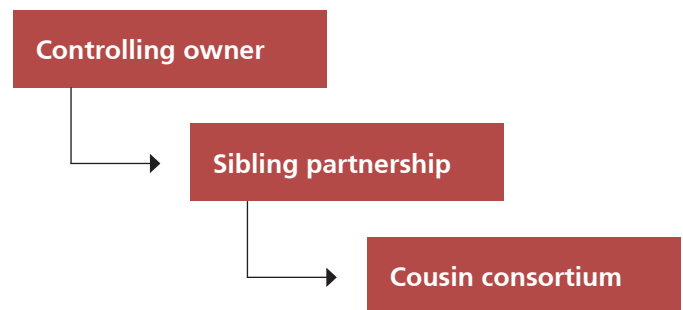
- Ownership transition—to whom? How to do effectively and efficiently?
- Board transition—new strategic plan?
- Management succession—to whom and how to evaluate?
- Family succession—new roles for family members and new methods of communication?<sup>7</sup>

Two illustrations can help family leaders think through the place of their families' businesses in these different facets of transition. The first is the "Three-Circle Model," developed originally by Renato Tagiuri and John Davis of Harvard.<sup>8</sup>



Many conclusions flow from the Three-Circle Model. The most basic is that a healthy family business will attend to each of these three circles; if one area falters, the whole system will ultimately be impacted negatively.

At the same time, the family business and these three circles are dynamic—they change over time. For example, as the family grows the ownership circle also tends to expand, as individual family members give or bequeath shares in the business to multiple children. The changes can be captured in these three phases of generational change and ownership:<sup>9</sup>



The controlling owner may be a single individual or a couple. The sibling partners are often their children and the cousins are their grandchildren. The leadership style and communication practices differ greatly at each of these stages. Problems tend to arise when family business enters a new phase but the leadership and communication practices remain "stuck" in an earlier phase.

The first step in thinking through family business transition, then, is evaluative. It is to ask yourself:

- Which of our "circles" gets the most attention—the business, ownership, or family? Which gets the least?
- Where are we in the transition of ownership and leadership—controlling owner, sibling partnership, or cousin consortium?
- Are our leadership and communication practices aligned with our family business' place within generational transition or are they stuck in a prior phase?
- Which of the four types of transition—ownership, board, management, or family—is most pressing now? Which will likely be most pressing 5 or 10 years from now?

# Prioritizing key activities in family business transition

With answers to these evaluative questions in mind, you can then begin to prioritize the many different activities that are key to successful transitions. The three main areas of work are:

- Successful management of the business.
- Appropriate inclusion of the family in the business.
- Development of a family governance system.

**Successful management of the business** involves taking steps that are common to all businesses, such as maintaining a distinct corporate culture, leading in niche markets, and focusing on quality.

**Appropriate inclusion of family in the business' management** is a multifaceted matter. To return to the Three-Circle Model, the work here concerns the areas of overlap between both the family and management circles and the family and ownership circles. It can mean transitioning away from family leadership by involving independent directors and non-family executives. Or it can involve setting out clear paths for family involvement in the business (such as requiring family members to work elsewhere for at least five years) and neutral processes for hiring and compensation. It is also crucial to educate and inform family members who are not managers but who may be or become owners (or spouses of owners). The business should adopt regular means of communicating with non-manager family members such as through family meetings. There also needs to be a transparent process to value and purchase the shares of family members who wish to exit the ownership circle.

**Family governance** is the area of activity most often overlooked by families with businesses but in the long run, it may have the greatest impact on the cohesion or dissolution of a family enterprise. Family governance necessarily reflects the culture of the family: is it "closed" or communicative? Hierarchical or collaborative? Does the family culture have certain views about gender or the inclusion of in-laws? How are decisions made? Is there a shared dream?<sup>10</sup>

The appropriate forms of family governance will follow from the functions that the governance seeks to perform. These functions become apparent by assessing the needs, strengths, and challenges of the family-business system. Such an assessment involves considering the level of engagement by the family in the enterprise, the phase of generational ownership, the family's current attitudes around keeping or selling the business, and the attitudes of the family toward balancing the business' needs versus their own personal needs.

Family governance can then take the form of shareholder agreements, as well as plans for the education and engagement of rising generation family members. Very often a family will establish a Family Council that represents and gives voice to the family in its interactions with the business and its Board of Directors.

Some families also take the further step of designing a Family Constitution. This document may start with a family mission and values statement. It will then go on to address the interaction of all three of the "circles." It will often include a plan for educating the family's rising generation, the "rules of engagement" for family members in the business; and the methods or structures for managing family ownership of the business.

- <sup>1</sup> Except as otherwise indicated, this piece draws upon material published by Hughes, Massenzio, and Whitaker in *The Cycle of the Gift*, 2013, used here with permission.
- <sup>2</sup> Family Firm Institute, [www.ffi.org](http://www.ffi.org), accessed February 20, 2017.
- <sup>3</sup> *Tharawat* Magazine, no. 22, 2014.
- <sup>4</sup> Bloomberg: UBS Wealth Management Research, as of December 16, 2010.
- <sup>5</sup> Craig Aronoff, Family Business Consulting Group, <https://www.thefbcg.com/Family-Business-Survival--Understanding-the-Statistics-I/>, accessed February 20, 2017.
- <sup>6</sup> See Carlock and Ward, *Strategic Planning for the Family Business*, 2001.
- <sup>7</sup> List adapted from Doud, *Challenges and Opportunities in Family Business Succession*, 59 *N.Y.U. Inst on Federal Taxation* 1401(2), 2001.
- <sup>8</sup> Diagram based on material in Hughes, Massenzio, and Whitaker, *The Cycle of the Gift*, 2014, page 127, from a model originally discussed in Tagiuri and Davis, "Bivalent Attributes of the Family Firm," *Family Business Review*, 1982. This model is the foundation of contemporary family business consulting.
- <sup>9</sup> Diagram based on material in James Hughes, *Family: The Compact among Generations*, 2007 and Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business*, 1999.
- <sup>10</sup> For more on family culture, see Grubman and Jaffe, *Cross-Cultures: How Global Families Negotiate Change Across Generations*, 2016.

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