THE DAVIS GROUP

ANTICIPATING TRANSITIONS IN FAMILY ENTERPRISES

One thing is certain about family enterprises: change is inevitable. Nothing is constant but change. This maxim applies equally to families who share assets as it does to other business enterprises. Family enterprises will always experience transitions. However, families can prepare for and manage such transitions in business operations, ownership, leadership and governance to ensure business success, continuity, and family unity.

In most business enterprises, owners focus on transactions rather than transition processes, and most professional disciplines reinforce this thinking in their training and practice. Sales or acquisitions of businesses are almost always viewed as transactions entailing discrete steps which are time bound. Similarly, transfers of stock from one generation of shareholders to another are typically part of an estate plan requiring technical legal and tax advice. Even leadership succession is viewed by most business leaders and advisors as a transaction in which one person assumes the role of another.

Leaders of family enterprises would do well to rethink these and other business transactions by viewing them as transitions rather than discrete actions. By understanding the processes which incorporate these issues, families and their advisors will be in a better position to prepare for and manage the transitions that they will inevitably face. Readers who are family members or advisors can benefit from understanding the integration of family dynamics and business decision-making in transition processes. By understanding that all transactions require transitions for the family, leaders can approach change as offering opportunities for future success.

Outlined below are numerous issues related to business transitions in family-owned enterprises, including: leadership succession; business diversification; shifts in asset ownership and identification; sale, recapitalization or continuation of a business; merger or acquisitions; and minority ownership of assets. A review of these should be helpful to leaders in preparing for and managing transitions in their family business enterprises.

Leadership Succession

Perhaps the transition most familiar to family enterprises is leadership succession. In any organization, the transfer of power to a new leader is a sensitive process. For family enterprises, leadership succession is even more complex since it most often involves both business and family leadership roles. When a family business transitions to new leadership, the successor must take responsibility not only for strategic management of the business but also for stewardship of the family's assets. In many cases, the next generation of leadership candidates includes family members, which means that the transitional process will include emotional elements.

When Harold Torrington indicated to his family and management team his intent to step down as CEO upon reaching his 70th birthday, his daughter, Ellen, and nephew, David, were considered to be candidates to succeed him. In twenty-seven years as the second generation leader, Harold had built the family's building materials company into a diverse network of four operating companies with assets valued at more than $450 million. Harold's brother had served as the company's VP of Sales and had retired five years earlier but continued to serve on the board along with one of his two sisters. Harold's siblings were pleased with his leadership of the family enterprise and the wealth that he had created for family members. Thus, Harold's intent to retire signaled a transition in leadership of both the business and the family.

Harold Torrington's decision to step down was seen a mixed blessing for the family: it signaled the end of an era of business success for the family; and it produced anxious feelings among family members over what they considered to be a contest between his daughter and nephew to determine who would be his successor. Although the company's management team and family members all wanted the leadership succession process to be fair and objective, family pride inevitably led family members of both generations to favor the selection of a member of their branch to serve as the next CEO of the family enterprise. The family sought out their primary advisors for advice on proceeding with the leadership succession process.

At some time, almost all family enterprises will face leadership transitions similar to the Torrington's. Many will view leadership succession as a transaction with winners and losers. But, others will approach it as a process which begins long before leadership authority is transferred and continues well into the next generation. Seen as a process, leadership succession entails: entry into the business of new family members; education of family members; mentoring and development of future leaders; planning for retirement; teamwork as intergenerational leaders; transfer of authority; and support and accountability for new leaders. Thus, leadership succession is best practiced as a multi-generational process taking place over many years instead of a transaction involving only successor selection and transfer of power.

Enterprising Families

Most families, advisors and family business literature use the terms “family-owned businesses” and “family enterprises” interchangeably. However, there is a subtle but important difference between a “business-owning family” and an “enterprising family”. The former term implies the ownership of one or more operating businesses, while the latter refers to families who diversify both their identity and their ownership of assets. Enterprising families are those who have made important decisions to diversify their ownership through the acquisition or sale of business assets, to share investible assets and other forms of wealth, or to expand the scope of their joint endeavors to include philanthropic or similar endeavors. Thus, enterprising families are those who have made conscious decisions to expand their identities beyond the operating businesses on which their legacies were built.

Trained as a lawyer, Belle Thompson never worked in her family’s chain of retail appliance stores preferring instead to join her husband’s successful construction company. While her father and two brothers were expanding Ginter Appliance into a multi-state operation, Belle negotiated construction contracts with mixed-use developers. Belle joined the board of Ginter Appliance when her father established a governing board with family and independent members.

In her role as a board member, Belle learned the important role real estate played in the success of Ginter Appliance since the family business was a “big box” operator with locations in numerous suburban retail developments. In two developments, Ginter Appliance owned and built their own stores, and in two others Ginter Appliance participated as equity partners in the development. At Belle’s urging, her father and brothers hired a real estate professional to plan future locations and execute real estate transactions for Ginter Appliance.

After twenty years of successful retailer, Ginter Appliance hit the wall in 2001 when specialty retailers began to succumb to mass marketers who sold the same products at deep discounts. While beginning to close unprofitable stores and to consider its strategic options, the family and board became aware that the company-owned real estate and lease holdings had greater value and presented less risk than the future earnings of the company based on its projected retail sales. Subsequently, the company was restructured into three operating entities: retail stores (reduced to 5); wholesale and online sales; and real estate. In the process, the family adopted a new identity as owners of a multi-business enterprise and began to look to its real estate holdings for its future success.

Becoming an enterprising family requires a shift in focus from the operating business to an expanded view of the family's shared ownership of assets. While such a shift may be prompted by success and growth of the core business, it may also result from the sale of the family business or some of its assets. To make this shift while retaining family unity, families must have effective governance structures and processes for communicating the risks and rewards to family members and for making decisions. In addition, families must have capable leaders serving as stewards of both the family assets and family relations if family unity is to be maintained during the transition to a new identity. Finally, enterprising families need to place added emphasis on the development of human capital if the family is to continue to provide leadership, education and support to family members as both the family enterprise and the family continue to grow in complexity.

Control and Minority Family Interests

When families undergo a generational transition, power usually is conveyed to one family member or a select few members of the next generation. When the transition is focused on leadership of the family's operating business, control may be conveyed to a CEO who also serves a Chair of the Board. In such cases, control of the operating business is clearly stated. However, often overlooked is responsibility for stewardship of the family's assets which typically accompanies the operating responsibilities. The stewardship role may be unclear to other members of the inheriting generation of family shareholders, and it is control over the family assets that can be controversial in such transitions.

Despite his relatively young age of 37, Kevin Kohl was welcomed as the natural successor to his mother, Allison, when she announced her early retirement as second generation CEO of the family's real estate business due to the return of her breast cancer. Having graduated with an MBA from The Wharton School, Kevin had joined his mother immediately after school and had worked at the right hand of the company's general manager for the past 5 years. No one questioned Kevin's passion for the business or knowledge of real estate. However, less than a year into his tenure as CEO, numerous family shareholders voiced dissatisfaction with his leadership of the family enterprise.

Unlike his mother who went to great lengths to meet with and inform her aunts, uncles and cousins of the status of the family business, Kevin preferred to consult with independent board members and consultants he hired to advise on and execute real estate transactions. Thus, family shareholders found themselves reading about the latest development project in the local newspapers long before they received any notice as shareholders. When several family members expressed concern about the family's holdings in face of the downturn in the real estate markets, Kevin dismissed their concerns as being "reactionary" and not helpful to management. After two quarterly board meetings during which concerns raised by family members of the board were not addressed, a group of ten family shareholders, representing two branches and 40% of the outstanding shares, offered their shares for sale back to the company.

Family transitions that result in significant changes in business conditions or expose family shareholders to increased risks can be very disruptive. Because the sale of shares of stock in family enterprises are rarely permitted outside the business or family, minority shareholders can be made to feel captive to the wishes of family management. Often the value of their shares represents a significant but illiquid portion of a family member's net worth, ownership without trust in family leadership can become a burden. Family members who seek to some or all of their shares are restricted by buy-sell agreements and by the lack of a market for their stock. Such shareholders can be made to feel disloyal or mercenary if they seek to sell their shares. To prevent family or business disruptions, family leadership transitions need to address both business and family ownership concerns.

In all business enterprises, there are dynamic tensions between the interests of management and those of owners. In family enterprises, these tensions can result in open conflict if family interests are not properly addressed. Thus, generational leadership transitions should clarify the management responsibilities being assumed by the new leaders and ensure that family and business decision-making structures are employed to communicate openly with family members while addressing the interests of all shareholders. In addition to issues of role clarification, performance measurement, compensation and accountability that are part of any leadership transition, family transitions need to sort business from family issues.

Major Transactions and Family Transitions

Perhaps the most monumental decision families can make is to sell the family business. Mergers with or acquisitions of other businesses are transactions that have similar impact on families who own assets in common. In each case, the significance of the transaction can set off emotions and other dynamics that challenge family identify. In transactions like these, families can benefit from transition processes that provide for open discussion in advance of making decisions, clear governance structures through which the transactions can be vetted and approved, and lots of family work following the transactions in order to establish new identity and shared visions of the future.

Even though transactions take place at specific points in time, families can benefit taking time in advance to review their shared interests and legacy. Decisions to pursue major transactions, like the sale of the family business, should be made only after taking into consideration the risks presented to family unity. In fact, inter-generational discussions undertaken in advance of the sale or acquisition of family assets can provide family members with opportunities to strengthen working relationship and prepare them for a new future together. By clarifying the family's mission, enterprising families can reduce the risk to family unity by defining what the family expects or needs from the transaction in order to maintain the family legacy as they move forward.

Often those responsible for pursuing transactions can provide the family with substantial benefits by presenting objective data about industry trends, economic conditions, the competitive environment and other forces for change external to the family enterprise. Similarly, families can benefit from an objective assessment of their company's strengths and weaknesses and projections of its future successes and challenges. By sharing an understanding of changes in the marketplace and considering strategies for moving forward, families can use their governance structures to make objective decisions about pursuing transactions that are proposed to them.

After three generations of success in textile manufacturing, the Abromowitz family found it impossible to compete with low-cost manufacturers from China and Southeast Asia. On the advice of its industry consultants, the family and the company's board agreed to accept a purchase offer from a global competitor. Surprisingly, the decision was not an anguishing one for the family. Instead, the third generation cousins engaged the fourth generation of 20- and 30-year olds in a process, led by a family enterprise consultant, to explore their options for working together following the sale. Over a one-year period, the family developed a new mission statement and vision for the family's future. With an eye to the fifth generation yet to come, the family decided to invest their newly liquid assets together, established the Abromowitz Family Foundation, and formed a Family Council to represent the family in documenting its proud legacy, providing financial education to family members and planning annual family retreats. The family emerged with a new identity and totally new family enterprise.

Families that enter into major transactions often need to redefine their vision of the future by continuing the family transition process following the transaction. Often, the sale of all or portions of the family's ownership of operating entities provides liquidity that was unavailable to prior generations. In such cases, families might consider to what extent they might want to invest together or how their new wealth will define their family identity. Liquidity events provide families with opportunities to explore additional dimensions of the family identity, including intergenerational family gatherings, family governance structures, programs to educate and engage younger family members, or shared philanthropic endeavors. It may be helpful for families to understand that younger family members – their next generation – will be responsible for extending the family legacy into the future and to provide them with major roles in the family transition processes following major transactions.

Anticipating Transitions

Family leaders should think of business transitions as processes offering opportunities for future success in the family enterprise. In this way, family members and professional advisors can prepare for and manage the issues that will inevitably prompt change in the family enterprise. Transition issues such as those presented in this article illustrate how family dynamics and business decision-making can be integrated and managed to provide for successful transitions.

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