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The thriving transition: Moving a business to the next generation

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Many family business owners initially feel confusion as they approach retirement and begin the process of choosing successors. In this story, we follow one couple[1] as they begin formal discussions with their adult children about the future of the business. We describe their work with us at the Merrill Center for Family Wealth™, where we help families navigate the complex dynamics of managing wealth and being in business together.

Meet the Russos. As John Russo, 62, nears retirement, he and his wife, Mary, 61, are struggling to figure out how he can transition out of running the company he founded 30 years ago. The business, a low-tech company, has grown tremendously over the years and currently employs more than 500 people — including two of the couple's four children.

Though they have yet to broach the subject with their children, John and Mary want to see the company stay in the family. John has received offers from strategic buyers in the past but has always declined them. He takes pride in taking good care of his employees and giving back to the community, and he recognizes that a strategic buyer is unlikely to share these priorities. Equally important to John is his legacy. He invested so much of himself into building the company, and he'd like his children to have the opportunity to step in to continue what he began. At the same time, he worries about how the business will continue to prosper and support future generations once he's no longer there. Mary, who ran the company's finances in its early days, and who remains John's primary advisor, shares his concerns, yet she also wants him to step back so they can enjoy the fruits of their labors.

The Russos are concerned about beginning a process that could easily tear apart their close family. Their oldest child, Jim, 35, currently serves as the company's director of marketing and, after some early conversations, believes he has been anointed as the next CEO. However, since then John and Mary have come to believe their daughter Wendy, 32, has the experience, personality and work ethic to be the more effective CEO. Wendy holds an MBA from Stanford and heads one of the company's three divisions. She has also performed well in operations, finance and logistics. Complicating matters further, both Jim's husband, Mateo, and Wendy's husband, Rick, are attached to the idea that their spouse will eventually lead the company. The Russos are also unsure how to include their two youngest children, Michael, 28, and Sally, 26, in the company's future. Michael works as a successful animator in Hollywood, and Sally recently graduated from law school. It's unclear whether either will eventually want to work in the company. In addition to engaging in advanced estate planning structure that will eventually transfer their entire ownership interests to heirs (or trusts for heirs), they now realize that management succession solutions must also be put in place in order for the valuable private business to thrive after they are gone. Such solution often include both family and non-family managers. Considerations often include key man insurance, buy-sell agreements and employee retention programs highlighted below.

John and Mary are typically able to look at any business matter objectively and come to an agreement about next steps — but they've found the task of moving forward toward retirement uniquely paralyzing. There are too many factors in play, and they're not sure how best to address the complexity of the situation. After months of late-night discussions without much progress, relief came when the couple casually mentioned their dilemma to their financial advisor, Seth.

Culture clash

The first breakthrough realization for the Russos happened when Seth identified that the family and the business were experiencing a classic culture clash, and it was this clash that had been muddying the waters on so many decisions. Seth pointed out that a successful business culture centers on performance, with employees hired, paid and promoted based on merit and competence. John's strict attention to meeting the demands of a complex matrix of staff, customers, bankers, suppliers and other key stakeholder groups is what made the company competitive and kept it profitable. Meanwhile, at home, an entirely different culture was required to raise a family. Mary and John provided their children with unconditional love, support, guidance and encouragement, which they distributed as equitably as possible among the kids, without regard to relative merit and achievement. While there was an expectation of hard work, measures of family success were the creation of secure, loving relationships — not performance. But this all changed the moment John hired Jim to work in the business. It brought the fair and equitable culture of family into the performance culture of business — and that immediately began to create latent problems that would only grow over time.

Known as the "two cultures phenomenon," this clash is faced by most families as they transition a business from the first generation to the second, Seth said. Difficult questions emerge the moment the children enter the business. In the Russos' case, there were many questions, a few of which were, *How should Jim and Wendy be paid? Should they have an ownership interest while mom and dad are alive? If so should those interests have any voting rights? Should the boss's children be treated differently from other staff? Even if they aren't treated differently, how will they be perceived by others? How should Jim and Wendy relate to each other given that they are brother and sister as well as co-workers?* The risk was always present that decisions would either degrade the performance of the company in favor of family inclusion or degrade family relationships in favor of performance. Now that John and Mary were looking at how to enact a business succession with four children and two spouses, all with concerns about the future, this tension was going to become increasingly difficult to manage.

Hearing their situation described so clearly — and realizing that it was shared by others — was a huge relief to the Russos. They could finally see the nature of their problem from a high-enough level to make sense of all the specific issues that concerned them. But they also wondered, "What do we do now? How can we take this abstract idea and create a practical set of solutions?"

Seth introduced the Russos to the team at the Merrill Center for Family Wealth™ ("Center"), which has helped guide many families through the complex process of wealth transition. We agreed to help the Russos by mapping out various pathways forward.[2] We began by laying out five principles that seemed germane to their situation and could help them progress toward a successful succession.

Principle 1:
Create a common vision based on common interests

Decide whether being in business is a common interest within the family, and, if so, what is expected from the business. If the heirs are uninterested or not capable of running successful business it may be the best decision from a wealth transfer standpoint for the parents to sell the business during their lifetimes and pass the sales proceeds to their children under their estate plan. Such sale could be to discrete family members or to unrelated buyers.

Principle 2:
Identify roles and responsibilities

Begin the process of professionalizing the business. Ensure that family members understand their roles and responsibilities, including ownership, oversight and operation.[3]

Principle 3:
Build capacity and capabilities

Help family members gain the skills they'll need to be competent operators, owners and overseers of the business through skills training classes, mentoring, peer groups, stretch assignments etc.

Principle 4:
Progressively transfer authority to the rising generation

Methodically pass management and control to the rising generation. Watch what happens at each step, and take the next step only when things are going well. Start slowly and accelerate the process over time.

Principle 5:
Make sure that family bonds remain strong outside of the business

Bring the family together regularly for fun and connection, perhaps enacting a "no business conversation" rule.

The key to navigating this complex process would lie in the family's ability to come to a common agreement about what everyone wanted for both the business and the family. They would also need to develop clear communication, shared expectations and well-defined guardrails. One way to kick off the process would be through a family meeting, and John and Mary agreed that the Center, in partnership with the Merrill private wealth advisor team, could serve as neutral facilitators. This would help keep the discussions on an even keel and allow the family to methodically work through the various layers of the issues involved. John and Mary also agreed with our recommendation to limit this initial meeting to immediate family members. The Center team first interviewed each of the children individually to help uncover individual perspectives and possible pitfalls, and then brought the family together to explore potential solutions that might lead to consensus.

Principle 1: Create a common vision based on common interests

John and Mary knew they wanted to pass the business down to the children, but now it was time to hear what the children thought and to see whether they were on common ground. The Center facilitated a substantial discussion with the entire family about the pros and cons of keeping the business or selling it.

In this facilitated environment, the family explored what challenges might be realistically anticipated and what would be necessary for them to be successful. This opened important conversations about commitment and how much the family was willing to work together. Ultimately, the family decided that it was worth trying to become a true family enterprise. The siblings recognized that they wanted to carry on what their parents had built. They also wanted to support the company's employees and continue to have a positive impact in the community in which they grew up, and they saw the business as a critical investment of family capital. They realized that the income stream from a successful, growing business, coupled with solid management of monies sensibly taken off the table, was the best way to support the long-term economic well-being of the family.

Significantly, family cohesion emerged as a top priority. The family recognized that, while challenging, being in business together would give them a common purpose that would combat the drift so many families experience as children move away and start families of their own. If handled well, the family business could provide a kind of glue that would keep them connected. Ultimately they committed to caring about each other, to being honest with each other, and to continuing to grow and develop together.[4]

Principle 2: Identify roles and responsibilities

After establishing a common purpose, the family began a discussion about existing roles at the company. To start the discussion, the Center described four primary roles often seen in family businesses — owners, operators, overseers and observers. The family identified that John had been performing three of these roles: He was the owner of the business, the manager or operator of the business, and his decisions were what drove the governance or oversight of the business. Mary also held the important fourth role as an observer of the business. While the roles of owner, operator and overseer are typically well recognized, it was noted that in most families, observers (those with no formal role) often exert a great deal of influence over the other roles. Spouses and extended-family employees are powerful players in most family businesses, often able to exercise significant soft or blocking power if they feel marginalized.

During succession the family would be making decisions about how roles would change in the transition. John would no longer hold all three roles, which would be held variously by the rising generation. It was suggested that, to be successful, these now-differentiated roles would have to work well together to uphold the business's high performance. Often this can be seen as the process of "professionalizing" the business in the second generation.

The Center described, for the siblings' benefit, how the merger between family culture and business culture had created fairness issues, which would need to be resolved, in both contexts. This discussion helped Jim and Wendy in particular see the complexity created by their joint status as both employees and family members. All four children came to see how running the business professionally — with fairness and performance at the heart of their decision-making — would create profitability that would support the well-being of the entire family.

The family also agreed that there was no rush to make decisions about how roles would ultimately be divided and professionalized. There were clearly many possible ways to distribute roles among the next generation. For instance, ownership could be divided between active and passive owners. Management responsibilities might rest with some children and not others. Governance might include some or all family members but also might include outside board members. Beyond that, spouses would have a keen interest in how the whole system functioned and would serve much as Mary had, as observers. Or perhaps they would take on more active roles as overseers as well as observers. It was suggested that over time, they should experiment and try different approaches to see how they would work in practice.

Tools for retaining family ownership

Right-of-first-refusal

Business owners who wish to pass their business interests down to their heirs should contemplate putting some controls around their heirs' ownership and their ability to make future transfers to people outside the family. For example, in order for such interests not to be sold or transferred to an owner who is not a family member, many businesses have executed shareholder agreements with so-called "rights of first refusal," in which any family member who has shares in their own name and who has received a qualified offer to sell some or all of the shares must first offer them at the same terms to the remaining family members.

Buy-sell agreements

Another tool commonly deployed to prevent a family member's shares from being transferred to a person who is not a welcomed owner is for the business or the owners to take out life insurance on the various family members, through what is commonly called a "buy-sell" agreement. This allows the business or other family members to purchase the shares from the stakeholder or stakeholder's estate, giving, for example, the surviving spouse and their children instant liquidity while keeping ownership and management with the surviving family members.

Every closely held business should have a written management succession plan in place in anticipation of the founder and/or the current managers not being with the business in the future. Such plans tend to have the following critical elements:

- List of current officers and directors, including a description of their roles and compensation structures
- List of any insurance (e.g., key-man insurance) established to shore up business losses that may happen after the loss of a key employee
- Manager succession plan with details on departure and replacement of all key employees (for example, the internal and/or external person who will step up and take a departed key employee's place)
- Ongoing mentoring and skills training plans for existing managers who could step up to fill a void
- Bonus retention plans or ownership plans for employees who are asked to step up in the wake of the loss of a key contributor
- Salary adjustment plans for employees who step into a new role

Principle 3: Build capacity and capabilities

While roles were not going to be assigned in this meeting, the family needed to address the elephant in the room, which was who would succeed John as the CEO. John shared for the first time that he and Mary thought Wendy might eventually be the best choice, adding that they also did not see her as being fully ready to take on the role. Jim was notably disappointed and concerned. Wendy was thrilled, though she also worried about how this could affect her relationship with her brother.

The tension in the room at this moment was thick. If the first role of the Center was education, the second was to help the family navigate difficult conversations. It was suggested that the anxiety the family was feeling was likely rooted in a sense of not having control on an issue that had high stakes.

Each family member was reminded that they had already agreed that family cohesion was of the utmost importance. With that shared value in mind, the Russos were able to come to an agreement that the CEO decision should not be made in a way that would break the close bonds of the family. To them, this meant that over time either Jim would have to feel better about Wendy's role as CEO or an alternative would have to be found, such as hiring a CEO from outside the family.[5]

Both Wendy and Jim recognized that the decision was not imminent and therefore shouldn't get in the way of the other important work to be done. Everyone knew that this would continue to be an important issue to address, but they felt comfortable waiting until more clarity emerged over time. Once the pressure had been taken off the decision in this heavily facilitated conversation, the family relaxed.

The family also agreed to continue doing the work of professionalizing the business. They realized that as their commitment to professionalism grew, decision-making would become clearer. As they dug into the details, a roadmap emerged. This roadmap was another benefit of a facilitated approach. One key step toward addressing issues of perceived unfairness and even entitlement would be to create an employment policy. Another was that Michael and Sally agreed that, if they were to become passive owners, they needed to enhance their understanding of business in general and the operations of the company in particular. Jim and Wendy agreed to receive professional coaching to help with their executive development. And, it was agreed that because of the delicate nature of the question of CEO succession, the issue should be completely tabled until a solid foundation had been laid so that the decision wouldn't fracture the family. This would give Jim and Wendy opportunities to learn and grow as executives.

Principle 4: Progressively transfer authority to the rising generation

The family realized that they could improve future oversight of the company by creating a formal board of directors. The board would include all immediate family members, bolstered by outside advisory members, who might eventually become board members. While the ultimate transfer of authority to the rising generation would unfold over time, creating the board would be a solid first step.

The family also agreed to hold regular stakeholder meetings where all family members would hear about the company's performance and strategy for the coming year. The family created a working group of family members both within and outside the business to identify solutions to issues created by the "two-culture clash" — a place to air concerns and find solutions by creating policies and both formal and informal agreements. They saw this as a constructive way to involve spouses.

They recognized that excluding spouses from future meetings could lead to questions of transparency about decisions that affected them and their nuclear families. Everyone realized that spouses would have to be brought up to speed about this meeting and also acknowledged that having the spouses' voices in the room would be helpful.

Principle 5: Ensure family bonds remain strong outside the business

The family also agreed to gather at least twice a year to have fun together. They already gathered for winter holidays but agreed to an additional summer vacation, to create more time to relax together and enjoy each other and to ensure that family business did not start to take over what it means to be family.

Three years later

Three years later, what had initially seemed like an impossible tangle of complex issues appeared to be resolving based on the willingness of the family to adhere to a few key principles, including their commitment to continue growing and developing together.[6]

Each of the children has found ways to make peace with their distinct role at the company and to make valuable contributions. For instance, after Jim learned at the initial family meeting that his sister Wendy was favored for the role of CEO, he decided to leave the business and embarked on a highly successful marketing career in a Fortune 500 company. He has no regrets about leaving and has in fact experienced great relief at not having to be responsible for the financial well-being of his siblings. His husband, Mateo, initially felt resentful about Jim's not moving forward to the CEO position, but the family was so inclusive — inviting Mateo to become part of the task force and also warmly including him in their get-togethers — that he became more comfortable with the decision.

After a few bumps, John and Wendy were able to develop a strong collaborative relationship, and John has managed to turn over the vast bulk of the day-to-day operation. Wendy has shown deep commitment to enhancing her leadership and executive skills, and is poised to take over as CEO on a provisional basis. It's recognized by the entire family that she'll have to prove herself worthy of the role. While John and Mary see Wendy as strong on operational objectives, they sense she has yet to truly develop the deep strategic insights she'll need to be a top-flight CEO. The family agreed that if, after five more years of coaching, she still isn't well suited to the role of CEO, she would step aside and the family would hire an outside executive. Her evaluations are overseen by both family members and an outside consultant, who was able to help benchmark her performance and set an appropriate salary together with the board.

A board of directors has been established. The board includes all the children as well as two outside directors, who bring strategic perspectives and help ensure that family dynamics won't derail the meetings, though that threat has become increasingly unlikely as the children have gained skill at dealing with difficult issues. John serves as the chair, to ensure that his steady hand still predominates as Wendy continues to develop.

After working for two years as a corporate lawyer at an outside firm, Sally joined the company as its general counsel, a hiring decision in line with the new employment policy, which requires outside experience. She has, by all accounts, done a terrific job educating the board about their fiduciary obligations. While Michael initially had difficulty understanding the books, he worked with John to gain a deeper understanding of corporate finance and has been instrumental in developing (along with the company's chief financial officer) an automated visual dashboard that tracks the company's key performance indicators in real time. This turned out to be a valuable tool for the board and the company's executives. Jim's outside experience has been useful in understanding industry trends and helping to spot strategic opportunities and challenges.

John and Mary took an initial and measured step toward transitioning ownership to the next generation by transferring a number of shares in the company to a limited liability company owned by a creditor-protected trust that was outside of their taxable estates, naming each of the four children as beneficiaries.

The family has also been keeping its commitment to gathering at least twice a year. One time is purely social, and the other includes a one-day family meeting that focuses on both business performance and family cohesion. (Other quarterly board meetings are largely virtual.)

Looking back, John and Mary feel more confident that the business is being positioned for success in the next generation. There are still challenges, but given the commitment to performance and fairness and the rest of the family agreements in place, the signs are promising for both the family and the business.

Conclusion

Thank you for joining us on the Russos' journey. If you are considering passing your business on to your children and would like to talk about the issues that may arise or how your family might navigate the complexity , please contact your Merrill private wealth advisor.

Appendix

While most businesses are sold to third parties in the first generation, many businesses do still pass within families. Here are a few examples of how ownership and decision-making can be structured, with some of the pros and cons of each approach:

- Some believe that only family members who are active in the business should be shareholders. This can avoid the perennial problem of whether to distribute or reinvest profits and minimize conflict with passive shareholders. Typically, if family members understand business and can sustain a long-term perspective, they'll see the value of reinvestment and create a balance between these competing objectives. If the family can't reach a consensus, there is often perpetual tension over the use and distribution of capital. The antidote is to make sure that passive owners are well versed in business principles, understand the strategy of the business, have confidence in the overseers, and understand the need for reinvestment.
- Other families split ownership into voting and nonvoting shares. The control shares will typically vest with the family member who is operating the business. This allows all children to participate in the fortunes of the business while not making decisions that could affect the company's strategy. The disadvantage is that minority-interest holders may contest the skill and acumen of the voting member if the company underperforms. For that reason, it's important to have buy-out provisions that are fair for people who no longer want to be part of the business, and to ensure the structure is not creating "unnatural business partners." (Dissatisfied minority shareholders can wreak havoc on both the business and the family.) Many families also consider including "buy-in" provisions to allow future generations to regain participation in the family enterprise.
- Yet another pattern is to pass the entire business to one child and pass other assets of equal value to the remaining heirs through the estate plan. This plan can go well, particularly

in early generations. However, if the business is highly successful, the value of the company will grow to a point where offset or buyout becomes almost impossible in later generations. It is one thing to balance out the value of a $25 million business and quite another to balance out ownership of a business worth hundreds of millions. The typical choices then are to sell the business or to go public via an initial public offering.

By the fourth generation, the original business of the family has almost always been sold and the proceeds diversified into an array of investments that might include real estate, operating companies, private equity deals and the like. This evolution from a business family to a family enterprise is a common progression in families like the Russos. As this happens, the question shifts from how to operate a successful business to each generation's asking how best to deploy capital. Thinking long term like this can sometimes help take pressure off the second generation as they decide how involved they want to be in the business's day-to-day operations.

[1] The Russos are a fictionalized composite of many client families we have worked with, meant to demonstrate realistic and common succession challenges. They do not reflect the specific realities of any single family.

[2] As a reminder, the Russos, while typical of many of the families the Merrill Center for Family Wealth works with, are a composite. That said, no two families are the same, and the Center's work is designed to fit the particular needs of each client's situation.

[3] Owners are people with an ownership stake in the enterprise. Overseers are those who sit on boards that set strategy and direction for the entity. Operators are those who are charged with implementing strategy. The owners elect the overseers, and the operators are accountable to the overseers. In addition, there are people with no formal legal or operational role who might be seen as "observers." These might be spouses or family employees without ownership, oversight or executive operational authority over the business. In many family businesses, the roles of owner, overseer and operator were held by the founder. In the next generation, these roles are often split among various family members, with ensuing confusion as to what each does and a tendency to stray from the proper lane.

[4] See *The Learning Family* white paper, authored by the Merrill Center for Family Wealth™.

[5] The solution of hiring an experienced nonfamily member comes with the advantage of being able to hire and fire without directly affecting family relationships. A substantial majority of third-, fourth- and fifth-generation family businesses have outside CEOs. Source: Dennis Jaffe, *Good Fortune: Building a Hundred Year Family Enterprise*, 2013.

[6] See *The Learning Family* white paper, authored by the Merrill Center for Family Wealth™.