ROUGH CORPORATE JUSTICE

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The Ownership Transition Challenge

For any family business, the succession from one generation to the next is one of the critical points in its existence. It is an emotionally charged transition that can put the capital integrity of the business at risk.

Although much has been written about estate and tax planning, selecting and training successors and valuing the business, little attention is given to what the business needs and can afford. That consideration is essential if the financial capacity of the business is to be balanced with the needs of the individuals who own and operate it. That balance requires flexibility achieved only when a company's ability to pay exceeds the needs of the senior generation. Every family business that has sustained continuity of family ownership for two or more generations has developed the ability to transfer ownership without threatening the capital base.

A New Transition Yardstick

A major deterrent to building that capital base is the senior generation's belief that they must somehow harvest their equity during the succession process. That perception is neither right nor wrong. Family businesses are frequently sold to family members to facilitate that harvesting. For the senior generation that may seem a natural and appropriate culmination to a lifetime's work. But as well as that may work for the senior generation, it is not a particularly tax-effective transfer strategy. And a sale to outside interests marks the end of the business as an economic resource for the family.

For the purposes of a successful intrafamily succession of ownership, the traditional concept of fair market value turns out to be a poor measure of the worth of the family business. A more realistic – and even more accurate yardstick is NEED together with ABILITY TO PAY.

Defining NEED

NEED is both a monetary concept and a state of mind. Monetarily it is not a cookie jar from which the senior generation can take whatever it wants, whenever it wants. It is best determined by carefully defining how much is enough and limiting unrealistic expectations. Attitudinally, it reflects the senior generation's commitment to sustaining the family's ownership into the next generation – and the willingness to seek balance between their needs and the needs of the business.

Defining the NEED of the senior generation involves five steps:

1. Understanding the capital needs of the business – what is needed to sustain (or re-energize) the company's growth.
2. Defining, in general terms, the economic goals for their family – looking at both children and grandchildren and at the senior generation's feeling about equality and legacy.
3. Determining their lifestyle preferences by doing some dreaming about the future, and linking those dreams to financial needs using a budget-driven planning model.
4. Putting the pieces together to form a realistic emotional and financial picture of the future.
5. Running the numbers to determine what is required in non-business assets to: a) Maintain the lifestyle they have worked hard to achieve; b) Attain the desired level of personal economic freedom; c) Leave the business confidently and d) Have sufficient resources to meet special family and community needs.

Determining Ability to Pay

On the other side of the family wealth/business prosperity equation, the issue is one of balance. Once the NEED of the senior generation is known the questions become: Does the business have the ABILITY TO PAY? Can it afford to meet that NEED?

ABILITY TO PAY is determined by the answers to the following questions:

1. Can the business generate sufficient resources to finance the senior generation's NEED, while still meeting its own capital requirement?

2. Will lenders, suppliers and other equity holders allow existing credit relationships to shift to the new ownership team without personal guarantees from the senior generation?
3. Is the successor generation willing to suppress their own financial ambitions so that the harvesting of this NEED can take place? (This assumes that the required level of suppression is realistic).

ABILITY TO PAY is based on the future. Planning an ownership succession that assures the senior generation that the business can afford to meet their NEED must be rooted in the fundamentals of long-term success. Determining ABILITY TO PAY based on historical performance alone is a mistake. Doing this right means looking ahead at a variety of considerations, including at what financial resources will be required to, for example: keep the company's manufacturing and distribution processes competitive; attract and hold skilled and motivated people; maintain effective marketing and selling of products and/or services; investing in R&D.

Thoughts to Keep in Mind

As you plan your ownership transition, keep the following in mind:

- Sustaining a business in family ownership over the generations requires patient family capital.
- Patient family capital is possible when:
  - A good part of the senior generation's NEED can be met from earning assets they have developed that are independent of the business.
  - The business is well managed, run efficiently and effectively, well position for the future and performing financially at or near its full potential. In other words, take good and responsible care of your business and you business will take care of you.