

## THE FAMILY OWNED BUSINESS – HOW TO GET OUT ALIVE

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***Are businesses considered family owned  
if ownership is shared by unrelated families?  
We believe the answer is an unequivocal "yes."***

***Most family business founders dream of keeping the business in the family for generations. Few succeed. The not-so-obvious reason: many are trapped by the very habits that made them successful founders in the first place.***

### **A Quick Look at Family Business Statistics**

Some years ago I read the results of a study about family business longevity. I was impressed by some of the results and shocked by other! What impressed me was that, according to the study, about 80 percent of all businesses in this country are family owned – including one-third of the 'Fortune 500.' Family businesses employ over half the work force and are responsible for half of the gross national product.

The results I found troubling were the statistics on family business mortality. That same study found that only 25 percent of all family businesses would ever survive into the second generation, and only one in eight would last to the third. Those, by the way, are no different than the mortality statistics for all businesses – and therein lies the source of my disappointment.

I'm a big fan of family businesses. For my partners and me, they are the backbone of our economy and a big part of the American dream. The commitment of those families that own businesses make them, at their best, formidable competitors able to out-perform their publicly-traded cousins. So for all the hopes, dreams, commitment and sacrifice, why don't they enjoy better longevity than other businesses?

### **The Role of Family/Business Dynamics**

The interest in and attention paid to family businesses have grown in the 25-plus years since that study was published. Despite that, I would venture to guess that if that study was done again the results would not have changed much.

One of the obvious reasons is cited by virtually every book written and every article published about family business; the complex dynamics that exist when family interest and business interests attempt to co-exist on a 24/7 basis. After all these years it is a message most have heard at least once. The run-of-

the-mill challenges faced in a world in which family and business overlaps include:

1. Do I hire my child because he/she needs a job (family thinking) or because my child is really qualified for an opening we need to fill (business thinking)?
2. When a child of mine is underperforming in the business, do I treat him/her as I would any employee (business thinking) or do I tolerate poor performance (family thinking)?
3. Who should be the next leader of this business? My first-born male child (family thinking) or the best qualified candidate – family or not (business thinking)?
4. Do I pay family members at market according to their performance (business thinking) or use the business to make sure they have enough income to support the lifestyle I think they deserve (family thinking)?
5. How do we balance the interests of owners who work in the business (and are more likely to support reinvestment policies) and those who do not (and are more likely to want dividends)?

Getting to answers that help the family balance the interests of the business, those of the family, and the personal needs of each family member is a lifetime challenge. One important characteristic of families that have successfully met this challenge is that they screw up their courage and invest the time to create a code of conduct – rules by which they agree to govern the interface between family and business.

### **The Unseen Trap**

It is usually the trap we don't see that does the most damage. After all these years I am convinced that much of family business mortality springs from owners who find themselves unwittingly trapped. They want to transition the business to the next generation, but they find it next to impossible.

Family businesses have the potential to move through four stages of evolution that can take their owners from Stage One where everything they have is plowed back into the business, to Stage Four – the financial family that has sold a successful business and is now investing the proceeds in other ways. But for most of us it really isn't about getting to Stage Four. Successful family businesses in this country can last for generations as good, solid Stage Two businesses. 'Getting out of the family business alive' means avoiding the trap that often snares the owners of Stage One businesses, thereby giving it a chance to get to Stage Two.

### **Stage One, Stage Two – What's the Difference**

Stage One businesses provide well above average incomes for their owners, but never quite realize the potential the founders thought they had. Along the way, members of the next generation come into the business, usually

under the assumption that the business will be theirs some day. Then the founder decides to retire and finds – to everyone’s surprise – that he/she cannot afford to keep the business in family ownership. The business is sold; the founder uses the proceeds as a source of retirement income, and the second generation members who were in the business scurry around making mid-life career change.

### **Setting the Trap**

The above scenario of a Stage One family business is not a pretty picture. Can it be avoided? The answer is ‘yes.’ The next question is “How can it be avoided?” The answer to “how” makes more sense if one first understands the nature of the Stage One family business.

Every business starts at Stage One. It is an informal, often scary, but always exciting place to be – at least at first. The founder usually has all the ownership and all the control. Nobody else has much authority, particularly other family members who might work there. The initial challenge is survival so everyone does whatever it takes in a very fluid, informal, undocumented organization. Policies and procedures are understood, not written.

Entrepreneurs thrive in this kind of environment. They enjoy the risk, the power and the informality. They take out of the business the money they need to live, and plow every other dollar back into the business for working capital and to fund growth. After all, institutions that will lend to such a business are hard to come by, the cost of accessing debt is high and most founders don’t like to borrow in the first place.

Then the business gets past the volatile start-up phase and the survival challenge is replaced by the challenges associated with growth. Managers are brought in to support the founder; family members (youngsters when the business was founded) grow up and come on board. More employees are hired and the organization becomes more complex. In most cases, however, the founder’s love of power and informality doesn’t go away, and he/she continues to plow every available penny back into the business.

Fast-forward to the day the founder decides to slow down, spend less time in the business and enjoy some of the fruits of his/her labor. Look around at the income producing assets to support this change and you will find only one meaningful source – the business itself. The founder would like to pass the business to the next generation, but can’t gift it because he/she needs earning assets. The kids can’t buy it – they don’t have the cash and can’t borrow that amount of money from the bank. A note to the founder sounds good, the business doesn’t produce enough cash to simultaneously support itself and service the debt. They are in a trap that often results in the sale of the business to outside interests and the hopes and dreams of the family unfulfilled.

### Avoiding the Trap

The best approach to ensure family business continuity is to move the business into Stage Two in the evolution of family business and wealth long before the founder starts to slow down. The table on the next page demonstrates some of the key differences between Stage One and Stage Two. It provides guidance about where to put your energies.

Stage One	Stage Two
Founders vision known on to the founder	Shared vision
Founder holds all power and authority	Some authority delegated to key managers
Informal organization: no organization chart or job descriptions; unwritten policies; no performance reviews; discretionary compensation; no annual operating planning or budgeting; etc.	Growing formalization of organization and management processes (such as those listed to the left)
No strategic planning	Systematic approach to strategic planning in which key managers participate
No formal governance	Board of advisors and/or family board
100% ownership in founder's estate	Minority ownership held by other family members
No buy/sell agreement	Ownership rights documented
Vast majority of founder's wealth represented by the business	Less than 50% of founder's wealth represented by the business
No formal system for family communication and family governance	Regular family/business meetings and formation of a "Family Charter" documenting the rules governing the family/business relationship

As the business takes on Stage Two characteristics, it is more able to create enough "extra" cash for the founder to start investing in income-producing assets that are independent of the business. Get far enough into Stage Two and when the time comes to retire, the owner's wealth portfolio has evolved to a point that he/she is no longer totally dependent on the business for income security in retirement. Less financial dependence means less financial pressure on the business. As a result, opportunities open up for a successful transfer into next generation ownership that would not be there for a Stage One business.