PLANNING TO SUCCEED: DEVELOPING AND IMPLEMENTING A FAMILY BUSINESS SUCCESSION PLAN

GENE WOLF is a native El Pasoan. He earned his B.B.A. from Baylor University in 1988 and his J.D. from Baylor School of Law in 1991. He began practicing law at Kemp Smith LLP as an associate in 1991 and has been a partner since 1997. Gene is member of the Business Department with practice emphasis on tax, corporate, estate and business planning, is a member of the firm's Management Committee, and is currently serving as Managing Partner. Since 2012, Gene has served on the Board of Directors of Hunt Companies, Inc. and as chair of the Governance and Nominating and Ethics Committee. In 2017, Gene began serving on the Board of Directors of EP Holdings, Inc. Gene is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and is Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate Law. Gene is currently serving as the President of the Texas Federal Tax Institute. Gene is a member of the American Bar Association Section of Taxation, the State Bar of Texas and the El Paso Bar Association. Gene is Past Chair of the State Bar of Texas Tax Section and Past Editor of the Texas Tax Lawyer. Gene has been recognized since 2006 as one of the "The Best Lawyers in America" in the sections of Tax Law and Trusts and Estates. In 2012, Gene was honored with the distinction of El Paso Best Lawyers "Tax Law Lawyer of the Year." He is qualified to practice in Texas, the Supreme Court of Texas, the United States District Court (Western District of Texas) and the United States Tax Court.

Gene's community affiliations include Rotary Club of El Paso (since 1992), Rotary Club of El Paso Foundation (since 2001), El Paso Estate Planning Council (since 1995), El Paso Chapter of Financial Service Professionals (2000-2006), El Paso Lighthouse for the Blind (2002-2006), Greater El Paso Chamber of Commerce Foundation (2002-2005), Junior League of El Paso Endowment Fund (2002-2010), El Paso Club (2007-2014), the Paso del Norte Group (2005-2012), the Borderplex Bi-National Economic Alliance (since 2012), American Red Cross, El Paso Chapter (1994-1997), Kids Excel El Paso, Inc. (since 2017), Junior Achievement of the Desert Southwest (2010-2014), Yucca Council, Boy Scouts of America (2010-2014) and a member of First Baptist Church of El Paso. Gene is married to Sherri and they have three children, Tyler, Kayla and Clint.

So, what makes me, a lawyer who is not trained in counseling or psychotherapy, think I am qualified to write or talk about the human side of succession planning? It's very simple—I'm not. My opinions and ideas are borrowed and come from on the job training. Nothing more.

I grew up the youngest of four children — the only boy. My mom and dad had a terrific marriage, caring, doting, and loving on each other in a way that makes my wife envious. My sisters and I get along well. But, like many sibling relationships, there are points of tension. Some of those points are pretty sharp.

My mom took care of the home. My dad was a family business owner, concentrating his efforts on land development, construction, and real estate investments. He dabbled—albeit less successfully—in other areas as well, such as new and used car dealerships.

A year before graduating from college, I told my dad that I wanted to return to El Paso to work for him. The Tax Reform Act of 1986 had just been enacted, and he was beginning to see its impact on the economy and his business. He told me to go to law school, saying it would "buy time" and be good training for eventually going into business. After finishing law school, I took a job with Kemp Smith, thinking I would work six or seven years as a lawyer and then go to work for my dad. Twenty-seven years later, I'm still a lawyer at Kemp Smith.

As the years passed, one of my sisters went to work for my dad. I never did. She loved the time she spent with him. His feeling was mutual. As he approached the end of his life, my dad recognized that there was not a successor in place to run the family business. Consequently, he began selling off properties and winding down his business. He finished his last construction project a few months before his death.

As will be discussed below, my family is a seventy percenter—that is, my family represents the seven out of ten families that see a once successful family business fail to survive to the next generation. In our case, however, it was a choice by my dad—although a forced choice.

In addition to being fortunate enough to have grown up in a family that was sustained by a family business, I have been fortunate in my legal career to represent numerous family businesses—some small, some very large. I also sit on the boards of several family companies and work closely with the owners on business, tax, succession planning, and a multitude of other issues.

It is against this background, along with a host of life experiences, working with trained professionals, and a fair amount of reading, that I write this article. The purpose of this article is to provide an advisor or family with a framework for thinking about the human side (or, as my colleague Mike Bourland calls it, the "adhesion" side) of family business succession planning.

THE HENOKIENS ASSOCIATION

As a starting point, consider the Henokiens Association.[1] The Henokiens Association is an association of bicentenary, family businesses. The Henokiens Association was established in 1981 and took its name from Enoch in the Bible who lived 365 years.[2]

To become a member of the Henokiens Association, a company must have been in existence a minimum of 200 years, the family must be owner or majority owner of the company, at least one member of the founding family must still manage the company or be a member of the board, and the company must be in good financial health. To date, there are only 48 member companies.

How do Henokiens Association member companies do it? In a special report, The Economist, looked at Henokiens Association member companies and observed that despite their swelling ownership groups, they were able to avoid ownership group arguments due to a common trait: they operated pursuant to an agreed upon protocol governing how the family and the business interact, including when and to whom shares can be sold.[3] In other words, the owners of long-lived companies adopt and follow written plans that address the ownership and management of their family businesses.

FAMILY BUSINESS BACKGROUND

A family business is a business that is owned, controlled, or influenced by a family. About 75 percent of family businesses are single founder or founder-couple owned, 20 percent are sibling partnerships, and five percent are cousin consortia.[4]

While most people think that family business is small business, that is not always the case. In fact, approximately 35 percent of Fortune 500 companies in the U.S. are family controlled.[5] Moreover, about 40 percent of the 250 largest companies in France and Germany are family controlled and more than 60 percent of large companies in East Asia and Latin America are family controlled.[6]

In addition to their size, family businesses account for an estimated 80 percent of all companies worldwide.[7] Furthermore, family businesses are the largest source of long-term employment in most countries.[8] In the U.S., for example, family businesses employ 60 percent of workers and create 78 percent of new jobs.[9] In addition, family businesses are better at retaining talent by creating a culture of commitment and purpose, avoiding layoffs during downturns, promoting from within and investing in people—nine percent annual workforce turnover at family businesses versus 11 percent annual workforce turnover at nonfamily businesses.[10]

In addition to being economic drivers, family businesses often outperform nonfamily businesses. One study found that family controlled companies in the S&P 500 generally have a return on investment that is 6.65 percent greater than their nonfamily controlled counterparts.[11] Finally, those professionals who work with family businesses know that family businesses can be the cornerstone for the family, creating a point of connection and family identity.[12]

CHALLENGES FACING FAMILY BUSINESSES

A family business combines all the stress of family life with the stress of operating a business. As the ownership group grows—transitioning from single founder or founder-couple owned to sibling partnership to cousin consortium—the relational complexity and stress grows exponentially. This complexity and stress reaches its zenith each time there is a leadership change or a generational ownership change. In fact, Professor Joseph Fan of the Chinese University of Hong Kong found that share value of family businesses drops on average about 60 percent in the eight years surrounding a CEO leadership change.[13] What is more, many of us are aware of the studies which show that approximately 70 percent of family businesses fail to survive generational transition.[14] Put another way, out of 100 first generation businesses, only 30 survive into the second generation. Of those 30, only ten survive into the third generation. Of those ten, only three survive into the third generation. These troubling statistics are not an exclusively American problem, as evidenced by these proverbs from across the globe:

- Shirtsleeves to shirtsleeves in three generations (American);
- Wealth does not survive three generations (Chinese)
- The third generation ruins the house (Japanese)
- From stables to stars to stables (Italian)
- The father buys, the son builds, the grandchild sells, and his son begs (Scottish)

While the statistics about transitional success are troubling, looking behind the numbers is enlightening. In Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values, the authors found that 60 percent of businesses fail to transition due to problems with communication and trust, 25 percent of businesses fail to transition due to the next generation's lack of preparation, and 15 percent of businesses fail to transition due to all other issues (e.g. poor tax or financial planning, legal advice, etc.).[15] Consequently, 85 percent of transitional failure is due to people issues—that is to say, relationships, trust, ability, and preparedness.

Another study is insightful. In a 2011 Peak Family Business Survey, it was determined that nearly 70 percent of family business owners wished to pass their businesses to the next generation.[16] This means that 30 percent of family business owners, for one reason or another, did not wish to pass their businesses on to the next generation.

In an unscientific conflating of the above-mentioned studies, I make the following observations:

- Thirty percent of family business owners do not wish to pass their businesses on to the next generation. While lacking empirical support, but based on my family experience, I suspect many of these business owners, after reflection, reached their conclusion after determining that no person in the family was willing or able to run the business.
- While 70 percent of family business owners wish to pass their businesses to the next generation, only 30 percent succeed.
- Forty-three percent (30% ÷ 70%) of family business owners who wish to pass their businesses to the next generation succeed.
- Fifty-seven percent (40% ÷ 70%) of family business owners who wish to pass their businesses to the next generation fail.
- Of the failures, 85 percent are attributable to people issues—specifically, relationships, trust, ability, and preparedness.

THRESHOLD QUESTION

To begin, families and advisors must recognize that most business owners have a blind spot when it comes to succession planning. In a recent survey, PwC noted that nearly 44 percent of the business owners it surveyed said that succession planning would be a challenge over the next five years.[17] Yet, only 23 percent of business owners surveyed indicated that they had a robust, documented succession plan in place.

Against this background, the threshold question that the family business owner must ask himself or herself is whether he or she wants the business to continue beyond his or her lifetime. This is a difficult question, involving many factors, such as, market conditions, capitalization requirements, technology and know-how, exit opportunities, long-term viability, and the presence or absence of family members who are willing and able to run the business. If the business owner decides that the business should continue, the business owner should immediately begin developing a formal plan to position the family business for survival. A business owner who fails to take such action may find himself or herself, whether intentionally or unintentionally, making suboptimal business decisions—that is, business decisions based on the business owner's work/life expectancy rather than decisions based on the potentially perpetual life expectancy of a vibrant going concern.

If, on the other hand, the business owner concludes that the family business should not continue (which is a perfectly legitimate conclusion), the business owner should begin developing an appropriate exit plan, even though that exit may be years or decades away. In addition, the business owner should begin developing a plan to provide for the winding down or sale of the business in the event of the owner's unexpected death or disability.

SUCCESSION PLAN

If the business owner concludes that the business should stay in the family and continue beyond his or her lifetime, the business owner should fully understand that the odds are against the family business's success. To defeat the odds, the owner must be willing to embrace the succession planning process. As the name implies, it is a process, not an event. And, in the same fashion that the tortoise in Aesop's Fable, The Tortoise and the Hare, beat the hare, the business owner and family must come to grips with the fact that succeeding at succession planning can be accomplished only through persistence and determination throughout the entire life of the business.

At its core, a succession plan is a formalized governance structure. It must set forth an agreed upon protocol governing the interaction of the family and the business. In addition, it must address ownership rights—namely, voting rights and economic interests—and management authority.

An effective governance structure is ultimately about protocol and people. Protocol is the agreed upon procedure governing organization and operation. It establishes the standard of conduct. In addition to protocol, an effective governance structure is dependent on installing the right people who are focused on the right things with the right information in their hands so that they can make decisions.

Two governance structures are at play in the family business setting: the family governance structure and the business governance structure. While each structure serves different roles and operates independently, there are points where they overlap, and, because of the uniqueness of each family and business, governance structures must be tailored to fit the family's needs and circumstance.

COMMON GROUND

As noted, there are certain elements that are common to both the family governance structure and the business governance structure. First, there must be family commitment and buy-in to the process. These are a function of attitude and action.

As to attitude, the family members must choose to have a good or positive attitude about the process and working together as a family for the health of the family and the success of the business. In this regard, I often cite the noted psychotherapist and concentration camp survivor, Viktor Frankl:[18]

> We who lived in concentration camps can remember the men who walked through the huts comforting others, giving away their last piece of bread. They may have been few in number, but they offer sufficient proof that everything can be taken from a man but one thing: the last of the human freedoms—to choose one's attitude in any given set of circumstances, to choose one's own way.

If a man who lived through the horror of a concentration camp can move past it concluding that how we respond to any set of circumstances is our choice, then, absent mental impairment, every family member has the ability to choose how he or she acts and reacts with other family members.

As to action, family members must be engaged, respectful, responsible, inquisitive, patient, appreciative, and forgiving. They also must show up and participate in family activities and, if they are involved in any manner with the business, they must give their best efforts to it. In addition, all family members should commit to a continual process of self improvement and issue education concerning matters affecting family businesses.

Second, there must be one to three family leaders who are responsible for driving the joining together of the family and the business and keeping them running on parallel tracks. These family leaders must personify the corporate identity, align differing interests of the family and the business around clearly defined values and a common vision, and focus on developing the next generation of family leaders, not the next quarter of business profits.[19] Not only is this healthy for the family, it is good for the business as the environment for innovation in a family business improves when more generations of the owning family are actively involved in the business.[20]

Third, family members must possess both self- and family-awareness, including an appreciation of the strengths and weaknesses of family members. As the noted sixteenth century theologian John Calvin said, "Let each of us examine his own defects, that he may not be swelled with vain confidence." This is an area where specialized advisors or outside participants who can be candid with family members may be especially helpful to the family.

FAMILY GOVERNANCE STRUCTURE

The family governance structure is relationship centric. As Harper Lee, the author of To Kill a Mockingbird, once said, "You can choose your friends but you sho' can't choose your family, an' they're still kin to you no matter whether you acknowledge 'em or not, and it makes you look right silly when you don't."

For family members to get along, they must be committed to do so. Like all relationships, there will be stresses and problems. Some families are fortunate and simply like being together. David Lansky, Ph.D., in his book, Family Wealth Continuity: Building a Foundation for the Future, calls this "familyness."[21] Lansky notes that familyness reflects a general sense of goodwill and caring among members such that they enjoy spending time together, trust one another, and are willing and able to give one another the benefit of the doubt. A healthy level of familyness, Lansky points out, underlies more stable families and allows them to take risks on both a personal level (such as sharing difficult feedback) and a business level (such as creating succession plans).[22]

Regardless of whether a family has a sense of familyness, for any family governance structure to function properly, there must exist a safe communication culture where honest, direct, and frank dialogue can occur.[23] In addition, the family must be willing to spend time together to get to know each other on a personal level. Finally, and as noted above, the family must be willing to learn and continually develop their knowledge about best practices in the area of family and business governance and the family business itself.

The family governance structure is often centered around a family council (or whatever other name the family chooses). The aim of the family council is to facilitate communication and decision making among family members. Initially, family communication skills and decision making can be worked on through seemingly simple family exercises and tasks, such as deciding when and where to meet, family get together activities, crafting policies, and making charitable gifts together. With careful guidance, the exercises and tasks will become more complex with the goal of moving the family from interacting as family members (i.e., parent/child or siblings) to mature, respectful adults who can tackle complex or difficult issues, even in the absence of mom or dad.

Turning to protocol, a family council is often governed by a charter describing the purpose and role of the council. Some family councils adopt additional governance policies and guidelines addressing matters such as membership eligibility, participation, committee structures, meeting structure, and such other matters as the family wishes to include. Ideally, the family council should meet two to four times a year, at least one such meeting each year being an in-person meeting.

Turning to people, one quickly realizes that there is not a lot of flexibility on the makeup of the family council. After all, and to paraphrase Harper Lee, you choose your friends, not your family. Generally, only family members will sit on the family council. Choices must be made, however, around the size of the family council, whether spouses should be included, the age or education level at which family members can attend or participate in meetings, who leads the family council, whether nonfamily members should sit on the family council, and whatever other issues the family concludes are important. Frequently, family office employees (if a family office exists) or external advisors are invited to participate in family meetings. External advisors are important for offering guidance and advice on issues and assisting with conflict resolution.

Family councils can be engaged in a wide variety of activities. They can develop, implement, and monitor formalized procedures defining the family's role in the business, including family board participation policies and family employment policies; defining the rights and obligations relating to the use, maintenance, and sharing of costs associated with nonbusiness assets, such as vacation homes, ranches, aircraft, and watercraft; and outlining expectations during times of togetherness, such as council meetings, family vacations, technology usage, mealtime conduct, and bedtime hours. Some family councils provide oversight to a family office or take the lead in issue education, such as education on budgeting, conflict resolution, family and business history, best practices in family and business governance, the importance of work and being a productive member of the community, and charitable giving. Family councils can also serve as a forum for the family to discuss the direction of the family business or the family foundation.

BUSINESS GOVERNANCE STRUCTURE

While the family governance structure is centered on relationships, the business governance structure is centered on discipline. For the business to continue, there first must be commitment to continue (and continual renewal of that commitment) by the family ownership group. The proper protocol surrounding the family business governance structure must focus on the ownership rights (including the voting thereof and the economics attributable thereto) and the good governance of the business.

Concerning ownership rights, thought must be given to how ownership interests (e.g., shares and membership interests) will be owned and voted in the future. Thought must also be given to how the economics (i.e., dividends and distributions and monetization proceeds) associated with the ownership rights will be handled and shared. These ownership rights are handled through the establishment of voting and nonvoting shares or interests, trust arrangements, distribution policies (which would be established by the board of directors or other governing body), and entity governing documents, including shareholder-type agreements. Special provisions in governing documents may include rights of first refusal, call rights, put rights, drag-along rights, tagalong rights, Solomon's (or push-pull) provisions, and dispute resolution provisions. The protocol surrounding these ownership rights must reflect a thoughtful balance between carrots and sticks.

Proper protocol also requires good governance of the business. Good governance of the family business is dependent on establishing and following a formal plan to get the right people on the board of directors (or other governing body) who are focused on the right things with the right information in their hands so that they can make decisions.

The right people are those people who have diverse skill sets, experiences, and views that will be accretive to the business and its operations. The right people may be outside the family. In fact, one study showed that 94 percent of successful, large family businesses were controlled by supervisory or advisory boards of about nine members, on average.[24] Interestingly, family representation on these boards averaged 46 percent in Europe, 28 percent in the Americas, and 26 percent in Asia. The board of directors (or other governing body) is responsible for governing and managing the business, but it should not micromanage the business. That is the role of the officers. In addition, the board should meet three to four times per year and should seek to follow current best practices, as applied to family businesses.

In addition to protocol focused on getting the right people involved in the governance of the family business, protocol must include adopting and abiding by policies governing the family's role in the business and rights or expectations as to distributions. As to the roles, the policies should focus on the rights and expectations with respect to serving on the board of directors (or other governing body), employment with the family business, as well as ensuring that family members who work for the family business are fairly compensated for the work they perform.

MONITOR AND COURSE CORRECT

As with any plan, life will disrupt it. Business cycles will come and go. Key personnel will leave. New competitive forces will emerge. Strategic buyers will surface offering a lot of money for the business. Families will experience births, adoptions and deaths, marriages and divorces, bankruptcies, addictions, and other successes and failures, some of which will be expected and some of which will not be expected. Views, opinions, and relationships will also evolve.

As life unfolds, both the family and business governance structures must be continually monitored and appropriate course corrections must be made to meet the families' evolving goals, objectives, expectations, and circumstances. The monitor and course correct process can be aided by family members knowing each other, communicating with each other, pursuing education and training on current best practices in succession planning, and working with skilled advisors who understand best practices in governance structures. In addition, useful insight can be obtained by systematically surveying participants—including family members, family council members, and board of directors—to assess the effectiveness of the structure and seek input on how to make the structure and process more effective.

ADVISORS

As a final matter, all plans are dependent on the people. The family needs to continually seek to improve themselves through reading and attending conferences. In addition, the family should seek guidance from advisors who can work with the family to guide them through the planning process and help course correct when necessary. Those advisors may include family business counselors, psychotherapists, or trusted advisors such as lawyers and CPAs.

CONCLUSION

In the end, positioning a family business for success is about being intentional. Intentional about developing an agreed upon protocol governing how the family and the business interact. Intentional about the family's commitment to the process. Intentional about ensuring that the family always has a family leader. Intentional about continually monitoring and course correcting the governance structures. And, intentional about seeking the right advisors.

Yogi Berra had it right when he said, "If you don't know where you are going, you'll end up someplace else." If a business owner wishes to give his or her family business the best probability of staying within the family, then he or she needs a formal plan—a plan that sets forth an agreed upon protocol governing how the family and the business interact, including when and to whom shares or interests can be sold. Absent a formal plan, the odds are that the family business will end up someplace else.

Notes

1 http://www.henokiens.com

2 Genesis 5:22–24.

3 Family Business: Passing on the Crown. (2004, November 4). The Economist. Retrieved from https://www.economist.com/special-report/2004/11/04/passing-on-the-crown

4 Id.

5 Conway Center for Family Business. *Family Business Facts*. Retrieved from http://www.familybusinesscenter.com/resources/family-business-facts/, citing Astrachan, J. & Shanker, M. (2003). Family Businesses' Contribution to the U.S. Economy: A Closer Look; FernandezAraoz, C., Iqbal, S. & Fitter, J. (2015, April). Leadership Lessons from Great Family Businesses. Harvard Business Review. Retrieved from https://hbr.org/2015/04/leadership-lessons-from-great-family-businesses

6 FernandezAraoz.

7 Id.

8 FernandezAraoz.

9 Conway citing Astrachan.

10 Kachaner, N. Stalk, G. & Bloch, A. (2012, November). What You Can Learn from Family Business. Harvard Business Review. Retrieved from https://hbr.org/2012/11/what-you-can-learn-from-family-business

11 Anderson, R. & Reeb, D. (2003, May 6). Founding Family Ownership and Firm Performance: Evidence from the S&P 500. The Journal of Finance. Retrieved from https://onlinelibrary.wiley.com/doi/pdf/10.1111/1540-6261.00567

12 Zellweger, T., Nason, R. & Nordqvist, M. (2011, December 16). From Longevity of Firms to Transgenerational Entrepreneurship of Families: Introducing Family Entrepreneurial Orientation. Family Business Review. Retrieved from http://c.ymcdn.com/sites/www.ffi.org/resource/resmgr/docs/goodman_study.pdf

13 FernandezAraoz.

14 Shepherd, D. & Zacharakis, A. (2000). Structuring Family Business Succession: An Analysis of the Future Leader›s Decision Making. Entrepreneurship Theory and Practice. 24. 25-39. Retrieved from https://www.researchgate.net/profile/Dean_Shepherd2/publication/284089707_Structuring_family_business_succession_An_analysis_of_the_future_leader%27s_decision_making/links/5a850e6d4585159152b8158a/Structuring-family-business-succession-An-analysis-of-the-future-leaders-decision-making.pdf?origin=publication_detail; see also FernandezAraoz. It is interesting to note that the turnover rate of Dow Jones Industrial Average companies is similar to the survival rate of family business. See Aronoff, C. (1999, July 1). Family Business Survival: Understanding the Statistics. Retrieved from https://www.thefbcg.com/family-business-survival-understanding-the-statistics/

15 Williams, Roy O., and Vic Preisser. Preparing Heirs: Five Steps to a Successful Transition of Family Wealth and Values. 1st ed., Robert D. Reed Publishers, 2014.

16 Conway citing Peak Family Business Survey. (2011).

17 PwC. (2017). The Missing Middle: Bridging The Strategy Gap in US Family Firms US Family Business Survey. Retrieved from https://www.pwc.com/us/en/private-company-services/publications/assets/pwc-family-business-survey-us-2017.pdf

18 Frankel, Viktor. Man›s Search for Meaning. Pocket Books, 1997. p. 86.

19 FernandezAraoz.

20 Conway citing Greater Washington D.C. Family Business Alliance. Family Business Fun Facts.

21 Lansky, David. Family Wealth Continuity: Building a Foundation for the Future. Palgrave Macmillan, 2016.

22 Lansky. See also Lencioni, Patrick. The Five Dysfunctions of a Team: A Leadership Fable. JosseyBass; 2002 (noting that trust is the foundation of effective business teams).

23 See Lansky; Lencioni.

24 FernandezAraoz.