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Wealth Planning Update

Business Succession—Keeping It in the Family

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Key takeaways:

- As you transition the family business to the next generation, there are many items to consider when selecting and preparing a successor. Awareness of your successor's mindset in comparison with your view over the years is important for a smooth transition.
- With the complexities that the growing ownership structure brings, it is important to create a formal, organized decision-making structure to support active and non-active owners.
- As you prepare the successor to take over the business, also prepare the rest of the heirs for their roles.

What this may mean for you:

- Preparing a thoughtful, actionable succession plan may not just benefit the successor to lead the company but also provide a blueprint for the family ownership structure and cohesion.

These are challenging times for many businesses and business owners, and if you have been thinking of succession planning, you may decide to move forward on transitioning the leadership to a family member. As a business owner and leader of a family business, you may feel that your succession planning is complete upon identifying a family member to lead your enterprise. However, that is just one step in a successful transition. Creating a transparent and intentional approach to business succession can help create family cohesion, furnish a road map for the next generation, and provide a foundation for sustainable business performance for all shareholders.

As you think about business succession and transferring ownership to the next generation, there are four critical components we feel are important to consider:

- Selecting a successor
- Creating business and family governance
- Preparing heirs in leadership and ownership
- Evaluating the economic impact

Selecting a successor

Perhaps you have founded the business, or maybe you are following in the footsteps of the founder, leading a business as the current steward of the family dynasty. You, or those that preceded you, likely identified a need and an opportunity. The passion for satisfying that need, the skills to solving that problem, and years of hard work have resulted in success.

The next leader of the business may require a different mindset. They may need to blend continuity of what the business has achieved and take a novel approach to incorporate new ideas and visions. Successors don't typically have the benefit of the founder's inspiration; they are inheriting the dreams of those that preceded them, including your contribution to the success. Their task could be to blend that dream with a renewed shared vision representing themselves and other members of the family owners. This could be a particular struggle given the current economic environment. This mindset difference between you and the next-generation leader is important to acknowledge; ignoring that difference may derail success, either by not using the strength of the past successes or by making no changes whatsoever.

You have likely identified (and helped developed) the business skills your successor brings to the business. In addition, you can assist them in fostering the mindset of steward/creator. Discuss what it means to follow the dream, take ownership of it, innovate, and adapt it to new circumstances. Strong successors see themselves as creators in their own right. You can be instrumental in supporting this identity and recognizing that the new leader's function is vital for strengthening and sustaining the family business. In addition to developing the right mindset, here are some considerations to evaluate if a designated successor is positioned for success and not just *taking over*:

1. Fit. Determine the skills and attributes necessary to step into the leadership role. Do they possess the right mix of both in order to run the enterprise and be successful on behalf of all shareholders?
2. Readiness. Consider working with an independent advisor to provide feedback to determine what areas need more attention.
3. Key insights. Provide an orderly transfer of knowledge across all aspects of the business. This isn't limited to reports and advisors you rely on; rather, it includes those *unwritten rules* that you have relied on over the years to help in decision-making. This skill could be particularly useful as your business may be facing a level of uncertainty unlike anything it has dealt with in the past.

Creating business and family governance

In business transition, it is important to recognize how the complexity of the enterprise has grown over time. The company you founded or took over may look very different than what you are transitioning. Operationally, the business may have multiple locations; many layers of management; a technology dependence; and a wider range of products, services, and customers.

Not only have the operations become more complex, so has the ownership structure. It may have evolved from you to include your children, their children, and other family members that joined along the way. Each new generation could have increasingly dissimilar views, interests, and loyalties, to which the new leader must respond.

As a way to tackle operational and ownership complexities during succession planning, you may want to create business and family governance structures that are coordinated. These are not two completely separate needs; rather, they run parallel, and ongoing communication is key. The goal is to create a decision-making process that is both formal and organized. An advisory board includes outside advisors that can supplement the decision-making and key consideration of the ownership team for the betterment of the enterprise. A Family Constitution creates a formalized process that focuses on the legacy of the family in relation to the enterprise.

One common family business challenge is defining active versus non-active owners' participation and compensation. In the founder generation, ownership and operational leadership typically resides in the same person. As more shareholders appear, it is necessary to differentiate between active and non-active owners and their compensation. This intersection of business and family objectives can be accommodated within the proper governance framework.

Preparing heirs for leadership and ownership

With the next generation, leading the company is not the same job as being an owner, yet many exiting owners overlook the difference. Roles, responsibilities, rights, and rewards are vastly different, and each require different pathways. It is important to prepare all family members that are owners, not just the individual that is leading the enterprise.

Preparing the next leader requires the transfer of knowledge across all aspects of the business. This time-consuming and complex matter needs a well-developed strategy. Coaching, mentoring, and continuous communication between you and the new leader can be paramount.

Unfortunately, preparation often stops there, leaving the other family members to become inactive, leading to uninformed shareholders. The next generation of owners should be educated and involved in:

- Economic and governance related to voting and nonvoting stock
- Distributions, bonus policy, and compensation
- Buy/sell planning for a preferred and contingency transition
- Estate tax liability issues for owners, the family, and the enterprise
- Their role as a responsible shareholder

Preparing heirs in a business transition is about enabling the success of both the active and non-active shareholders. Engaged owners are important to the enterprise regardless of the role they play in the family business.

Evaluating the economics

The succession planning process is not complete without an analysis of the impact on the company and shareholder cash flow, debt capacity, value, and risk. One action can influence many aspects of the business and the family, so the transfer of ownership through gift, sale, or redemption can affect control, risk, income, and estate tax. The impact should be evaluated by a team of professionals for you and subsequent generations, especially if the enterprise is to remain as your family's foundational asset. This evaluation can help with unintended consequences and allows for alignment between the family's objectives and the financial sustainability of the enterprise results.

Conclusion

Transitioning a family enterprise is a complicated endeavor, and with successive generations of owners, the complexity expands geometrically. For the exiting generation, focus should shift from running the family business to enabling the success of the family enterprise system, which includes developing a comprehensive succession and ownership plan. Reach out to your Wells Fargo relationship manager to discuss putting these principles into action.

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