CHAPTER 1

SUCCESSION PLANNING

"The father buys, the son builds, the grandchildren sell, and his son begs."

-Scottish Proverb

There is an old American saying attributed to Andrew Carnegie (1835-1919): "From shirtsleeves to shirt sleeves in three generations." Approximately 30% of firms survive into the second generation of family ownership, and just 15% survive into the third generation[1]. The rate of survival for a small family business is lower, down to an average five to ten years.[2]

Succession is one of the hardest decisions that is made by a family business. Yet, succession is one of the most important decisions that will ever be made. A well-structured succession can preserve the business in the family for future generations. A poorly structured succession can result in expensive litigation among the members of the next generation, and the ultimate sale or failure of the business.

Succession planning may significantly differ for a first generation single owner family business as opposed to a second generation sibling partnership or a third generation cousin consortium family business.[3] Nevertheless, despite these differences, there are best practices for each type of family business. For ease of reference, we will generally refer to the owner or owners of the family business as the "owner" recognizing that there can be multiple owners.

---

[1] Kets and Vries, M.F.R. (1993), "The Dynamics of Family Controlled Firms; The Good News and the Bad News", *Organizational Dynamics*. 21, Winter, 59-71; Ward, J.L. (1987), *Keeping the Family Business Healthy*, Jossey-Bass; San Francisco, CA; Matthews, C., Moore, T.W. Fialko, A.S. (1999), Succession in family firm: A cognitive categorization perspective, *Family Business Review*, 12(2), 159-169.

[2] Perricone et al. Patterns of Succession and Continuity in Family-Owned Businesses: Study of an Ethnic Community; *Family Business Review*, Vol. 14, No. 2 (2001)

[3] J. Ward, "Perpetuating the Family Business: 50 Lessons Learned from Long-Lasting, Successful Families in Business", (Palgrave MacMillan 2004)

This chapter is designed for the family-owned and family-managed business and does not apply to professionally managed family-owned businesses.[4]

Mentoring The Next Generation

Successful succession planning requires mentoring of the next generation.

Succession is a process that takes time to develop and needs to be managed in order to be successful.[5] For a small family business to survive, it is essential that the founder engage in a process of transferring the founder's knowledge and intellectual capital to the next generation.[6] Even though a successor may choose to reject some of the business practices and judgments of the founder, it is, nevertheless, important that the founder provide the successor with the founder's intellectual capital. Founders who are extremely secretive about their business knowledge will seriously decrease the ability of the family business to survive.

Best Practice: Early childhood experiences and responsibilities imposed by parents play a significant role. Experience with other businesses is helpful to successors.

Ronald Perelman, an American billionaire, stated the following in an interview concerning his relationship with his father, Raymond Perelman, who owned Belmont Ironworks, later renamed Belmont Industries:

"**Q:** I heard that when you were a kid your father used to put you in a tie and a jacket and take you to the board meetings of your family's business.

---

[4] R. Chittoor and R. Das, "Professionalization of Management and Succession Performance A vital Linkage", *Family Business Review* (Vol. XX, No. 1, March 2007)

[5] Stéphanie Brun de Pontet, Carsten Wrosch and Marylene Gagne, "An Exploration of the Generational Differences in Levels of Control Held Among Family Businesses Approaching Succession". *Family Business Review*, Vol. XX, no. 4, December 2007, p. 337; Handler, W.C. (1990), Succession in Family firms: A mutual role adjustment between entrepreneur and next-generation family members, *Entrepreneurship, Theory and Practice*, 15, 37-51.

[6] Bracci, Enrico,A Knowledge Framework for Understanding Small Family Business Succession Process (July 29, 2008). Available at SSRN: http://ssrn.com/abstract=1184620

“**A:** I don’t know if he put me in a tie and jacket, but it was me wanting to go. I was always fascinated by the decision-making process and the managerial process and just business in general. So every opportunity I had to hang around with him, I did. Just watching him do his job – I mean, he’s very good at his job. He’s a very clear thinker. He was a great believer in decision-making. making decisions. That if you don’t make a decision, a decision’s going to be made for you. He let me work on my own to a far greater extent than I should’ve been – just to learn as I was making my own mistakes.”[7]

An academic study[8] divided the knowledge into three categories:

- Industry related competencies (e.g., specific knowledge unique to the industry)
- Business competency (e.g., methods of operating the business, products and services, taking calculated risks, resolving problems and conflicts, etc.)
- Ownership competency (e.g., governance, maintaining a fair balance between various stakeholders and adding economic value to the business)

The process of educating the next generation must begin in early childhood, particularly to early responsibilities that are imposed upon the child by his or her parents. One academic study of five small family businesses cited this early childhood education as a key to entrepreneurial success.[9]

A more recent academic study[10] of six small family businesses found that positive parent – child relationships between the founder or incumbent and the potential successor played a key

[7] “Wiseguy: Ronald Perelman”, Men.Style.com, October 2006, http://men.style.com/details/wiseguy/full?id=content_4986

[8] Francesco Chirico, “The Accumulation Process of Knowledge in Family Firms”, Electronic Journal of Family Business Studies (EJFBS) Issue 1, Volume 1, 2007.

[9] Frank Hoy, Nurturing The Interpreneur, *Electronic Journal of Family Business Studies*, Issue 1, Vol. 1 (2007)

[10] John James Cater, III and Robert T., Justis, “The Development of Successors From Followers to Leaders in Small Family Firms: An Exploratory Study”, *Family Business Review*, June 2009, Vol. 22, No. 2.

role in successfully passing the business to the next generation. Examples were given of a daughter who enjoyed driving to work with her father when she was a teenager, a son who cherished the extra days and years he was allowed to spend with his father after his father suffered heart attacks, and a daughter who was trusted sufficiently by her father to help with the accounting. In each case the positive relationship began in the childhood of the potential successor and grew over time.

The same study found that family business owners should speak to their potential successors in balanced terms concerning both the positive and negative aspects of the business. If the family business owner is constantly complaining about the business, such as lazy employees, rude customers, etc., this is all that the child or other potential successor will hear regarding the business and tends to turn them off.[11] It is important to instill pride in the family business in the founder's children while at the same time frankly discussing the risks and problems of the business.

Dinnertime is an excellent occasion to discuss the family business. These conversations should begin as soon as the child is able to comprehend things that happen in the family business. Many families have a "no business rule" for dinnertime conversation with their children. Although dinnertime conversation should not be focused exclusively on the family business, a "no business rule" is counterproductive to the mentoring process.

Dinner conversations should include anecdotes of interesting things that occurred in the business which would give the child a better understanding of both the benefits and challenges of operating a family business. The child will have a better sense of their future place in the world if the owner shares his or her pride in the family business. Although the owner should give the

[11] Id.

child a feeling for the benefits and challenges of the family business, this does not mean that the owner should limit the child's opportunities outside of the family business.[12]

In addition to dinnertime conversations, the owner should, on occasion, bring the child to work and, at appropriate times, hire the child to provide services for the family business.

Owners should utilize excellent outside resources for guiding the next generation. For example, there are games and books for parents and children to explore together that begin with preschool and continue through young adulthood. Parents should plan trips to Wall Street. Children should be sent to financial education camps where they spend time learning the basics of budgeting, saving and investing.[13]

When the child is older, starting in the 14 to 18 year old age bracket, the family should engage in career counseling and vocational aptitude testing, preferably through outside consultants. Some attempt should be made to distinguish between those children who are interested in the family business and have the appropriate aptitudes from those who have neither the interest nor the aptitude.[14]

Mentoring should continue through college. Suggestions should be given by the owner about possible college courses (e.g. accounting) and degrees to pursue which would be helpful in understanding the operations of the family business. Although attending a prestigious business school is helpful, some children are not interested in pursuing a business degree or cannot qualify in a prestigious business school and would prefer liberal arts courses. The study of English literature can be particularly useful in understanding human behavior and may have more relevancy to the family business than some business courses.

---

[12] M. Paisner, "Sustaining the Family Business: An Insider's guide to Managing Across Generations", Perseus Books 1999

[13] J. Martel, "The Dilemmas of Family Wealth", Bloomberg Press, 2006

[14] J. Ward, "Perpetuating the Family Business", Palgrave MacMillan 2004

It is not unusual for some children to be interested in art and music careers while in college and after graduation. After pursuing these careers for a few years after college, these children may decide that participating in the family business would be more rewarding. Therefore, if a child is an art or music major, it is important to suggest that the child take accounting and other business courses while in college.

Mentoring should continue throughout the post-college years for those children who are participating in the family business. A number of the major business schools provide week-end and evening courses for adults and executive education programs.

It is helpful to have the potential successor work in other businesses before joining the family business, even though this is rare.[15] This helps to build self-confidence and affords the successor credibility when entering the family business. The child's experience in other businesses can, once the child joins the family business, be extremely useful in developing new ideas, practices and procedures for the family business.

Mentoring involves more than just teaching specific skills and methods of doing business, since the next generation may have completely different ideas as to how to operate and grow the business. Mentoring requires asking hard questions and being prepared to allow the next generation to make a few mistakes from which they can learn.

Some family members may wish to start their own businesses as entrepreneurs, separate from the family business. Here the founder can play an important role. That role would consist of providing some of the intellectual capital of the family of these newly-minted entrepreneurs. In addition, the founder should be prepared to provide some financial assistance where appropriate.

[15] Barach, J.A., Ganitsky, J., Carson, J.A. and Doochin, B.A. 1988. Entry of the Next Generation: Strategic Challenge for Family Business, Journal of Small Business Management, Vol. 26, No. 2, pp. 49-56.

The intellectual capital of the founder is the most important asset which can be transferred by the founder to succeeding generations. The transference of this intellectual capital must be done in a manner which is acceptable to the next generation, who may have quite different ideas as to how to operate a business. Therefore, a wise founder will make himself open and available for mentoring but will avoid being didactic and authoritative, both of which qualities tend to turn off the younger generation.

The founder must not only impart intellectual capital but also ethical norms to succeeding generations. Albert Boscov, whose remarkable story is recited in Chapter 9, is the co-owner of 39 retail stores called Boscov's. The family business was started by Solomon Boscov, a Russian immigrant, who owned a general merchandise store in Reading, PA. One of Albert's first jobs in the store was to catch 30 flies a week for a dime – just enough for a movie ticket. It was hard to catch flies because he was so short. Since all dead flies look alike, Albert Boscov concocted a scam one week and passed the old flies from that week as the new caught flies for the next week. His father, Solomon Boscov, caught him in the scam and gave him a lecture on integrity – he also lost the dime. Albert Boscov apparently learned his childhood lesson well, since he developed an outstanding reputation for honesty. Because of that reputation and the friends he made over the years, he was able to obtain financing to buy back the family business after its bankruptcy filing in 2008.[16]

Develop A Written Strategic Plan Which Considers Succession Issues

Many owners of family businesses fail to develop a systematic framework for thinking about the future of their families and their businesses. One survey indicated that close to 70% of

[16] Maria Panaritis, "How he rescued Boscov's", The Philadelphia Inquirer, November 27, 2009, p. A1

respondents reported not having a strategic plan.[17] Many owners also fail to consider in their succession planning whether some of their children should not be involved in the business.

Best Practice: Develop a written strategic plan for the family business which considers family succession issues, including whether financial inducements should be given to family members to **not** participate in the business and whether different children should be given different business units to manage and to own.

Succession planning should be part of the strategic plan for the business. The process of preparing a strategic plan for the business which includes succession issues helps to focus the thinking of the family business owners on the future. There are a number of books which contain an excellent discussion on how to prepare an integrated strategic business and family succession plan.[18]

It is important to involve the next generation in the strategic planning process. One academic study[19] has indicated that involvement of potential successors in the process may play a critical role in building and reinforcing next generation knowledge and skills, particularly industry and business knowledge, functional capabilities and decision making skills.

Both advisory boards and boards of directors can play a significant role in the development of a strategic plan and succession planning, as discussed more fully in Chapter 3.[20]

Finally, a strategic plan which addresses succession issues should consider whether financial inducements should be given to certain family members to **not** participate in the family

---

[17] Arthur Andersen/MassMutual, *American Family Business Survey* (Springfield, MA: MassMutual, 1997).
[18] Randel S. Carlock and John L. Ward, *Strategic Planning for the Family Business: Parallel Planning to Unify the Family and Business* (Palgrave 2001)
[19] Pietro Mazzola, Gala Marchisio and Joe Astrachan, "Strategic Planning in Family Business: A Powerful Development Tool for the Next Generation",, *Family Business Review* (September 2008) Vol. XXI, no. 3, p. 2 39
[20] T. Blumentritt, "The Relationship Between Boards and Planning in Family Businesses", *Family Business Review*, vol. XIX, no. 1, March 2006, p. 65

business and whether independent business units should be established for different family members, as described later in this chapter.[21]

Example:

Jack, Sr., age 65, is the founder of a family business engaged in manufacturing and selling swimming pool supplies. Jack, Sr. would like to retire in five years when he is 70. He has three children in the family business, namely his oldest child, Alice who is 40 years old, and two sons, Jack, Jr. who is 38 years old and Jim who is 36 years old. Jack, Jr. has had problems with both customers and employees and numerous conflicts with his siblings. Because the swimming pool business is seasonal on the East Coast, Jack, Sr. recently purchased a small manufacturer of snowboards and also has real estate holdings outside of the family business. Jack, Sr.'s strategic plan is to grow both the swimming pool and snowboard businesses during the next five years, to gradually give ownership of the swimming pool business to his daughter Alice and to have his youngest son, Jim, who is an avid skier, manage and operate the snowboard business. The snowboard business is very small at this time and therefore significant capital is required by the strategic plan to increase the revenues of the snowboard business to the point where it can support his youngest son, Jim. Jack, Sr. believes that he must get his middle son, Jack, Jr., out of either business because of his conflicts with his siblings and Jack, Jr.'s difficulties with customers and employees. Therefore, his strategic plans contemplates increasing his real estate holdings outside of the family business and ultimately giving them to Jack, Jr. to manage and subsequently to own.

Periodically Review And Reevaluate Succession Planning

[21] J. Ward, "Keeping the Family Business Health: How to Plan for Continuing Growth, Profitability, and Family Leadership", (Jossey-Bass Publishers 1987), p. 12.

Succession planning, which should be part of a strategic business plan, is an evolving activity and requires periodic review as the situation changes, preferably at least once every five years. Failure to do so may result in a failed succession plan.

Best Practice: Succession planning must be periodically reviewed and reevaluated, preferably at least once every five years. Difficult succession decisions should be reviewed with an independent board of directors.

The owner of the business may initially think that the oldest son is the most capable of the owner's children in running the business. Five years later, that evaluation could change when the owner becomes disillusioned with the oldest son's business judgment and begins to consider the capabilities of the owner's second eldest son. Five years later, when the owner's daughter enters the business, the owner might want to reevaluate the succession plan.

Many succession decisions are very difficult to make. One real life example of the difficulties of succession planning involved a father who had both a son and a son-in-law in the business. Both the son and the son-in-law wanted to succeed the father and to run the business. The son-in-law was clearly the more competent to succeed the father and the father knew it. However, the father was unable to choose his son-in-law over his son, who had spent his life working in the family business. The company formed a board of directors which included independent directors and they selected the son-in-law to succeed the father.[22]

Example:

In the prior example, after operating under the strategic plan for two years, Jack, Sr. comes to the conclusion, with the advice of his independent directors, that the snowboard

[22] Judy Martel, *The Dilemmas of Family Wealth: Insights on Succession, Cohesion, and Legacy* (Bloomberg Press 2006) p. 41

business is too competitive and cannot grow to the size needed to support his youngest son, Jim. Therefore, he sells the snowboard business and uses the proceeds to further develop the swimming pool business. Jack, Sr. changes his succession plan to retire at age 75, instead of 70, to place Alice in charge of marketing for the swimming pool business and to bring Jim back to the swimming pool business, in charge of the manufacturing. At age 70 he expects to make Alice president of the swimming pool business, and Jack, Sr. would become Chairman of the Board.

Consider Communicating Proposed Succession Plans To Family Members

Some owners of family businesses prefer to maintain their succession plans in confidence. This is particularly true of first generation single owners. In addition, even in sibling partnerships and cousin consortiums, relationships among family members may already be strained and would be further strained by an open discussion of succession planning. Therefore, an open discussion of succession is not necessarily appropriate for every family business. However, at a minimum, serious consideration must be given to the desirability of communicating proposed succession plans to family members and receiving feedback.

> **Best Practice**: If appropriate for the owner's family situation, consider communicating proposed succession plans to family members, either through family councils or otherwise, and receive feedback from family members.

It has been said that family businesses succeed when dreams of the subsequent generations are integrated with the dreams of the family.[23] It has also been suggested that there are more CEOs in family businesses with lost personal dreams than in any other type of

[23] Edward Monte, a therapist and family business consultant, as quoted in Shel Horowitz, "Father and Sons, Mothers and Daughters", Family Business Center, University of Massachusetts Amherst (http://www.umass.edu/fambiz/articles/successors/fathers_sons.html)

business.[24] Open discussions of succession planning within the family tend to identify potential CEOs and their aspirations.

For many family businesses, frequent communication with family members is important to family harmony and helps air grievances resulting from succession planning. Succession planning is one of the most important functions of the owners of family businesses and the owner must be prepared to receive the emotional reaction, comments and recommendations of other family members. The owner's spouse plays an important role in this communication process, particularly if she is the mother, who sometimes acts as the CEO (chief emotional officer) and is committed to the both the family and the business.[25] Indeed, women behind the scenes of family businesses often serve as the "family glue".[26]

Family businesses are not normally operated as democracies. Ultimately, after hearing all family views, the owner must decide on the succession plan.

Consider Retaining Control In The Owner's Surviving Spouse

Many owners have not, at their death, developed a succession plan. Other owners have developed a succession plan but are not certain that the succession plan will be successful after their death. This is particularly true if the owner has more than one child in the business and it is not clear how well these children will get along after the owner's death.

Best Practice: If the owner's spouse has good business judgment, the owner should consider giving the surviving spouse the power to change the owner's succession plan and should retain voting control for the owner's spouse during that spouse's lifetime.

---

[24] Id

[25] H. Van Auken and J. Werberl, "Family Dynamics and Family Business Financial Performance: Spousal Commitment", *Family Business Review*, vol. XIX, no. 1, March 2006, p. 49

[26] K. Cappuyns, "Women Behind the Scenes in Family Businesses", Electronic Journal of Family Business Studies (EJFBS) Issue 1, Volume 1, 2007. See also Hampton Book Review, Book Review Vol. 22, Number 4, December 2009.

If the owner of the family business is survived by his or her spouse, the owner should consider giving final say on succession to the owner's surviving spouse. This assumes, of course, that the owner believes that the surviving spouse has the capability of making good business decisions.

Once the owner dies, there is typically a significant change in the family relationships and chemistry. Prior to the owner's death, the owner typically plays an important role in preventing and resolving family business conflicts, while the owner's spouse may play a leadership role in resolving non-business family conflicts. Once the owner has departed, the relationships among the owner's children may change, sometimes for the worst. The owner's surviving spouse, provided the spouse has good business judgment, may see problems in the owner's succession plan which were not present during the owner's lifetime. It may be desirable to give the surviving spouse the legal power to change the succession plan to reflect the new reality after the owner's death.

If the owner gives the stock or other equity of the family business outright to his or her spouse, that spouse can maintain control of the business. If the surviving spouse wishes to makes gifts of the stock during her lifetime, the surviving spouse should retain voting control of the stock which is gifted to other family members. Voting control can be maintained by either a irrevocable spendthrift trust or a voting agreement or voting trust, or both, depending upon state law. This voting control will help to maintain family harmony and also permit the surviving spouse to reexamine the owner's succession plan.

For estate planning purposes, it is typical to not give the stock outright to the spouse but have it held in trust for her during her lifetime. In this case, the owner can, in his or her Will, give the surviving spouse the power to allocate the stock or other equity of the family business among the children. This would permit the surviving spouse to give each of or the children an equal share of the assets of the Estate, but allocate the equity and control of the family business to a single child, with the other children receiving property of equal value.

The author has seen many Wills which fail to give such a power to the surviving spouse, even in situations where the surviving spouse has good business judgment and is trusted by the owner. It is important to have the owner's attorney review the estate planning to make certain that this power of allocation of assets among the children is included in the Will of the owner and the owner's spouse. The owner can provide that this power of allocation of equity of the family business would terminate upon the remarriage of the surviving spouse.

Example:

Patrick and his wife, Maureen, started and grew a substantial business, at the same time they were raising five children. Their sons in age order (starting with the oldest) were Sean, Daniel, Ryan, and Kyle. The fifth child and also their youngest was Shannon, the only girl. Each of the children got jobs in the business and, during Patrick's lifetime, his oldest son, Sean, was the clear favorite of both Patrick and Maureen. Patrick died at age 70 years and was survived by Maureen, who lived for an additional ten years. During the ten years after Patrick died and until Maureen died, Sean succeeded Patrick as president of the company. Sean initially did a good job but then, after Sean's divorce, he began drinking and fighting with his brothers over both business and personal issues. Other brothers also began to have conflicts about business and personal issues, including which of their children should be hired by the business and how much to pay them. After Patrick's death and before Maureen died, Shannon began to blossom in her executive abilities and served as peacemaker during the many fights among her brothers. Patrick's Will gave all of the stock ownership in the company to Maureen during her lifetime. Upon Maureen's death, all of his assets would be divided equally among the five children, including Patrick's substantial real estate holdings.

Patrick's Will gave Maureen the power to designate which children would receive specific assets upon Maureen's death. Because this power had been given to Maureen by Patrick's Will, Maureen determined that, upon her death, Shannon would become the controlling shareholder of the company and also it chief executive officer. Maureen therefore designated that 51% of the equity of the company should go to Shannon, with the remaining 49% divided equally among the remaining children. To make up for the additional value of the business going to Shannon, a greater share of the real estate was given to the remaining four sons than was received by Shannon.

In the absence of this power given to Maureen, each of the children would have received 20% of the equity of the company, with the probability that there would be substantial conflict among the equity holders.

Will Provision

The following is a simple Will provision which accomplishes the purpose described above. It is assumed that the Will of each spouse will create a testamentary trust for the life of the surviving spouse for tax planning purposes and that the provision which appears below will be included in each Will as a provision of each testamentary trust:

> "Upon the death of the survivor of myself and my spouse, the principal shall be distributed to, or held in trust for the benefit of such person or persons among the issue of my spouse [insert name of spouse], and me and upon such estates and conditions as my said spouse shall appoint by Will, making specific reference to this power. Any unappointed property shall be divided into as many equal shares

as there are children of mine then living and children then dead, leaving issue then living. Thereafter:…"

If The Business Will Be Divided Equally Between Two Children, Provide For An Independent Impartial Tiebreaker

The best succession plan for a family business is to have only one child, similar to the Chinese law of one child per family. However, this is not practical for most family businesses. Therefore, careful succession planning is necessary to preserve the family business for future generations.

If the family business is to be divided equally between two children, it is important to have an independent impartial tiebreaker. The tiebreaker can be a trusted friend or a member of the board of directors of the family business. Many of the litigations involving family businesses result from clashes occurring after the death of the founder between the founder's two children, each of whom owns 50% of the business.

Best Practice: If equity ownership is divided 50-50 in the next generation, provide for an independent impartial tie breaker.

Example:

Vito, an Italian immigrant, starts a small manufacturing business and when he dies the business is given to his only son, Anthony. Anthony grows the business substantially and he and his wife, Carmella, have two daughters, Isabel and Angela. Both of the sisters are active in the business and help it further grow. However, the two sisters are both very strong-willed with completely different personalities. While Anthony is alive, any conflicts between the sisters are resolved by Anthony. When Anthony and Carmella pass away, each sister is given 50% of the equity of the business. The sisters try to divide the functions of the business between them, but they are constantly in conflict. One sister runs the West Coast operation and the other runs the East Coast operation. The conflicts sufficiently threaten the business so that the sisters seek counseling. However, the counseling does not work well and ultimately the business has to be sold.

The mistake made by Anthony was his failure to recognize the risk that his two daughters would have difficulty getting along once he and Carmella were not in the picture.

Since Vito, Anthony's father, only had one child, the transition to the second generation by Vito was very simple. However, the transition to the third generation by Anthony was much more complex.

The answer to Anthony and his problems would have been to develop, long before his death, tiebreaking mechanisms within the company. The impartial tiebreakers could be created by establishing an independent board of directors during his lifetime. Anthony could then have selected one or possibly three of the directors who would serve after his death as the impartial tiebreakers.

It should be noted that independent directors should not be given legal authority to make decisions except when the family is in disagreement. A family business should be run by the family as long as they are in agreement.

How Would a Tiebreaking Provision Work?

Tiebreaking provisions can include a specific individual who would break ties or a legal mechanism to break ties after the death of the owner of the business or after the death of both the owner and the owner's spouse. Many surviving spouses of owners do not have the business acumen to break ties and even if they do have good business judgment, do not want to be placed in the position of favoring one child over another.

A person chosen as an impartial tiebreaker should be someone close to the owner and preferably someone who has served on the owner's board of directors and is very familiar with the business (see Chapter 3). One legal mechanism for tiebreaking includes having a person close to the owner choose a second person as an impartial tiebreaker rather than act as an impartial tiebreaker themselves. There are many other legal mechanisms to create impartial tiebreakers including using a panel of business persons in whom the owner has confidence, or letting that panel pick other persons who can act as impartial tiebreakers.

The following case[27] in the Supreme Court of Wyoming illustrates the benefit of an impartial tiebreaker, in this case between two trustees.

This case, and the two others with which it was consolidated, arose in the context of a squabble among siblings over control of a family business following their father's death. Raymond Woods started Imperial Homes, Inc. which engaged primarily in residential construction. Before his death, Raymond established the W R Revocable Trust into which he transferred his majority Imperial shares. After his death, the trust remained the majority shareholder, with the other shares divided among Raymond's four children and his brother. The trust documents provided that sons Steven and Roger would be successor co-trustees; however, their disputes led to Roger filing a lawsuit against Steven for an accounting and declaratory judgment. After various procedural skirmishes, the district court ordered the removal of both brothers and Norwest Bank Wyoming was named sole successor trustee. (The bank later merged with Wells Fargo.) Norwest exercised the trust's rights as majority shareholder and served on Imperial's board of directors and a bank trust officer was named as president of the company.

The Mistake: Raymond Woods' W R Revocable Trust should have provided for a trusted person to be the impartial tiebreaker in case a conflict between his two sons, Steven and

[27] *Woods v. Wells Fargo Bank Wyoming*, 90 P3d 724 (Wyo2004)

Roger. The trusted friend could have then hired a competent president to run the company, and the tiebreaking director could have avoided much of the later litigation that occurred between the sons and the company. The failure of Raymond Woods to include an impartial tiebreaker provision in his succession plan resulted in a bank trust officer ultimately running his family business.

Worst Practice: Divide the family business 50-50 between two siblings and fail to provide for an impartial tiebreaker in case of a dispute.

Dividing the Business

Some businesses are divisible by their nature, either geographically, horizontally or vertically. An example of geographic divisibility would be a retail operation with stores in the east coast and the west coast. An example of a horizontal divisibility would be a food wholesale distribution business which included two divisions, one for supermarket sales and one for institutional sales. An example of a vertically divisible business would be a manufacturer of product which also owns retail stores as outlets for its manufactured products.

When there is more than one child involved in the business, it is tempting to divide the business either geographically, horizontally or vertically among the children upon the death of the owner. This supposedly avoids conflicts among the children, since each child has a separate business to run.

There is no clear best practice in this area. Dividing the family business may not always be practical, particularly if the individually units are too small. Sometimes dividing the business works well and at other times it merely leads to conflict between independent businesses, each owned 100% by a single child. For example, the child that owns the west coast retail stores may decide to come to the east coast, and visa versa. The owner should not be in the position of limiting what each child can do with the business after the owner's death.

If The Business Is Easily Divisible Into Separate Businesses, Give Each Child 100% Of Each Of The Equity Of Each Of The Separate Businesses.

If the family business is divisible into separate businesses, some succession plans will provide either equal ownership among the children of the founder or majority ownership with one child in the majority and the other child or children in the minority. This form of division tends to sow the seeds of future discord.

We have discussed previously what happens if the ownership is equally divided. However, even if majority ownership is given to a single child, with the remaining children in the minority, future conflicts should be anticipated after the death of the owner and the owner's spouse.

Best Practice: If a business is to be divided after the death of the owner and the owner's spouse, each child should preferably receive 100% of the equity of each separate business.

If a business is to be divided between two or more children, each child should preferably receive 100% of the equity of the separate business to be run by such child. The owner should attempt to avoid creating minority interests of one child in another child's business, for example, giving one child 51% of the equity and dividing the remaining 49% of the equity among the other children who also may have their own separate businesses. A minority interest tends to lead to conflicts in the next generation.

This is easier said than done since most owners would prefer to give equal value to each child upon the death of the owner and the owner's spouse. The businesses to be divided among various children may have unequal value and there may not be sufficient assets (e.g. real estate) to equalize the shares of each child. This may necessitate giving minority interests to other children in one child's majority-owned business.

The following actual court case[28] illustrates why it is a bad idea for the family to provide for minority interest of two siblings in each others business.

Jerry James is the majority shareholder in Franklin Homes, Inc., owning 57% of the stock; his brother, Thomas James, is one of three minority shareholders and owns 31.11% of the stock. Thomas was the majority shareholder of Indies House, Inc., owning 56% of the stock, while Jerry was one of two minority shareholders and held 41.5% of the stock. The stock in both corporations had been held by the James family since their incorporation, and Jerry and Thomas were involved in each of the corporate businesses. The Indies House corporation was having financial troubles and it was sold during the trial.

At trial, Jerry introduced evidence indicating that Thomas had paid himself excessive salaries, had paid members of his family excessive salaries, had bought automobiles for his children with corporate funds, and had used excess corporate cash to finance loans and had personally retained the interest paid on those loans. Jerry argued that the amount that he received from the liquidation ("sale") of Indies House was less than it should have been, because of Thomas's mismanagement and theft. Jerry's expert suggested an amount of damages by taking the total amount Thomas claimed to have lost by each act of wrongdoing and multiplying it by .415 – Jerry's interest in Indies House being 41.5%. At the conclusion of the trial, the jury awarded Jerry James the sum of $4,213,283.10 against Thomas James, and the jury's verdict was for the most part upheld on appeal.

[28] *Thomas James v. Jerry James*, 768 So. 2d 356; (Supreme Court of Alabama 2000)

The Will Of The Owner And The Owner's Spouse Should Provide Legal Mechanisms To Resolve Family Disputes If Equity Interests Are Given To More Than One Child.

If the succession plan contemplates that equity interests in the family business will be given to more than one child, owners should anticipate that there will be disputes between and among the children. In the absence of a legal mechanism in the Will of the owner and the owner's spouse to resolve such disputes, these future disputes may materially damage the family business.

Best Practice: If equity interest in the family business must be given to more than one child in order to equalize inheritance valuations, the Will of the owner and the owner's spouse should include legal mechanisms to insure against destructive conflict among the siblings.

Once the founder of the family business passes away or retires, it is not unusual for disputes to occur among his or her children or grandchildren or other relatives in the business. Indeed, sensational litigation between family members is very common. Such litigation is extremely expensive, diverts the time of the management away from the business, and many times results in the sale or failure of the business.

Family businesses are particularly susceptible to disputes because business issues and emotional family issues get intertwined. Sibling rivalry mixes with genuine business disagreements and the results can be disastrous to the business.

There are many causes of family conflict. Family businesses encompass business and family, which are two competing systems. The business contacts encourages productivity and profitability whereas the family contacts encourages nurturing and acceptance. These different roles result in confusion and the inability to manage complex roles and relationships that need to be maintained between the family and the business. A few of the focal points for conflicts are differing visions concerning the business, succession, jealously, poor communication, poor conflict management skills, and inequality in rewards.[29] Very wealthy families have been known to have extreme conflicts on philanthropy decisions.

Many family businesses do not last beyond the second or third generation because of this heady mixture of emotion and business. The businesses are sold, liquidated or end up in bankruptcy.

These unfortunate results can be avoided if the founder of the business, while still in control of the business, establishes a dispute resolution mechanism using independent directors to resolve the disputes. An example of a dispute resolution mechanism, upheld by the courts, involving Hanover Foods Corporation, is discussed in Chapter 3.

Many family disputes are the result of poor succession planning by the prior generation. Chapter 4 contains a description of four litigations involving family businesses which are the result of defective succession planning. Three of the litigations were the result of the failure to provide an impartial tiebreaker in the event of disputes in the next generation and the fourth was the result of the failure to provide reasonable severance and a clawback mechanism (i.e. the family members loses the severance payments if they litigate their employment termination) in the succession plan.

The legal mechanisms in the Will can include impartial tiebreaker provisions, and put and call provisions which are given to both the majority and the minority equity holders. Under a put and call provision, a majority equity holder could have the option (also called a "call") to

[29] Finch, Nigel, Identifying and Addressing the Causes of Conflict in Family Business (May 2005). Available at SSRN: http://ssrn.com/abstract=717262

purchase the minority interests at an independently appraised value, with payments spread over a number of years, plus interest.

The minority equity holders could be given a put, i.e. an option to force the company to buy back the minority equity, with yearly payments (plus interest) limited to a small percentage of cash flow from operations (as determined by the independent accounting firm) so as to avoid burdening the cash flow of the business as well as other payment limiting protections. For example, if the minority equity holders decided to exercise the put, they would be limited to yearly payments (plus interest) which would not exceed 10% of cash flow from operations and in no event could the payments cause a default under any bank or other financial institution loan to the business or otherwise cause the business to become insolvent, as determined by its board of directors.

If the child with the minority interest is also employed in the business, consideration should be given to protecting that child from employment termination by the providing a generous severance arrangement. The severance arrangement should be subject to a clawback, i.e. forfeiture, if that child brings legal suit to challenge the employment termination. (See Chapter 4 for the Squabbling Brothers litigation.)

Dispute Resolution Mechanisms In Charter

Dispute resolution provisions which are placed solely in shareholder agreements or in Wills may not necessarily be specifically enforced by the courts. The courts may decide that the sole remedy for violating the dispute resolution mechanism in a shareholders agreement or in the Will is damages.

Best Practice: Establish tiebreaker and other dispute resolution mechanisms in the charter of the family businesses which is automatically effective once the founder dies or retires.

The best practice is to establish tiebreaker and other dispute resolutions provisions in the charter of the family business, which provisions would automatically become effective once the founder dies or retires. The charter of a family business is, in the case of a corporation, the articles or certificate of incorporation, and, in the case of a limited liability company, the certificate of organization and the operating agreement. Dispute resolution provisions which are placed in the charter of the family business are much more likely to be specifically enforced by the courts.

Pruning the Family Tree

Best Practice: Family members who do not share common values with the rest of the family should be eliminated from the family business. Multi-generational family businesses should consider simplifying the family business ("pruning the family tree") by reducing the number of family shareholders, splitting up the family business, reducing the number of family managers, and otherwise simplifying the government structure.

It has been suggested that those family members who do not have the same shared common values as the rest of the family should be pruned from the business in order to eliminate destructive conflict.[30] This prevents the family from becoming fractionalized, leading to a downward spiral in personal relationships within the family business.

Multi-generational family businesses are inevitably confronted with greater family complexity. These well-established businesses tend to have large numbers of inactive shareholders and are engaged in a number of different kinds of businesses which can be split

[30] C. Aronoff, Ph.D. and J. Ward, Ph.D., "Family Business Values: How to Assure a Legacy of Continuity and Success", Family Enterprise Publishers 2001 (2nd Printing).

between family members. Likewise, these multi-generational family businesses may have a complex governance structure and a large number of family managers.

There are advantages and disadvantages of simplifying these advanced stage family businesses. For example, purchasing the equity of inactive shareholders may simplify the business but also deprive the business of capital needed for expansion.

At a minimum, the issue of pruning the family business should at least be considered by all multi-generational family businesses.[31]

Family Businesses Over 100 Years Old

The author has interviewed a number of family businesses that are over 100 years old. Although each family business is unique, some of the characteristics that they have in common are the following, with the first factor being most important:

- The family business presents a good economic opportunity for family members as compared to their alternative careers.
- The family business typically involves a staple product or service such as food manufacture or distribution or, in the case of Kongo Gumi (see article below), Buddhist temple construction.
- The family has developed mechanisms to resolve disputes within the family, including purchasing equity from unhappy family members, without resorting to major litigation which ruptures the family ties and makes a sale inevitable.

Appendix 1 of this book contains a speech by Philip Clemens, the Chairman and CEO of Clemens Family Corporation, which is well over 100 years old. The speech contains insights as to how that business survived for more than 100 years.

[31] Johan Lambrecht and Jozef Lievens, "Pruning the Family Tree: An Unexplored Path to Family Business Continuity and Family Harmony" Family Business Review 2008: 21; 295

There are family businesses that have survived over 1,000 years as illustrated by the following article:

The End of a 1,400-Year-Old Business

WHAT ENTREPRENEURS STARTING FAMILY BUSINESSES CAN LEARN FROM THE DEMISE OF JAPANESE TEMPLE BUILDER KONGO GUMI

THE END OF A 1,400 YEAR-OLD BUSINESS

By James Olan Hutcheson

"The world's oldest continuously operating family business ended its impressive run last year. Japanese temple builder Kongo Gumi, in operation under the founders' descendants since 578, succumbed to excess debt and an unfavorable business climate in 2006.

"How do you make a family business last for 14 centuries? Kongo Gumi's case suggests that it's a good idea to operate in a stable industry. Few industries could be less flighty than Buddhist temple construction. The belief system has survived for thousands of years and has many millions of adherents. With this firm foundation, Kongo had survived some tumultuous times, notably the 19th century Meiji restoration when it lost government subsidies and began building commercial buildings for the first time. But temple construction had until recently been a reliable mainstay, contributing 80% of Kongo Gumi's $67.6 million in 2004 revenues.

"Keys to Success

"Kongo Gumi also boasted some internal positives that enabled it to survive for centuries. Its last president, Masakazu Kongo, was the 40th member of the family to lead the company. He has cited the company's flexibility in selecting leaders as a key factor in its longevity. Specifically, rather than always handing reins to the oldest son, Kongo Gumi chose the son who best exhibited the health, responsibility, and talent for the job. Furthermore, it wasn't always a son. The 38th Kongo to lead the company was Masakazu's grandmother.

“Another factor that contributed to Kongo Gumi's extended existence was the practice of sons-in-law taking the family name when they joined the family firm. This common Japanese practice allowed the company to continue under the same name, even when there were no sons in a given generation.

“So if you want your family business to last a long time, the story of Kongo Gumi says you should mingle elements of conservatism and flexibility—stay in the same business for more than a millennium and vary from the principle of primogeniture as needed to preserve the company. The combination allowed Kongo Gumi to survive some notable hard times, such as when it switched temporarily to crafting coffins during World War II.

“Burst Bubble

“The circumstances of Kongo Gumi's demise also offer some lessons. Despite its incredible history, it was a set of ordinary circumstances that brought Kongo Gumi down at last. Two factors were primarily responsible. First, during the 1980s bubble economy in Japan, the company borrowed heavily to invest in real estate. After the bubble burst in the 1992-93 recession, the assets secured by Kongo Gumi's debt shrank in value. Second, social changes in Japan brought about declining contributions to temples. As a result, demand for Kongo Gumi's temple-building services dropped sharply beginning in 1998.

“By 2004, revenues were down 35%. Masakazu Kongo laid off employees and tightened budgets. But in 2006, the end arrived. The company's borrowings had ballooned to $343 million and it was no longer possible to service the debt. In January, the company's assets were acquired by Takamatsu, a large Japanese construction company, and it was absorbed into a subsidiary.

“To sum up the lessons of Kongo Gumi's long tenure and ultimate failure: Pick a stable industry and create flexible succession policies. To avoid a similar demise, evolve as business conditions require, but don't get carried away with temporary enthusiasms and sacrifice financial stability for what looks like an opportunity. These lessons are somewhat contradictory and paradoxical, to be sure. But if sustained success came easy, then all family businesses would have a 1,428-year run."[32] **[End of excerpts]**

When Kongo Gumi was acquired by Takamatsu in 2006, its place as the world's oldest family business was taken by Houshi Onsen, a spa and inn located a few hours from Tokyo, founded in 718.[33]

Chapter 2 of this book discusses family employee agreements and shareholder agreements which are important not only in succession planning but also in the protection of the business during the lifetime of the owner.

---

[32] James Olan Hutcheson, The End of a 1,400-Year Old Business, *BusinessWeek* (April 16, 2007)
[33] Leah Kristie "The World's Oldest Family Companies", Family Business (Autumn 2008)