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Transition phases in a family business.

Family businesses are usually the creation of a single entrepreneur who owns and controls the enterprise. The business is established and developed by them over a number of years. As the founder nears retirement, he/she must decide whether to pass the business on to the next generation or to sell the business. The decision is a complex one. Some factors which impact on this decision are beyond the original founder's control, such as number of children and their individual talents. Other factors may be within the founder's discretion, such as the capacity of the business to accommodate family members and which family members are invited into the business.

If the founder wishes to keep the business in the family, the founder will need to decide whether the business will be passed on to another owner manager who will operate the business by themselves or whether it will be passed to a team of sibling owners. Where the business is passed to a sibling partnership, those family owners have a different set of decisions to make in operating the business. They can consolidate their ownership into one branch of the family, they can split the business up amongst the various siblings, they can sell the business or they can in turn pass ownership to all or many of the cousins in the next generation.

The choice to remain an owner managed business, become a sibling partnership or a collaboration of cousins is one of the most fundamental decisions for a business-owning family and different families will make different decisions in large part because of different assumptions about how the family works best together and how the family and business interact. Certain other factors will ultimately shape the decision, such as:-

- Family size, larger families are more likely to become sibling partnerships or cousin collaborations;
- Commercial environment is such that the family is able to keep their business operating for years;
- Nature of the business and profitability, a more capital intensive business has less flexibility to adjust for family preferences;
- Non business assets, the more assets which the business owner holds outside of the business the more flexibility, he or she will have to provide for his/her children from outside of the business; and
- Estate taxes, in some countries may drive how the business ultimately devolves.

By the time a family business reaches the third generation and beyond, there may be dozens of family members who have an ownership stake. Ownership can be in the hands of many cousins from different branches of the family, with no one overall branch having a controlling shareholding. Some of the shareholders may work in the business but most probably will not. The potential for friction and dysfunctional behaviour if the large-scale complexity arising within the shareholder and family groups is not controlled and managed can be significant. The governance of the business needs to be tailored to meet the specific circumstances of these families where ownership devolves through generations. Different family members and indeed other stakeholders in the business will have different perspectives.

Successful families learn to communicate and share thinking about the critical issues the family must face into and devise strategies and governance structures that help them keep issues that are likely to overlap or cause friction under

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control, maximise clarity and transparency and minimise the scope for misunderstandings. The essence of all good governance is communication. Good governance provides a framework for open, frequent and effective communication which encompasses a set of parameters to manage people's expectations as part of the overall communication process.

The willingness of the family to plan for the succession process is often a decisive factor in determining whether the business will survive into the next generation or fall by the waste side. Statistics worldwide show that one third of family businesses survive into the second generation and one tenth of family businesses survive a transition from the second to the third generation.

The transition from founder to siblings is the first major transition which introduces greater complexity into the business at a management and governance level and if not appropriately managed, becomes another of those stark statistics as to why family businesses rarely transition as far as the third generation. For a sibling partnership to work, it takes the effort of parents, in laws (spouses) and the siblings themselves to ensure that siblings can evolve into teams and work successfully together.

Sibling Partnership

The framework for making decisions and how the business is run within a sibling partnership will differ significantly from the way in which the business was managed by its founder who owned and controlled the entire enterprise.

Board of Directors

The founder may have successfully operated the business without a functioning board of directors for many years. However, at sibling partnership stage, a functioning board of directors is a very important part of the governance structure, as it becomes a forum that elevates discourse to the most constructive level. The advantages of a functioning board of directors at sibling partnership stage include:

- Ability to appoint independent outsiders to serve on the board. These can act as a moderating force that helps siblings resolve differences and enable the siblings to gain more independence from their parent, the founder of the business. In addition, outsiders can act as mentors for siblings and can encourage siblings to become an effective ownership or management team.
- An active effective board is an additional resource for siblings giving them feedback and providing objectivity in decision making. Competent outsiders can assist the current generation to take appropriate steps to prepare the next generation, which would be important if the business passes on to cousins in the future.
- Independent outsiders can also assist in educating those siblings who are not actively involved in the business and help them understand the realities of the business in addition to their role in it.
- An active and effective board also provides a degree of discipline and accountability and can serve as a check on siblings and assist in making sure they are not making unwise decisions.

Meetings

Regular meetings to enhance communication within the sibling partnership are important. Meetings at a sibling generation level are somewhat simpler than those which would be required at the next generation when the family and business are larger. These can comprise:-

- Sibling team meetings within the business, consisting of those siblings involved in the business meeting regularly to discuss performance plans, policies and keep each other informed of their specific areas of responsibility within the business.
- Shareholder meetings may be required if there are shareholder siblings who are not actively involved in the business. These would generally be held a number of times a year to maintain unity, to communicate financial results, to approve major transactions and to facilitate participation of those not taking an active role in the business.
- Family meetings may also be useful, these could include all of the siblings' spouses, parents and perhaps children and are an important tool to make sure there is an appropriate and adequate flow of dialogue and information amongst family members.
- Board meetings should also be held a number of times a year, these may serve as a forum for strategic discussions on oversight and accountability.

Policies

The development of policies can help a family business achieve success through generations by resolving issues before they arise. By developing policies, siblings are in effect agreeing on solutions to problems in advance. This removes the emotional component that may otherwise arise where individuals take matters personally and enables discussions and decisions to be more objective.

Policies that can assist the family at the sibling stage include:-

- Policies dealing with employment participation
- Policies dealing with compensation
- A code of conduct
- Shareholders agreements
- Policies dealing with exit / redemption of shares and liquidity
- Personal investment policy i.e. how new investment opportunities will be handled

In addition, other policies that might be considered include those dealing with ownership rights and responsibility, conflicts of interest, company loans to family members, dividends, retirement age, ethics, publicity and how to assist family members who may have special needs.

Cousin collaboration

The transition to the third generation of the family, the cousins, results in greater complexity at a governance level given the different familial relationships. Siblings, for example, have more shared experiences than cousins do as they generally grow up together in the same household and as a result there is a greater intimacy in their relationships. There is a sense between siblings that 'we are in this together and we need to take care of each other' to a far greater extent than between cousins. However, brothers and sisters are as a result of that intimacy, more likely to experience sibling rivalry, than their cousins. In addition, while siblings may stay geographically close, work in the business together and share similar values, cousins can become a lot more diverse.

It is both the diversity and loosening of family ties in the cousin generation that poses two of the major challenges in building shareholders' voluntary commitment to the family enterprise and in holding the family together with a common set of values to drive the business forward. Siblings can set the stage for how cousins interact together and may have put in place a process around family meetings, decision making and governance and have created functioning structures, processes and policies that will enable their children to move forward together and make decisions appropriate to their generation. If the siblings have not accomplished these tasks, then they leave the next generation with a greater challenge and danger that the business will not transition successfully. Cousins can of course also prepare themselves by educating themselves to be effective owners of the company and developing constructive relationships with each other, getting to know each other and getting to know the issues that may arise and confront them collectively.

Some of the key challenges facing a business as it moves from the second generation to the third generation include:

- Ensuring it continues to attract competent family members to employment in the business. This becomes more difficult as the business moves from one generation to the next as cousins feel more remote from the business than their predecessors. In addition, as the business becomes larger and more complex, the family is increasingly raising standards for entry into the business which may make the business more intimidating and less appealing. Freedom of choice is often encouraged in the third generation and such freedom increases the likelihood that family members will make career commitments in places other than the family business.
- Equality in all things at the cousin stage will probably not be feasible and it will be necessary to introduce democracy in a fair way by designing a process that everyone perceives as fair and appropriately inclusive.
- How decisions will be taken, for example, determining whether to count votes on a per capita basis or on per share basis? It may be that the cousins work towards voting one way (on a per capita basis) for family issues and another way (on a per share basis) for shareholder issues. The separation of the family and shareholder agendas can help members to understand the difference between the two.
- Deciding what kind of owners they want to be both individually and collectively. Ideally cousins not employed in the business will be active owners who are engaged with the business and keep themselves informed about the issues facing the business. Collectively, the cousins should strive for a shared ownership vision and develop a shared understanding of their relationship with the business.
- The cousins will also need to look at how to give owners a voice to enable them to exert influence over the management to rectify, where possible, causes of dissatisfaction and where rectification is not possible to provide an exit mechanism for dissatisfied owners.

Governance in a cousin company

Good and effective governance both of the business via the board of directors and of the family via such institutions as a family council, family office is essential for the successful transition of the business from the second to the third generation.

Good governance offers assurances that all family members will be listened to and also provides opportunities for family members to participate in significant and critical ways both in the business and the family. It enables the family to define the goals which the business should strive for and the values which should guide its conduct in so doing.

As ownership moves from a smaller group of siblings to a larger group of cousins, basic assumptions about governance may change dramatically. The cousins may need to consider the following issues as the family designs and implements a new governance system:

- What kind of board is envisaged?

  As the business transitions it is likely that independent directors will be required. The directors may have a supportive role, have a background for example in a family business and understand the family dynamic and value system. Alternatively, they may have a background for example in a public company and have a role in challenging the existing board and increasing accountability for stakeholders. A mixture of both might be suitable.

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- Who is "family"?

  Who is family becomes a complicated question at the cousin stage and will very much depend on the individual family involved. The family might consider whether spouses/step children should be included? Who gets to vote in the family council? What happens if a family member has sold her/her shares? What happens if a family member is separated or divorced?

- How are family members selected for governance roles?

  How will family members be picked to serve on the business board, family council, family office etc.? For example, family members could be chosen by merit or representation or a combination of both. Consideration might be given to having limited terms in office, whether the ballot is open or secret and how and by whom any evaluation will be carried out.

- How are family members who are employed in the business to be remunerated?
  i.e. policies might be introduced to deal with bonuses, benefits, perks. In addition, consideration may be given to how family members not working in the business but playing an important role in service of the family are rewarded.

- Consideration might be given to how the diverse family spread over a wide geographical area will retain a feeling of being close to the action and being a valuable part of a bigger team. This may be achieved, for example, by inviting family members on a rotation basis to be observers of governance activities.

Transitioning a family business from one generation to the next involves an analysis of complex issues. One generation can't run the business in the same way in which the previous generation has. Each generation faces different issues. Effective governance is essential at each stage in the transition to enable the siblings on the businesses first transition and the cousins on the businesses second transition to work together as an effective team and give continuity to a viable business. The challenge particularly at the cousin stage is more about managing the family than it is about the business, because without a united family, the business will be at risk. The family is the foundation that helps make the business successful by defining the goals for which it should strive and the values that will guide its conduct.

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