DENTONS

Succession Planning for Family Businesses

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The greatest wealth transfer in history—from Baby Boomers to younger generations—is underway.

According to the US Federal Reserve Board, Americans age 70 and above have US$35 trillion of wealth, compared with only US$4 trillion held by this age group 30 years ago. This is expected to be transferred to younger generations over the next 20 years.

This will have an enormous impact on investment trends, the financial sector and the global economy in the decades ahead. This massive wealth transfer will widen the gap between the rich and the poor, as the richest 10 percent of Americans hold 70 percent of the country's wealth.

Much of this wealth was generated by, and remains in, privately held family businesses. This is challenging because the assets involved can sometimes be illiquid or non-fungible, may generate subpar returns relative to capital value and are often imbued with history, sentiment, and emotion.

Such wealth transfers typically occur in one of two scenarios:

- A planned and orderly exit, such as a sale, management buyout or phased family succession
- An exit forced by events and circumstances, such as divorce, family quarrels, death or incapacity.

What does success look like?

Success in a family business succession plan means different things to different families. It is important that each family define at the outset what that success will entail. This could be determined by such factors as:

- The family's hopes and expectations going into the process
- How family members engage with each other during and after the process
- Any financial value realized at the end of the process
- What the family does next
- How the family finds purpose after a transition or a sale of the business

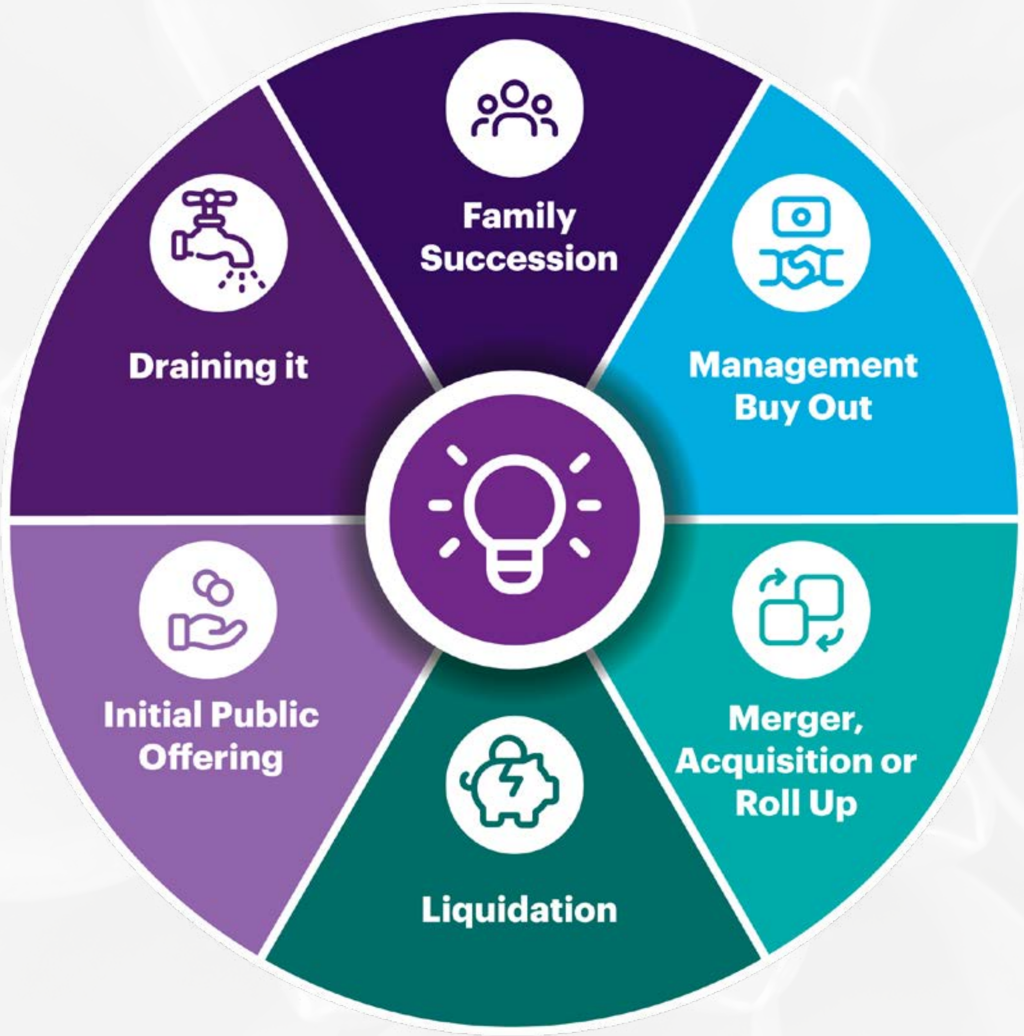
The outcome of a successful process is often:

- An equitable (not necessarily equal) division of *financial* capital between family members who then go on to become successful independent economic units in harmony with other family members
- A consolidation and aggregation of *all forms of family capital* (financial, social, human, intellectual and spiritual) into a sibling partnership or cousin confederation held together by a formal governance program

Keeping wealth concentrated in family ownership is often held up as being an exemplar of success. Devolution and fragmentation into individual, autonomous family units does not necessarily mean that a family has failed or achieved a suboptimal outcome. In some families, fragmenting wealth is a better and more appropriate solution, especially if the decision is planned and the family is well supported by a relevant and experienced internal team and external advisory network.

What are the succession planning options?

In many private businesses, there are usually several potential succession planning options:



Succession is a process and can take many twists and turns. It is important to start early, take plenty of time, work with experienced experts, follow due process, communicate effectively and clearly with stakeholders, and deliver a managed business that thrives on its own without ongoing support from the transitioning owners/managers.

Family businesses have some special challenges

These include:

- A key element of delivering a managed business is ensuring that it has intrinsic value independent of its owners and underlying real estate valuations. This is the difference between delivering a job and a business.
- Before a business transfer, sometimes it is more optimal for the owners to step down from day-to-day roles and shift from working in the business to working on the business (in other words, governing).
- Family members who take over the business may face higher risk (e.g., concentration risk, illiquidity, opportunity costs, resource constraints, etc.), and uncertainty than other family members who may have the opportunity to forge traditional careers in professions and receive financial support in other ways (e.g., loans secured against the business that are then used to purchase homes or pay for tertiary education).
- Some family businesses are operated with a mixed ownership and co-governance model, which allows all children to be owners, but only some to be involved in management of the business. This can work well. However, it can also potentially lead to tension between the shareholders not involved in the management who want dividends from their invested capital, and the managing shareholders who are dealing with the day-to-day challenges of running the business and meeting its current and future capital expenditure requirements.
- It can be difficult to recruit talent for family businesses. Sometimes family members are either not capable of, or not interested in, working in the business. Sometimes external talent is reluctant to join a family business due to concerns about cultural fit, pathways to equity and opportunity cost.
- The timing of any equity release may need to be phased over several years (or even decades). It is essential that all family members understand the process and are afforded some certainty as to timing, quantum and any expectations on them. The length of this process can then raise its own set of challenges, because individual family members will go through their own transitions and personal life events, which can have an impact on the wider family and any succession planning.
- It may not always be possible to achieve equality in terms of ownership or management responsibilities, but families should strive to treat all children fairly. It is important that all children are actively involved in the decision-making processes. Sometimes this won't happen because even parents have favorites and "fair" can be difficult to define.
- Once a succession strategy has been agreed, then it is essential to determine how the distributions will be funded and how capital will be set aside to fund the retirement of the parents. It can be helpful to this process if capital reserves have been set aside or liquid investments made over multiple prior years. These reserves can be combined with bank debt to provide the necessary liquidity. However, the nature of business is such that this is not always possible.
- Some family businesses have strong balance sheets but weak cash flow. This constrains borrowing to purchase certain types of non-income-producing assets (e.g., family homes) for family members not involved in the management. But a bank may be willing to release some equity in the business to finance the purchase of income-producing assets (e.g., a commercial building) for such a family member.
- There is often pressure to keep a business in the family. There are various positive reasons for this including legacy building, avoiding fragmentation, tax benefits, providing an enduring platform for family prosperity, community engagement and social status. Other reasons are societal and arise from negative stereotypes about businesses rarely surviving past the third generation. However, selling the family business is *not* symptomatic of a failed succession plan. The failure in many succession plans is usually procedural. Frankly, the process is more important than the outcome.

Steps to success

An important goal when succession planning for any family business is to transition financial capital between the generations, while preserving and enhancing family relations.

In our experience, the best outcomes:

- Occur when succession discussions begin well in advance of any anticipated transition
- Require an in-depth understanding of the family dynamics drawn from considerable time and effort in understanding and meticulously documenting all the relevant circumstances
- Involve regular and effective communication and engagement with all stakeholders, including family members and management
- Are based on a game plan that is simple, documented and agreed at the outset before any substantive steps are taken
- Are recorded in a family charter that harmonizes the many and various legal documents and structures that bind and hold the financial capital
- Occur when the qualitative forms of family capital (social, human, intellectual and spiritual) are prioritized and supported by the financial capital
- Occur when potential successors are identified early and provided with the necessary training and development opportunities to prepare them for leadership roles
- Involve communicating openly with the wider family ecosystem, including the second and third generations and in-laws, family business management and advisory teams, as well as adopting relevant technology solutions to centralize and share important data
- Are not tax-driven; in our experience, some of the worst succession plans are often those designed principally for tax efficiencies
- Involve the principal family members taking a leap of faith in the advisors, management and other family members—so they need to choose their "team" wisely
- Involve the free flow of information among the management team, lawyers, accountants, financial advisors, bankers and other relevant professionals who work together from the outset, rather than alone in silos
- Are often led by professionals skilled in the science of human behavior, rather than lawyers and accountants
- Are predicated on independent valuations and reporting
- Take into consideration financial products, such as insurance, to manage risk and annuities to manage cash flow and services such as wealth management, where there is liquidity
- Occur when the family's financial capital is diversified and includes some liquidity
- Occur in families that recognize private wealth planning as an intellectual discipline and empower the traditional "trusted advisor" to select a "team of trusted experts" to provide specialized and independent governance and advice
- Recognize the value of independent governance, whether that be at the trust or company level (and in this regard, the family lawyer and accountant may not always be "independent" and perhaps should concentrate on advice rather than governance, which involves a different and much wider set of fiduciary responsibilities).

Overcome inertia and make a plan!

A well-designed family business succession plan should articulate the vision and values of the family and help ensure a smooth transition to new owners or the next generation. This can create prosperity for future generations of the family and the communities in which they live and work.

The challenge is to first overcome inertia to develop an appropriate, coherent and agreeable strategy. In our experience, once that hurdle is overcome, then the execution can often be expedient and effective.

If this challenge can be met, then family businesses will continue to fuel the global economy, bind communities and stimulate regions for generations to come.

Dentons, the world's largest law firm, advises family businesses through all aspects of their lifecycle. Dentons Exit+ is a cross-disciplinary team comprised of legal, M&A advisory, wealth management and accountancy experts who help families and entrepreneurs develop and implement effective strategies for selling their businesses and preparing for life after exit. Dentons Private+ is a "one-stop," global legal services concierge that supports high net worth families and helps private offices organize their affairs during and after this process.

Henry Brandts-Giesen

Henry is an expert in wealth planning, family office design and governance, family business succession, trust law, fiduciary risk management, family/private wealth/relationship property-related dispute resolution, residency by investment, cross-border wealth structuring, transitional residency tax planning, private funds, strategic philanthropy, captive insurance, global tax reporting and compliance, and financial regulation relating to private wealth.

Henry is general counsel and strategic advisor to single-family offices, investor migrants, foreign investors, multi-family offices and trust companies, entrepreneurs, private fund managers, limited partnerships, family businesses, philanthropists, athletes, player associations and sports agents.

Jurisdictionally neutral, Henry develops global strategies and provides and procures global solutions for global clients from within and beyond the Dentons platform.

Edward V Marshall

Edward V. Marshall is the Global Head of the Dentons Family Office and High Net Worth (DFO) group. Edward is a family office insider and a renowned family office researcher, advisor and author. He is regarded as a thought leader in the family office space, distinguished by his service to complex families around the world. He is also a risk and threat management specialist and works with families to reduce their cyber, physical, financial, operational and reputational risk profiles.

DFO is a global cross-practice group that services Dentons' clients who are family businesses, investors, family offices or high net worth individuals. The team works closely with families considering a family office, families with an existing family office and advisors to families. The group curates a program of insights, advice and connections to advise the firm's clients and relationships across the globe.

Christopher Rose

Chris is a corporate partner at Dentons. His focus is on cross-border private equity and venture capital investments and exits, as well as mergers, acquisitions, and joint ventures. He has developed considerable expertise in corporate governance and is frequently asked to advise boards of directors, shareholders, family stakeholders and corporate leadership on the full range of governance issues that confront them.

An emerging markets specialist, Chris has advised on more than 250 transactions on behalf of leading private equity and venture capital investors in the Middle East, CIS, Central and Eastern Europe, Asia and Africa. He has served on the Global Steering Committee for the Dentons Family Office and High Net Worth group, which provides cross-sector and cross-practice services to ultra high net worth individuals and their family offices globally.
In this role, he conceived and oversees Dentons Exit+, a cross-disciplinary team comprised of legal, M&A advisory, wealth management and accountancy experts which help families and entrepreneurs develop and implement effective strategies for selling their businesses and preparing for life after exit. He also created and manages Dentons Private+, a "one-stop," global legal services concierge that supports HNW families and private offices on their investment transactions.