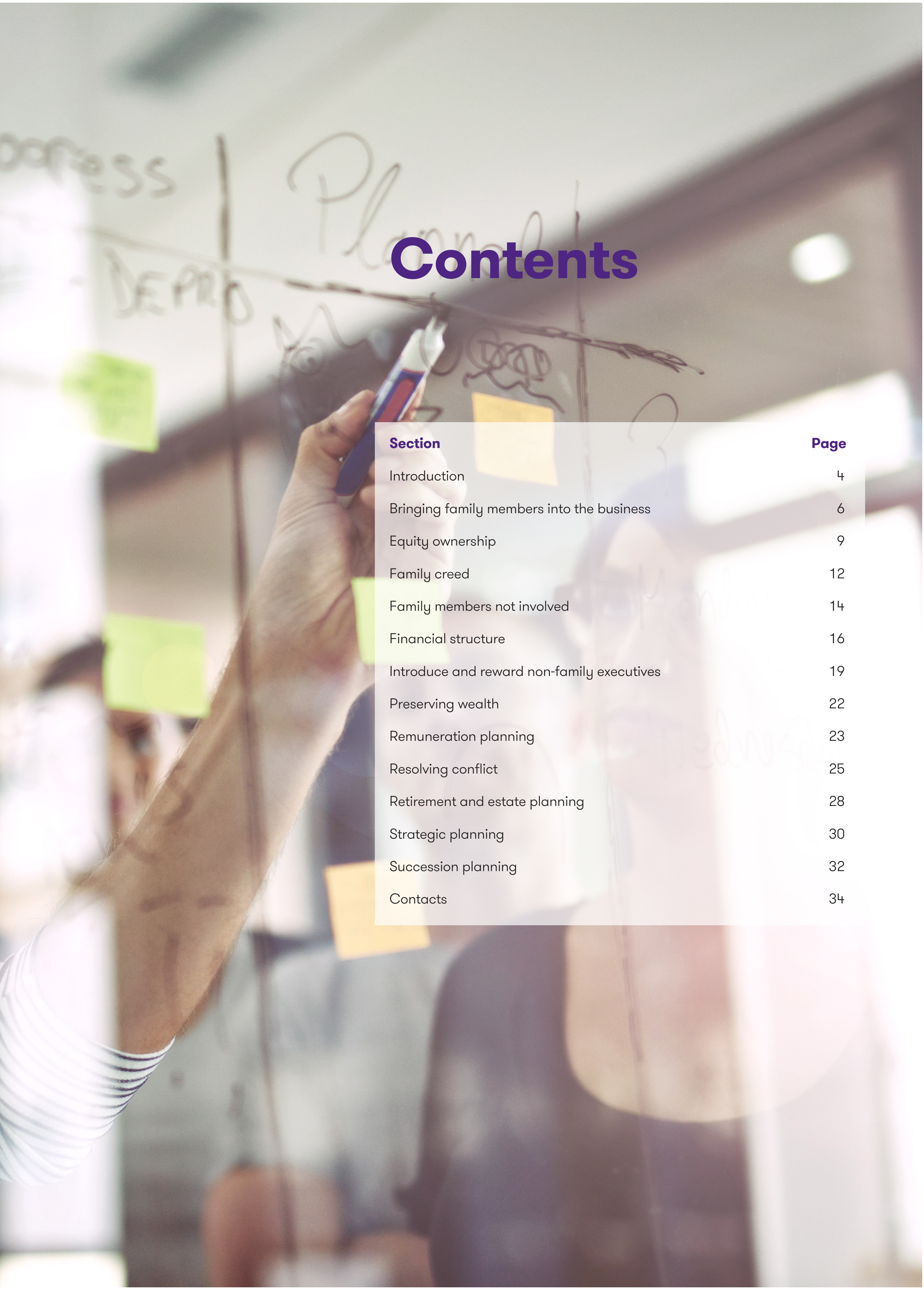
Succession planning

Successful succession

Passing on family businesses



Contents

Introduction

As business and personal advisors we are often in the very privileged position of learning business owners' inner thoughts on what they want to happen with their business in the coming years. Naturally, this often includes significant time addressing their aspirations for their families as well.

In the following pages we outline some of the key matters that are required to be addressed in order to achieve a successful succession. There are many examples in Irish business of long-established family businesses passing to the third and fourth generations and beyond. However, there are significantly more who have not got to that stage, primarily because they didn't adequately address one or more of the key considerations we outline, with sufficient care or regard.

Many of the items for consideration require regular review and refinement as businesses grow or change in nature. Investing adequate time at the outset alleviates many of the risks that are inherent in a growing family business and modifications to either structure or approach are often easily addressed.

With the recovery of the economy in the past number of years people are now actively engaging in the succession discussion again. Hopefully the outline we provide will aide the discussion and provide some focus to key points that should be addressed.

At Grant Thornton we have extensive experience guiding our clients successfully through the succession process. This involves advice on both the qualitative and quantitative aspects of the process. While there is a business at the core of each succession plan we advise on, it is all predicated on understanding the people and their respective wishes.

How do these aspects link together?

The purpose of this booklet is to enable key matters impacting succession to be viewed from different perspectives and to ensure that they are not addressed in isolation. It provides a comprehensive review of practical management issues especially where there is close involvement of the family in running the business. Our approach looks at the needs of the business, the family and the individuals who own and manage it, as a whole.

Bringing family members into the business

Bringing family members into the business may be a source of hope, a threat or cause frustration for family members in power. For those aspiring to attract their family to the business as well as the incoming generation, several issues complicate 'being in the family business'.

- How can the next generation prove their ability?
- Will they always 'walk in the shadow' of the prior generation?
- How do they deal with cousins and in-laws?
- Should they work outside of the business first?
- Must they start 'on the shop floor'?

Entry criteria for both family and non-family members should be established, as by defining rules or policies, critical precedents are set.

As family controlled companies move into their second, third and fourth generation, most recognise the dangers of indiscriminately promising employment to family members. Concerns include:

- the business may become overburdened with family members;
- family conflicts are more likely if clear standards are not communicated concerning employment and advancement;
- motivation of non-family employees will suffer if family members are awarded jobs and promotions without application of appropriate standards; and
- family members may not develop themselves fully if family business jobs are too readily available.

Families should address these concerns by the development of specific employment policies from family and non-family members. Family members should have appropriate prior work experience and should meet the requirements of the position, relevant experience should be defined for family members wishing to join the business. Education should be appropriate to the job sought.

Experience

As a general rule, family members should come into the business with between two and five years of 'outside' experience to help ensure that they are independent and able to add value to the business. If the family member is a potential successor to the incumbent generation, this experience will help them bring new ideas to the company and establish themselves as their 'own person'. It is also likely that the skills required by the current management team will be different from those required by the next generation.

Advantages of outside experience include:

- the opportunity to see a bigger world and gain some personal time and space;
- the experience of getting a job and learning its market value;
- the chance to make mistakes and gain some self confidence;
- enhancement of a sense of independence;
- enhanced credibility with non-family employees; and
- helps eliminate the 'grass is greener' syndrome.

Entry into the business

Family members should have a genuine commitment to and interest in, joining the business, rather than see it as a duty. Entry should be into an existing or necessary position, not one created to meet with the education and skills of the family members. It should have precedents for pay and performance expectations.

When the family member joins the business they will be adding new dimensions to existing relationships. Therefore, it is essential that family members review their current and past relationship, before they go on to define the way in which they will work together in the future. It is advisable to discuss and clarify these relationships as soon as possible, for example, this may be as fundamental as a son or daughter clarifying how they are viewed by their parents.

A systematic training programme must be devised to ensure that family members who are preparing for specific positions are appropriately trained. The programme should be sufficiently flexible to cater for unforeseen circumstances.

Working relationships

It is not advisable that family members report directly to other family members. In smaller enterprises achieving this is not always possible however, where it is, family members should be mentored by a non-family executive. This individual should be someone everyone trusts, both the management and staff and someone who is willing to take on the role. If the idea is that the family member will eventually take over the role of the mentor, careful management of the situation is needed to ensure conflict does not arise. Clearly defined areas of responsibility should be established. The basic principles should be cast in stone in a **family creed** **(see page 12)** and made available to the next generation.

Where the family member is being trained for a particular role, the programme of training they receive should ensure they gain the necessary skills. Where the ultimate aim is for them to succeed the founder or current managing director, the training should encompass as many aspects of the business as possible without disrupting the day-to-day management and smooth running of the business.

The salary paid to family members should be based on the service they perform for the business and be comparable to that of other employees doing the same work. It is common in family businesses to pay family members what they need rather than what they are worth. This can lead to tension with key non-family executives. Strategies can be put in place to give family members more money, for example the owner-manager could establish an executive family committee for which each family member is paid a fee. Alternatively, family members could be given a class of shares, which pays a regular dividend to top up their market value salary.

The levels of pay to family members within the business can be driven by a number of factors. Some of these are linked to personal issues rather than being driven by sound business principles. For example, some parents use the salary they pay to retain control over their children, others use the salary to resolve emotional issues within the family and others will even pay family members below the market rate for the work they do, as a method of teaching them thrift!

The second and third generations

As the business moves into the next generation the dangers of indiscriminately promising employment to family members must be recognised. The business must ensure that it does not become overburdened with family members. This may lead to a point where reporting lines and roles and responsibilities become blurred, resulting in the inevitable conflict. Also, non-family members and especially the key executives will become demotivated if they are overlooked for awards and promotion. Family members who are promised positions in the company may not develop themselves fully either academically or as people and may find themselves disadvantaged if, for example, the business failed.

Families should address these concerns by the development of specific employment policies for family and non-family members. The criteria must be reviewed regularly and discussed by family members and existing management. Clear communication and fair application of the rules are far more important than how strict or liberal they are.

For family businesses it is not merely a case of every family member being invited to join the family firm, nor is it a case that every family member should feel the company is there to support them.

The following must be in place:

- room for every family member who is invited to join the business;
- the individual must have the necessary skills and be appropriate for the particular job; and
- there must be clear line of authority and succession for the family member to report through and follow in due course.

Equity ownership

Should the issues of equity ownership in the family business be a birthright? Can the shares in the business ever be sold? If so, can they ever be sold to family members only or to outsiders? What expectation of regular dividends can a family member reasonably expect and what is an appropriate amount to pay as a dividend?

Family shareholders need to feel that they benefit financially from having equity in the business, either through dividends or because they are able to sell their shares it they choose, if ownership does not translate into reward, they could become mistrustful and trigger conflict.

As a starting point, policies should be set out for the transfer, acquisition and disposal of shares. A method of valuing shares equitably should be determined and the ownership structure must be documented and assessed. The issues should be openly discussed with spouses and children, as they are more likely to support your approach if they have been actively involved in its development. They need to understand that, while there may be no ideal solution, there is a commitment to achieving fairness.

Overall it is generally believed that those family members in the next generation who are actively involved in the business should have an 'enhanced' right to equity over those not actively involved. Agreement should be reached between family members as to whether they subscribe to the principles of per capita (equally to each person) or per stirpes (equally by family line) for the passing on of equity in the business.

Neither approach is 'right' and at some point, both approaches raise issues of fairness.

On the question of dividends and balancing the needs of the business and the family, it is in certain circumstances recommended that the business pay a minimum fixed dividend. Beyond the minimum, a variable dividend that fluctuates with profits by formula should be provided.

This policy risks reducing dividends from time to time, potentially disappointing shareholder expectations. It also goes against the wisdom of a stable dividend payout. However, it caters for the shareholders' need for a level of cash flow they can count on and the businesses need to link dividends and profits, particularly during hard times when there is a need to preserve cash flow.

If a family is, as a basic principle, committed to maintaining a healthy business, then business' needs should be considered first when determining how 'extra funds' should be used. To determine whether there are in fact any 'extra funds', the following questions should be considered:

- Has the security of incumbent family owners/managers been achieved?
- Does the business have adequate reserves to weather difficult times?
- Is there adequate investment in managerial resources?

The establishment of a meaningful and fair dividend policy requires information on, and an understanding, of business and family needs.

Family owners should have the freedom to dispose of their equity. Family shareholders who feel trapped in their ownership can become mistrustful and could trigger conflict.

There should be an acceptance amongst family members that selling family shares is not an act of disloyalty, but an expression of a right to determine their own future.

Family creed

One way to help prevent or resolve conflict is to develop a **family creed**, a written distillation of the family's core values and principles, underpinning how the business is to be run.

The values embodied in a committed family with a 'mission' can make a powerful statement to the employees, customers and suppliers, but:
- How should a family go about establishing a creed of core values?
- How often does the family need to revisit its beliefs and cultures?
- How do they find the cohesive 'thread' that unites the family business?

A family creed document or mission statement should be drafted, spelling out the family's values and basic principles in relation to the business. This is in essence the family's strategic plan.

The document should be reviewed at least annually and should be subject to expansion and amendment as necessary. Binding principles, practices and philosophies within the firm should be agreed upon. The creed should answer questions such as:
- What are the family members' risk tolerances?
- What is the family's true level of commitment to the long-term business continuity?
- Why do we care about the business?
- Why is this business better because the family own it?
- What are our obligations toward each other?
- What are our responsibilities as owners of our business?
- How can we prepare ourselves to be effective owners and leaders of the business?

The stress of working through conflicts helps families recognise the usefulness of having clearly articulated principles to serve as touchstones.

What may seem to be an abstract philosophical exercise before the experience of confronting conflict, may become a practical experience in laying the foundation for future relationships and decisions.

Principles embodied within the creed might include the following:
- family members should endeavour to deal professionally with one another and not bring personal differences into the business;
- family members should respect one another, be loyal and treat one another fairly;
- family members should restrict public and restrain private criticism;
- the creed should define where the family's priorities lie in terms of its commitment to the community; and
- the family should act in good faith and not place undue pressure on company officials. This includes requesting employment or other benefits.

Some family values typically identified are as follows:
- loyalty;
- trust;
- respect;
- the need for openness and communication;
- a belief in the concept of the family business;
- family first;

- philanthropic values – responsibility to the employees;
- a desire to make a contribution to society;
- honesty;
- tradition and religious heritage; and
- sound entry principles for family members wishing to join the business.

The basis of a creed

Preamble:

- company visions;
- statement of family commitment to the business;
- family vision and values; and
- how the business supports those visions and values.

Policies and guidelines:

- participation and exit policies;
- ownership policies;
- share buyout process and formula;
- family compensation policies;
- education plan for family managers, owners and other members;
- plan to involve all family members (ie business, philanthropy and civic);
- how to monitor and communicate personal goals, achievements and expectations within the family, including:
  - new venture support;
  - dividends;
  - shared family resources (houses, boats, etc);
  - family vacations;
  - support for those 'in need' (education, health, etc);
  - plan to administer family functions;
  - family council leadership and governance plan;
  - defined relationship between family council and board;
  - family offices and services; and
  - budget and funding.

Family members not involved in the business

Does share ownership confer 'rights' on family members not involved in the business or do active family members have absolute control over business decisions?

The majority, possibly all, of your wealth could be tied up in the business. When it comes to providing an inheritance for children, you may feel that the only way to treat them fairly is to bequeath an equal number of shares, whether or not they are involved or are likely to become involved, in running the business.

Often such good intentions lead to conflict and disunity. Members of the next generation who are part of the management team may come to resent interference from those who are not, while the non-active members may feel that the business is not being run for their benefit. As the business matures the number of non-active members is likely to multiply, as will the following problems:

- What rights does share ownership confer on family members in the day-to-day management of the business?
- Which needs should have priority – funds for reinvestment or funds for distribution to shareholders?
- What about spouses, the 'unelected' shareholders? How do 'home' and 'boardroom' influences affect the family business?

Family members not involved in the business should be encouraged to continually improve and update their knowledge and understanding of the business.

Family shareholders have a right as investors in the business to be informed regularly about the goals of the business, as well as to receive a frequent report back on the financial position of the business.

This should result in non-active shareholders having a more realistic financial expectation for the business, which will help alleviate any undue cash flow pressure on the business. The mechanism for this is the family council.

In order to build the enthusiasm of non-active investors, the following guidelines should be followed:

- explain profit in relative terms that helps everyone understand it, such as the use of graphics, industry comparisons or benchmarking;
- communicate how the business is succeeding because of the family's inherent strengths; and
- thank them for their trust, support, commitment and long-term perspective.

A potential solution to consider is to form a structure whereby there are different classes of shares in issue, with voting control in the hands of those actively involved in the business. Equal amounts of shares could be 'handed' to the children, but there would be differentiation between voting and non-voting equity. Per share, they could have equal rights to say dividends, appreciation, financial information, etc.

The non-voting shareholders would also have the right to ask questions such as whether the controlling shareholders are properly handling their responsibilities.

Another important factor to be considered will be the drawing up of a buy/sell agreement, both to regulate the movement of shares within the family and to create a mechanism for disenchanted family shareholders or shareholders with changed objectives to sell their shares. This would generally be enshrined in a shareholders agreement.

Financial structure

The **financial structure** of a family business should create maximum flexibility and ensure that there is sufficient finance available to allow the company to achieve its strategic goals. Financing is often a crucial issue for owner-managed businesses.

In addition to meeting day-to-day liquidity requirements, owner-managers may need to fund capital investment projects and provide returns to family shareholders. The combination of these demands can place a heavy strain on the business.

Owners are often tempted to fund these requirements through the business's own resources, in order to avoid being beholden to outside investors or the bank. However, the effect of this can be to starve the business of the investment needed to maintain competitiveness or fuel growth. Realising part of the value in the business might enable investment in new technology or equipment or to replace a non-active family shareholder with an outsider who can provide funds and additional expertise or management skills.

Financial structures should allow maximum flexibility in running the business and be precisely tailored to the owner-managers circumstances and needs.

The financial structure should create maximum flexibility and fiscal efficiency, especially for the transfer of ownership, the flow of income, taxation and estate duty related payments. Family controlled companies are often highly geared and this issue could cause significant problems if the patriarch were to die prematurely. The solution can be addressed under the following factors; succession planning, adequate insurance cover and the building of an asset base outside of the business.

Group structure

The group structure should be documented and critically analysed. The vehicle for the holding of interests must be reviewed. For example, by way of a holding company or in their own personal names.

Overdraft and other facilities

The facilities available should be documented as to the type of facility, purpose and limit. The rate of interest on the overdraft should be recorded, as well as the next review date of the facility. The banking covenants should be examined to ensure reasonableness of costs, rates and security.

Monitoring the cost of capital

An understanding of the cost of capital for shareholders in family controlled companies is critical for making sound financial decisions. Many family business owners assume that their cost of capital is the rate at which they can borrow money. In a family controlled company, there is another aspect to be considered, the investment return required to meet family shareholder's expectations.

Maintaining family control

There are a variety of financial tools, which can help a family in business to meet the liquidity and capital needs in a planned manner. Any option selected, should have the objective of making the most of the financial resources at hand while maximising the opportunity for future generations to do the same.

There are **five basic principles**, which should be kept in mind when considering financial solutions and they are as follows:

- The option selected should be fair to all shareholders, including those who remain in the business. For example, if a family business is planning to buy out inactive shareholders by borrowing a large amount of money, will this leave the company highly geared? Will it be unfair to those who remain in the business, with a company saddled with a large amount of debt?
- The solution must provide adequate capital to sustain a healthy business. A failure to meet shareholders' liquidity needs in a sustainable long-term manner could encourage shareholders to focus on current returns. This leaves less capital available for investment, weakening the business and generating less cash flow that in turn leaves less cash available for shareholders' liquidity needs. A sound financial solution must address this downward liquidity spiral.
- The financial solution may be based on a plan to shift from 100% family ownership of the business to family control of the business. This may be necessary to sustain business growth without allowing the family business to collapse, destroying family control.
- The solution must be adaptable to the unique needs of each business.
- A financial solution should always have a programme to inform and educate shareholders about the solution and the reason for the solution.

The following is a collection of techniques which may be used to meet capital and liquidity needs. These techniques can be divided into two parts, **internal solution**, requiring no outside capital and **solutions**, requiring outside capital.

Internal solutions

Many family businesses have preferred, where possible, to finance shareholder liquidity needs internally. In fact, family businesses are often difficult to persuade to look outside in order to meet their capital needs. The techniques presented below are in addition to the satisfaction of shareholders requirements through salaries, etc.

Payment of dividends

A periodic distribution of a portion of earnings to shareholders, based on factors such as cash flow, shareholders expectations regarding their rate of return and the level of the return available on competing investments. The advantage of this distribution is that it can meet shareholder liquidity needs and is relatively simple and predictable. The disadvantages are that it drains capital from business and risks fostering a sense of entitlement among shareholders.

Employees share ownership plans

This technique entails the setting up of a structure whereby key employees are incentivised to remain with the business. This is normally funded with either internal cash flows or perhaps with borrowed funds. The main advantage of this is that it acts as a means of incentivisation of employees.

Split up of assets

Usually, dividing the assets of the business amongst shareholders to tailor family member holdings to their individual liquidity needs and investment or risk management goals.

External solutions

There are an increasing number of sources of external finance willing to invest in owner-managed businesses where there is closely held shareholdings.

A loan to finance growth

This involves borrowing money from a commercial lender in the form of either revolving credit or a term loan. The debt is typically secured either by assets and/personal guarantees.

The sale of a subsidiary

This would involve the sale of a non-core business unit with the purpose of raising cash for business capital or to meet liquidity needs.

Finding a private equity partner

This method involves the sale of shares to an individual or another investor. This transaction typically results in representation on the company's board and the right to financial information.

Strategic alliances and joint ventures

This method allows two or more companies to pool resources and pursue a common strategy for their mutual benefit. Prospective partners include any business entity, including other family controlled companies, with compatible assets and complementary characteristics.

Introduce and reward non-family executives

Any senior executive joining a family business from the outside is likely to be apprehensive. How can a family business retain, introduce and reward non-family executives?

While many family members will say they value the outsider's skills, non-family executives will be concerned about the family's willingness to accept change and the scope of the contribution they will be allowed to make. To recruit and retain high quality managerial talent, the family must provide assurances that the new executive will play a key role in running the enterprise.

Some questions to consider:

- What percentage of ownership can be 'safely' allocated to these executives?
- Should the family control the ultimate destiny of these shares with mechanisms to buy back the shares when employment in the business ends?

The qualification requirements for the specific position should not vary depending on whether it is a family member or an outsider who is to fill the position. Service contracts and terms of employment should be standardised for all employees. Properly structured schemes can deal with different employees on different terms. Significant tax advantages may be available.

A family controlled company should provide equity ownership for non-family members who play strategic roles in the business. Equity ownership tends to give an employee a longer-term perspective, while cash bonuses tend to focus on annual profit performance.

General matters for consideration of reward:

- Is the chosen scheme to apply to all employees or just to key employees and directors?
- Is the 'reward' recognition of past efforts or an incentive for the future?
- Is the 'reward' calculated by reference to pre-set targets or is it discretionary?
- If it is an incentive for the future, is the reward based on the achievement of measurable goals (eg a bonus based on profitability) or is it an indirect incentive aimed at general motivation (eg permitting an individual to acquire an equity stake)?
- If an incentive scheme has measurable goals, then is there room for improvement (headroom) and how directly can the individual affect the performance measure (leverage)? High headroom, leverage schemes tend to work very well.
- Is there a floor or ceiling cost to be borne by the company or is the proposed scheme to be open-ended?
- What effect will any proposed incentive scheme have on other employees' motivation, existing pay structures and pension arrangements or future pay structures and pension arrangements?
- What is the desired result of the incentive scheme: short-term reward for performance or long-term employee retention?
- What will be the tax implications (for company and staff) of the chosen option(s)?

Equity specific considerations:

- How much equity does the owner-manager have to 'give away' for it to be a meaningful incentive?
- How much dilution will be acceptable to existing shareholders?
- Does the owner-manager wish to issue options or are they looking for an immediate financial commitment from participants?
- What buy-back arrangements are required? What restrictions are there on share transfers?
- How will minority share stakes be valued?
- What is the expectation on the part of the employee as regards the price of the shares?
- Is there a need for an internal market in the shares to exist?

Advantages:

- family controlled companies have to compete for talent with public company compensation packages, which frequently include some form of equity participation;
- reduced impact on cash flow by issuing equity; and
- alignment with the long-term goals of the business.

Disadvantages:

- relinquishing the birthright;
- the cash flow impact of buying back equity when they leave or die, valuation formulae and pre-determined pay-back;
- periods are vital in this regard, in order to alleviate disputes and cushion the cash outflows;
- opening of the family to scrutiny by non-family employees; and
- the percentage ownership needs to be carefully considered in the light of the existing circumstances, a 'safe percentage' of the shares must be determined and ownership of these shares must be a condition of employment. This will require the drafting of buy/sell agreements to cater for the situation where employees leave the business.

The relationship between shares owned by family members and non-family executives should be clearly defined.

Analysis of options for remuneration

Option	Advantages	Disadvantages
Discretionary bonus	Encourages clear goal setting and comprehensive review.	Rarely done well, usually uncomfortable for both parties.
Discretionary perquisites	Strengthens personal-family ties.	Others may be offended and can create paternalism.
Annual profit bonus	Related to ability to pay and to company performance.	Not long-term orientated and profits can be affected by uncontrollable events.
Long-range or multi-year profit bonus	Ties employee to company longer and encourages more long-term view.	Profits don't necessarily measure most important criteria.
Phantom shares	Long-term orientation and related to shareholder benefit.	Difficult to value for private company.
Equity	Long-term orientation and related to shareholder benefit. Confers greater emotional meaning/ status.	Complicated legal administration and difficult to value.
Non-company Investment opportunities	Strengthens personal-family ties. Doesn't affect company's share ownership.	Not readily available. Any failure brings major disappointment.

From our experience we have found that non-family executives ask themselves the following:

- What is their role in a growing family controlled company?
- What are the family's expectations of them?
- What is their worth to the business?
- Where is the business going?
- What would happen to the business if the patriarchs were to die?

These issues could be addressed by one or more of the following strategies:

- the issue of equity;
- appointment as a director;
- the opening of communication channels;
- involvement in the strategic planning process and in decision-making;
- the assignment of responsibility and accountability; and
- structuring of remuneration packages.

Consideration of the following:

- What happens if they get sick or are disabled?
- What happens in the event of premature death?
- What will they have accumulated at the end of their tenure?

An important element of communication with management is to ensure that key managers understand and are involved in strategic planning for the business.

Ideally, key managers should be involved in plan development, not just receiving communication on the plans after they have been developed. This will improve their buy-in and commitment to the continued success of the business.

Preserving wealth

Consideration needs to be given to **preserving wealth** outside of the business, thus developing an asset base which is not reliant on the fortunes of the business and provides a way of spreading financial risk. It is likely that you will have accumulated wealth as your business has matured.

How can you best ensure that this wealth is conserved? No matter how successful your family business, you should still have a personal nest that is protected from the risk in the business. As part of a retirement plan or financial planning in your younger years, it is never too early or too late to begin building some personal security. Having outside resources also helps lessen the tension of passing the business on to the next generation. The family members should therefore consider the following questions:

- How should the 'fruits of the business' success be managed?
- Who will share in the wealth?
- How does one accumulate wealth outside of the family business without crippling the company?
- Should wealth be available for contingencies or even security pledges on behalf of the business?

In order to prepare for retirement the family's wealth should be managed to provide financial security to the patriarch's spouse and dependants. Accordingly, the family should build wealth outside the company to develop an asset base, which is not reliant on the fortunes of the business.

Further, if appropriately devised, the key family members will not be financially dependent on the business for a livelihood after retirement, paving the way for successors to take the helm and providing an effective basis for estate planning, eg wealth outside of the business can be passed onto family members who are not actively involved in it and shares in the business can be passed onto those who are.

However, when extracting wealth from the business it may be necessary to reconsider its financial structure which, historically, is likely to have been funded by family capital.

Building wealth outside the family business

In order to evaluate its net wealth, the family should list all of their assets and liabilities, then compare the value of assets tied in with the business and those outside it. Typically, the proportion of the family's wealth tied up in the business is disproportionately high. Accordingly, a strategy should be devised to diversify and divest.

Having listed the family's wealth, the businesses' assets and liabilities should be reviewed and non-core assets, ie investments, assets for leisure and pleasure and personal assets, should be identified. Non-core assets may then be extracted from the business in a tax efficient manner, whether it be over a period of time or a one off transaction.

If it is not possible to extract wealth from the business, for instance if there is insufficient liquidity, it may be necessary for them to sell a minority stake in the business, make a public offering or to sell out completely to secure the patriarch's financial independence. In the case of the former two options the family should consider the control and ultimate destiny of shares and incorporate buy back mechanisms where necessary.

The management of assets outside of the core business should also be structured in such a manner that:

- an appropriate distribution to heirs is facilitated; and
- inheritance tax is minimised.

Similar to any financial investment, criteria must be established in relation to the patriarch's personal requirements, asset mix and required return. These should be underpinned by their income requirements and risk tolerance level.

Remuneration planning

Family controlled companies usually represent an enviable source of financial independence for family members active in the business. The question of fair remuneration for family employees is a burning issue. Attitudes to pay are often coloured by personal circumstances and relationships within the business, particularly where members of the family are involved.

For example, a business owner may decide to pay their child above the market rate, so that they can enjoy a good standard of living or the business owner may underpay the child, while they are learning about the business.

The business may be used to support a relative who is in financial need, the founder may continue to draw a salary long after retirement, on the basis that it is still 'their' business. All these practices can undermine morale and cause resentment, among non-family executives, employees or the family members themselves.

Common causes of family controlled company pay problems:

- **role confusion** – confusing payouts to family members in their roles as owners or family members with compensation for performing a job in the business;
- **using pay to achieve tax savings** – using high salaries, perks or 'phantom jobs' to transfer tax-deductible wealth to family members;
- **using pay to maintain parental control** – using pay cheques to convey messages or accomplish goals that have nothing to do with the market value of the job performed, eg luring reluctant children to work in the business or pressurising children to learn the importance of frugality;
- **preserving secrecy at all costs** – assuming that it is always discreet, impolite or wrong to talk about how people working in the business are paid;
- **confusing business and personal funds** – the assumption that one can draw as much compensation from the business for as long as they need it, to support the retirement lifestyle of their choice;
- **taking relationships for granted** – assuming family members will respect and be satisfied with their pay just because they are family members; and
- **using salary substitutes** – offering titles or perks to appease family members unhappy with their pay.

One of the key areas to explore is to determine what is a fair and appropriate method of remuneration for all. Family members employed in the business should be rewarded in accordance with sound business principles – a pay cheque in the family company is often confused with return on ownership, parental concern or a method of achieving an emotional goal.

Remuneration should be divided in to two components:
- **a basic remuneration which is market related; and**
- **a performance bonus for meeting predetermined objectives.**

Family members employed in the business should be made aware of the difference between seeking to satisfy a lifestyle to which they have become accustomed based on the family wealth, as opposed to performance related remuneration as an employee in the family business.

Underpaying a family member in order to convey a discipline, a value appreciation principle or to keep control has very negative effects. It demotivates the family members and can result in lack of credibility amongst other employees who become aware of their poor earnings.

Accordingly, companies may like to consider the introduction of a formalised remuneration committee to determine pay structures and their relationship to market value, as well as the terms and conditions of employment including gender discrimination, age of retirement, etc. The tax efficiency of remuneration packages should also be reviewed.

Steps in building a compensation plan:

- decide on a philosophy of compensation, including whether to pay family members equal amounts or based on the market value of their jobs;
- determine the market value for the particular jobs.
- consider whether pay should be set at the market average or whether a cultural statement will be made with pay at levels above or below the market average;
- adjust pay to reflect qualitative characteristics of the job, does the job have strategic importance?
- decide if an annual incentive plan is on offer, based on personal goals and/or company performance;
- establish classifications and criteria for assessing company performance; and
- communicate clearly to the entire organisation and family, the philosophy of compensation and an intention to review and refine the plan on an ongoing basis.

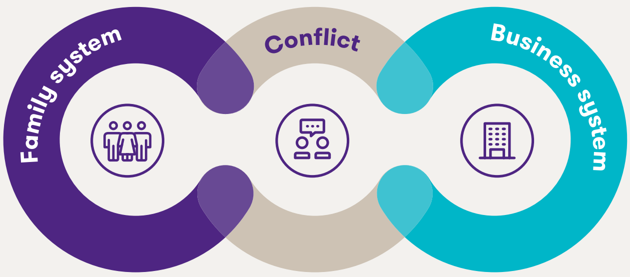
Resolving conflicts

Resolving conflicts quickly and professionally in a family business is very important in order to minimise the impact on the business. Like any organisation with overlapping roles and conflicting objectives, the family and the business will not always run smoothly.

A number of difficult questions need to be considered:

- If a dispute arises, is it a 'family' or 'business' problem?
- What mechanisms are in place to resolve the conflict?
- What proactive procedures can prevent conflict?
- Will the family survive these painful moments?

Family system vs business system



Family system:

- inward looking;
- emotion based;
- unconditional acceptance;
- lifetime membership; and
- averse to change.

Business system:

- outward looking;
- task based;
- rewards performance;
- perform or leave; and
- embraces change.

Different families experience different degrees of conflict at different times and in different ways, but all experience it. While conflict tends to be viewed negatively, it can provide opportunities for constructive change. The family must be proactive in settling disputes before they arise rather than being reactive to events. Preventative measures are preferable to damage control procedures. Conflict resolution needs to be regulated by agreement in so far as possible. A mechanism must be formally agreed upon, clearly communicated and committed to writing. All family members must be committed to this process. The mechanisms may vary depending on the nature of the conflict:

- for technical disputes, external technical experts in the specific field may be selected. Their opinions should be binding on all the parties involved for general disputes, an arbitrator may be called in and their decision is binding on all parties; and
- another alternative is to use a facilitator who chairs the discussions, but does not arrive at the ultimate answer. A decision may be arrived at by means of a majority vote.

All aggrieved parties must agree that once the dispute has been settled the issue cannot be constantly regurgitated and must be 'put to rest'. Clear guidelines should be drawn to determine whether a dispute may be classified as:

- **a family dispute** - to be dealt with in family meetings; or
- **a business dispute** - to be resolved by the company management.

Safeguards should be implemented to avoid abuse of authority and manipulation by majority shareholders.

Shareholders' agreements

An important element of conflict prevention is a shareholders' agreement or buy/sell agreement. The key reason to implement such an agreement is to establish plans for ownership structure and the orderly transfer of equity, particularly when unexpected events, eg death and divorce, make ownership transfer imperative.

Key issues to be addressed in such an agreement include:

- shareholdings - voting rights, resolution procedures;
- insurance;
- directors – appointment, resignation, etc;
- financing – shareholders loans and external financing;
- employment;
- service contracts;
- remuneration packages; and
- retirement ages.

50/50 partnership tie breaks

Many companies are run on the basis of partnership, eg two siblings. Some mechanisms for resolving disputes in these circumstances include:

- outside directors as mediators/facilitators;
- outside directors as voters, with the power to vote a tie breaking share;
- outsiders as arbitrators – a mutually respected person is pre-selected; and
- alternate authority between the partners.

In the situation of sibling partnerships, buy/sell agreements are typically designed to redeem shares from the estate of the first to die, leaving the surviving sibling with ownership of the equity. Life insurance would be required to provide liquidity to the estate and ensure that the deceased's husband/wife will be financially secure, but would not become a partner.
If children are or intend, to join the business, the agreement is clearly inappropriate. This illustrates the need to draft a buy/sell to reflect the specific circumstances and goals and to periodically review the situation.

Principles for breaking deadlocks

The following is an example of a set of rules which was developed by a company to help resolve conflict over major decisions:

- we will remain true to the mission, philosophy and values that we have agreed to for our firm;
- we will use the policy and procedures that were established by us to guide our work with employees and staff;
- when questions arise about our growth and development as a firm, we will refer to our strategic plan;
- in policy disagreements, we will strive to achieve consensus. If all else fails, a unanimous vote will be required to decide the issue;
- if unanimity cannot be achieved, we will hire a skilled facilitator to assist us;
- disputes over procedural matters, such as screening of job candidates or collection of overdue accounts will be decided by a majority vote;
- family members who have conflicts deal with the problems themselves and not through others such as parents, spouses or family and non-family employees; and
- we will keep the focus on what is best for the family rather than for any individual.

A strategy for resolving conflict

The following are guidelines to assist in resolving conflict within families. The best forum for addressing conflict is usually in a family retreat or within the format of several ongoing sessions or meetings with the family.

Establish a safe environment

A safe environment is one in which the individuals feel comfortable to be open and take the risk of bringing up conflicting or controversial perspectives. Usually the presence of an adviser can help create a safe environment in which the family can explore difficult issues. One method of creating a safe environment is to establish and enforce ground rules. Typical ground rules could include the following:

- listen respectfully and don't interrupt;
- focus on the issue, not the person or personality;
- leave titles outside the door, address one another as peers;
- offer feedback with consideration and kindness, avoid making attacks; and
- use 'i' statements, not 'you' statements, eg "*I feel irritated and hurt when people interrupt me*" rather than "*you irritate me when you interrupt me*".

Follow a system conflict resolution approach:

- identify the issues;
- determine each parties motivation to address the issue;
- outline the positions and options suggested by all;
- list the characteristics of an ideal outcome which would address each parties needs;
- consider a list of options, what are the pros and cons of each;
- select the best option, help the family select the option that addresses their description of an ideal outcome;
- give an opportunity to reflect, the decisions should be 'slept on' and not rushed; and
- monitor the implementation, ask the family to evaluate how the solution is working and how they feel about the entire conflict resolution process.

Some typical family business conflicts:

- employment and exit policies;
- role definition;
- who is in charge;
- salary/remuneration policy; and
- recognition.

Retirement and estate planning

Retirement and estate planning for security and financial independence is a common sense approach for any executive. In an owner-managed business inadequate planning can be a powerful obstacle to succession, put simply, until the older generation feels financially secure it is reluctant to release control to the next generation.

One of the most difficult situations facing individuals who own, as well as manage their business, is how to prepare for retirement and when to pass that business on to others. These problems are similar in nature irrespective of the size of the business although in many cases such businesses are run within a single family or several family groupings.

Questions to be considered include:

- At what ages should retirement issues and needs be considered?
- How can family business owners diversify their wealth beyond the existing business?

Planning is necessary to provide for an orderly transition of assets to the next generation. Before developing an appropriate estate plan, it is necessary to establish a planning philosophy. As hard as you may try to be fair to all the heirs, fairness lies in the eyes of the beholder and conflict over inheritances is common, particularly when a business is involved.

The principal cause of unhappiness is probably due to the assumption that fairness, by definition, means equal, when applied to a business it fails to recognise the differing interests of children who are active in the business and those who are inactive.

The principal objective is to provide for the financial security of the surviving spouse and dependants. The correct structure must be in place to provide for ownership of the business to pass to 'the right hands' in the next generation.

Significant shareholders should know each other's estate plans and share transfer intentions, each shareholder's plans affect the other owners. The rationale for this is that uncertainty can create great anxiety.

Estate planning is an ongoing process and should be reviewed, for example when there is a major family event, such as a birth, death or remarriage, when there are tax law changes and as a matter of course, every three to four years.

Sufficient funds must be set aside in order to pay related estate taxes without impacting on the cash flows of the business. This will require a determination of the amount of taxes payable and planning to ensure that the minimum amount is payable. It must be ensured that there is sufficient liquidity to settle any inheritance tax liability. The extent to which family members are personally liable for liabilities of the business must be regulated.

Key-person insurance policies should be acquired to provide funds to help offset the loss of one of the businesses' major assets, the owner.

Trustees

The trustee of a family trust must be carefully selected. Appointing a banker as trustee can be problematic – people make better decisions than institutions? The wrong trustee can:

- defeat careful tax planning;
- squander the trust property; and
- alienate family members.

There are a number of related considerations in selecting a trustee, including:

- competence to manage trust property;
- discretion – the person selected depends on the amount of discretion a planner wants to give a trustee; and
- respect and acceptance of the beneficiaries.

A fundamental principle of estate planning is that an owner/manager should never plan for their family's security at the expense of risking their own. They should never be in a position whereby they are totally reliant for future income on the trustees of an inter-vivos trust, sufficient assets must be retained under direct control so that the source of income is not totally dependant on the co-operation of friendly trustees.

Wills

The most important tool of estate planning is a will, intestate succession is not recommended. For this reason:

- its terms and consequences must be carefully considered;
- it should be regularly reviewed to take into account changing circumstances;
- the owner should take into account family needs and commercial realities, saving estate tax should not override good commercial and family sense;
- patriarchs and/or matriarchs often have a joint will which adopts the principle of 'share and share alike' – the 'equal value principle' should be considered in order to prevent the potentially problematic situation of share-owning family members who are not active in the business; and
- wills are often outdated and no longer representative of the patriarch's wishes.

The children

Often the children do not have wills. As they begin to accumulate an asset base in their own right, they should consider drawing up wills.

Insurance

Families often maintain a portfolio of policies managed by their financial advisor. This offers an excellent opportunity for cross-selling, by reviewing the following aspects of a portfolio:

- type of cover;
- annual premiums;
- claim values;
- tax efficiency; and
- beneficiaries.

The businesses best interests are served by providing substantial family owners with business funded life insurance. The objective is to reduce the business's vulnerability on the premature death of a shareholder. Another aspect to consider is the adequacy of personal liability insurance and the potential impact due to 'deep pocket' syndrome on the business in the case of insufficient insurance.

Due to the perceived problems with a handover, individuals may be tempted to soldier on rather than face the issues, at longer-term detriment to the business. All closely held, successful businesses will face this process at some stage. With appropriate help, the owner's objectives can be formalised and the problems identified and tackled. Solutions can be found to most situations so long as a positive attitude is taken to the process.

Strategic planning

Properly integrated, **strategic planning** for the family and the business can be a powerful competitive tool and help the family secure its future for generations. Every business, regardless of its size, needs to decide what its objectives are and how these are going to be achieved.

The objectives might range from increasing profits and return on capital, to building growth for the long-term.
For family businesses it can be more complex: commercial goals will need to be balanced against personal and family considerations. One of the purposes of strategic planning is to define these various objectives and identity how they can be reconciled.

In assessing how the business should develop, you will need to take family considerations into account. For example, the prospects for achieving growth may depends on the enthusiasm and commitment of the next generation, while the ability to adapt to shifting market conditions may depend on the willingness of older members to embrace change and acquire new skills. Strategic planning will create an opportunity to confront the issues and debate and resolve differences of opinion.

Questions to be answered include:

- Which strategic responses are most suited to a family controlled business?
- How can the strengths of the family unit be channelled into positive avenues for the business?

Ongoing strategic planning is a requirement for both the business and the family. The businesses' strategic plan or at least the ability to implement it, is strongly influenced by the family and in particular succession considerations and vice versa. The key to strategy in a family concern is to set a course, which uses the inherent strength of having family involved in the management.

A strategic plan should be developed with key non-family management's involvement and buy-in and, should be 'welded together' with the family's strategy, usually set down in the family creed.

To implement a business strategy successfully, management must have the necessary ability, focus, resources and will, the succession process determines whether these elements will remain available. Strategic planning for the family controlled company should be conducted in a market-focused manner, rather than from the family perspective, this reduces perceptions of ulterior motives and hidden agendas and allows for more healthy strategising.

The quality of the output of the strategic planning process is only as good as the quality of thought and effort invested and a structured but flexible approach is therefore required.

Visionary companies

Research into the distinguishing characteristics of visionary companies has shown the following to be the foundation of their success:

- most of the 'greats' started slowly and small, without any special idea;
- the owner managers concentrated on building an enduring institution rather than on being great individual leaders;
- they pursue a cluster of objectives, guided by a core ideology and a purpose beyond just making money;
- there is no 'right' set of core values. The crucial variable is not the content of the ideology, but how deeply it is believed;

- the core values do not drift with trends;
- they appear conservative, but they challenge and excite their people by making bold commitments to goals; and
- only those who ‘fit’ extremely well with the core ideology and demanding standards flourish. This culture creates the sense of participation in an elite organisation that can accomplish almost anything.

By considering each of the above characteristics in as far as it applies to a family controlled company, it becomes clear that a family controlled company has a great competitive advantage over other companies as many of the attributes are inherent.

> “I am more concerned with retaining assets in the family than management positions, which should be left to those best qualified to carry them out”

Source: Founder of a third generation successful business

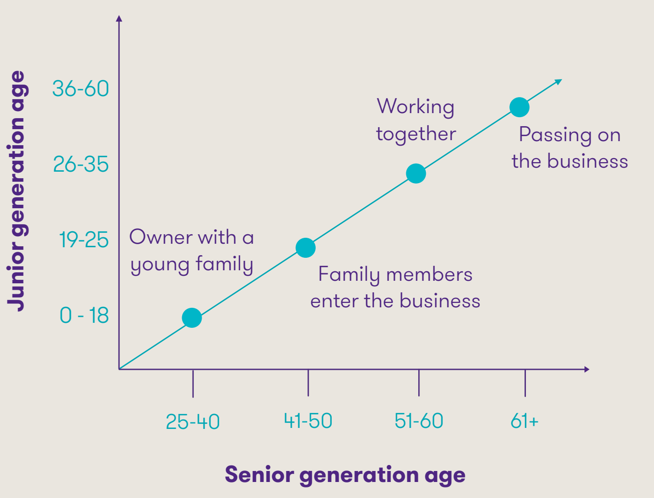
Succession planning

One of the most agonising experiences that any business faces is the moving from one generation to another. Succession planning should not be an overnight event but a carefully thought out process over a period of 10 to 15 years.

As a business leader, you are used to being in control and your ability to control events is part of what makes you a leader. Planning for succession, the process of passing control to others, is likely to be unfamiliar and difficult territory. It can be a critical factor in ensuring that the business prospers into the future.

The first question to ask is whether the business will be sustainable without you? Some enterprises are so dependent on the qualities of a single individual that succession isn't possible. If the business can be passed on, you will need to tackle a range of issues. For example, you may hope that your children will take over, but do they have both the aptitude and inclination to step into your shoes? Which child is best suited to lead the business after you've gone? Will you need to bring in management talent from outside the family to fill any gaps?

Four stages of a family controlled owner-managed business



Succession plan

It is of vital importance that a detailed succession plan be developed and documented. Putting the plan in writing will help to ensure that difficult issues are confronted head on and that everyone, non-family executives as well as family members, know where they stand in relation to the business. The plan should include criteria for selecting the next generation of management, details of how successors will be prepared for their roles and contingency arrangements to cater for unforeseen events.

The seven stages of successor development

1. Attitude preparation

Important attitudes towards work and the family business are formed during a child's first 25 years of life. This stage includes part time work, occasional business related trips and outside work experience.

2. Entry

This usually occurs when the successor is between 20 and 30 years of age and takes an existing necessary job in the business. An important element includes training, orientation and developing relationships with other employees.

3. Business development
This phase usually occurs between the ages of 25 and 35, when the successor should be cultivating necessary skills and abilities.

4. Leadership development
This usually occurs between the ages of 30 and 40, when the successor's plans stretch beyond any one job to the time when they will be responsible for the entire business. Skills developed during this stage include team building and shared decision-making.

5. Selection
If multiple candidates exist, selection would occur at this stage. Methods of making a choice include an early choice by the incumbent, selection by the outside board, selection by the family executive team and consensus among family, board and executives.

6. Transition
During this period, authority and responsibility are transferred to the successor. This is the time when the successor becomes involved in strategic decision-making and in developing their management team.

7. The next round
Succession planning in a family business should always be on the agenda and the new leader should begin talking about developing the next generation of leaders.

Tips on succession planning in a family-run company

Ask yourself what you want to do with your company
You don't have to keep it in the family. Consider the options of a trade sale or some other exit route.

Plan now
Plan at least five years out. Involve all members of the family and board members in the process. If possible, take advantage of outside help from accountants, lawyers or consultants as they will have a new perspective.

Make sure you can walk away
Build a financial framework from which you can walk away. You have to get away from the mentality of "*the business is mine and I am the business*".

Don't spoon-feed your family
If any family members want to join the company then encourage them to get extensive work experience in another organisation first and preferably in other industries too.

Choose a successor
Do this as early as possible and begin to transfer leadership and control of the business step-by-step so that new roles and responsibilities can be adopted with minimum pain and disruption.

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We have extensive experience guiding our clients successfully through the succession process. This involves advice on both the qualitative and quantitative aspects of the process. While there is a business at the core of each succession plan we advise on, it is all predicated on understanding the people and their respective wishes.

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