Rough Corporate Justice

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In the succession of a family business from one generation to the next, the corporation's ability to pay must be balanced with the needs of the individuals who own and operate it. Described here is an economic model and consulting tool for promoting a business-driven dialog that can result in the transferring of the business in a tax-advantageous manner while preserving the corporation's capital base.

Introduction

Family business owners and their families understand that their enterprises are fundamentally different from their publicly traded cousins, and, for the most part, they would have it no other way. Basic in this distinction is how the two types of businesses cope with the inevitable stressors, or "pinch points," that all businesses and all families must confront.

One of the most critical pinch points is the succession of the family business from one generation to the next. With public companies, which usually have a clear line between management and ownership, succession is accomplished, at least in theory, by the board of directors, which selects the best-qualified person to lead the corporation. Succession is normally not a major capital-allocation issue and is managed without affecting the capital structure of the corporation. For most family businesses, however, succession is not only a highly charged emotional transition, but it also may put the capital integrity of the firm at risk.

Although a great deal has been written about training and selection of successors, estate planning for the owner/manager, and valuing family businesses, very little, if any, attention has been given to what the business needs and can afford. That consideration is essential if the capabilities of the family business are to be balanced with the needs of the individuals who own and operate it. Such a balance requires a flexibility that is gained only when a company's ability to pay exceeds the needs of its senior generation.

This paper explores that concept and suggests ways to promote a business-driven dialog that can meet the needs of all constituents in the succession process: the senior generation, the successor generation, and the business and its stakeholders. Although I developed the theory behind this concept, its transformation into an economic model and consulting tool is, to a great extent, the accomplishment of the Family Business Alliance, the multidisciplinary team referred to as the "we" in this paper (see acknowledgments).

Stages of a Family Business

A family business experiences a progression of phases as it passes through the generations. As Ivan Lansberg so perceptively points out in his work on "sibling partnerships" and "cousin consortium," a successful transition to multiple owners requires a shared vision (Lansberg, Gersick, Davis, & McCollom, 1997). We have found that this progression may occur smoothly from one phase to the next through the generations, or one phase may be repeated over several generations before the next one is entered. This progression has a great deal to do with family and business

economics, but it deals even more with a family's governance philosophy, values, and its unique definitions of the benchmarks of success. Such a progression might look like this (Carlock, 1994):

Survival. This is the initial stage of any family enterprise and is characterized by the struggle for financial stability. Such a business is typically owned and operated by a single person or couple and represents the majority of the owner's net worth.

Stable. This phase characterizes an enterprise that is still probably owned and managed by a single person or couple, but it now has a stable product and customer base and has been profitable for a number of years. This type of enterprise is no longer being financed by the owner's compensation (or lack thereof), and, although the owner has begun to build net worth outside the business, its principal bank guarantor is the owner.

Professional. An enterprise in this phase of the progression has taken a fundamental step in a new direction. Ownership is probably spread among brothers and sisters (or even cousins), and although they are all involved in the business, they understand the distinction between their ownership and their management responsibilities. The business is likely experiencing fairly dramatic growth and revitalization with a blend of family and nonfamily managers leading the charge. Employment compensation is still the principal revenue source for family participants, but they also now have secure nonbusiness net worth and are no longer the principal bank guarantors for the business.

Institutional. In this final stage, the business is still privately held but now has a mix of family and nonfamily shareholders, and management has become a true "meritocracy." Family members may or may not be involved in management as their talents and interests dictate, but they take their shareholder responsibilities very seriously by ensuring that the board of directors is the true governing body of the organization and that it understands the needs and values of the shareholder base. Such a board will certainly have family members; however, it also will have management and independent representatives. Dividend income is now the principal revenue family members receive from the business, but they also have significant net worth exclusive of their family business stock interests. Preserving the corporation's capital structure and avoiding transfer tax dilution during future generational shifts in ownership are now the focus of the family shareholders.

From Survival to Institutional

Just what are the factors that make it possible for some businesses to move in three generations from "survival" to "institutional," whereas others never get past the "stable" phase? A quality product, solid management, and good people are obviously essential for getting out of the survival mode. But it is not all good practices, good engineering, and luck. In institutional family enterprises, the family members share three basic characteristics, regardless of their industry or tax situation:

They Understand and Are Committed to the Basics of Business Governance. Family members are first and foremost shareholders who understand that they are responsible for electing directors who will serve the best interests of the corporation while striving to meet the needs of all of the company's stakeholders, including its shareholders. As shareholders, family members also understand the limits of their authority and agree as a group that as long as they wish to keep the company private, they must leave governance to their board and day-to-day operations to their management team.

They Understand the Fundamental Competitive Advantage They Have over Their Publicly Traded Competitors and What They Must Do to Preserve that Advantage. Family members know that though they may not have access to the large pools of equity capital the public market offers, they have the ability to measure their success in decades, not fiscal quarters. They are also inherently more private in their dealings, capable of making faster decisions, and free to form organizational structures and strategic alliances that fit their needs rather than those dictated by the public market (Barnes & Kaftan, 1991).

They Understand the Critical Need to Build and Preserve their Capital Base. At some turning point in the history of these family businesses, a family value of "corporate stewardship" was created. Like the family farm, the business became something more than a personal financial scorecard; it became the financial (and, in all probability, the emotional) centerpiece of the greater family. This philosophical shift was founded on the idea "use the income as you need, but never spend the principal" (i.e., do not dilute the capital of the business or harm the land).

Preserving the Capital Base in a Succession

Most businesses that have progressed to the "institutional" phase have figured out how to transfer ownership down the generations without threatening the capital base every 25 to 30 years. A major deterrent to building and preserving an adequate capital base for family businesses is the senior generation's perception that they must somehow harvest their equity during the succession process. That perception is neither right nor wrong. Family businesses are sold every day to facilitate such harvesting, and, for the senior generation that built the enterprise, selling may well be a natural and highly appropriate culmination to a lifetime's work. But as well as the sale option works for the senior generation, it is not a particularly effective transfer tax strategy and may mark the end of the business as an economic resource for the family.

Access to a stable capital base is essential for the long-term success of most enterprises, especially in an economy with short product cycles that require nearly constant retooling and a highly competitive atmosphere that demands well-compensated, talented, and motivated people. No business can sustain its market position, let alone grow, when its capital base is dramatically diluted each time the mantle of ownership shifts from one generation to the next.

A simple example, unique to family businesses, illustrates this problem: Dad started a business that has now become a substantial enterprise. Like most entrepreneurs, he and Mom poured everything they had into the business. The years have been filled with financial risk, long hours, and an unflagging commitment to the enterprise. Today, the business is successful, and, at least on paper, Dad and Mom would be considered wealthy. A closer examination of the facts reveal, however, that Dad and Mom are still on the credit line at the bank; Dad's compensation, including "informal perks" that are run through the business, has not changed dramatically over the past decade; no richly funded retirement package waits in the wings, and, perhaps most distressing of all, the product life cycle in their industry has never been shorter and is getting shorter every day.

What's more, both the business and the family have put a great deal of time and effort into selecting an heir apparent for Dad—his daughter. She is very bright, earned an MBA from an outstanding midwestern university, is well respected in both the corporation and the industry, and, most important, is dedicated to the family enterprise as her life's work. Everyone, including the two siblings who are not involved in the business, is excited about where the business can go with her leadership.

Recently, Mom has begun to lobby for that long-promised retirement home in Scottsdale, Arizona. Meanwhile Dad, although not ready to retire completely, is proud of his daughter and eager to begin turning over the reins to her. Dad and his board of directors concur that it is high time they began planning the sale of his and Mom's stock to his successor.

Time for a reality check! Dad has the business appraised and finds that (on paper) he and Mom truly are among the well-to-do. Daughter begins doing spreadsheets on her personal cash flow and soon discovers that she will never make enough to buy Dad and Mom out; in fact, things are getting worse every day as the company continues to grow. The family lawyer suggests a redemption of Dad's and Mom's stock from the business, but their banker does not particularly like this idea unless the buyout is over a very long period of time and Dad stays on the corporate credit line until the process is complete. This option

leaves Mom without the funds any time soon for the Arizona home and puts a tremendous debt burden on the corporation just when it needs to begin tooling up for the next product cycle.

In short, Dad and Mom have a tiger by the tail. The business provides a nice living for them day to day, but how do they ever get out? And what about the business? It has developed the next generation of stable, talented management, grown to a position of leadership in its industry, and demonstrated its ability to cope with a quickly changing marketplace. It has never been stronger, but it needs its capital to sustain this growth and prepare for the highly competitive years ahead.

To an outsider, the answer might seem easy: It is time to sell. But to many families in business, this is not a viable option (Ward, 1987). Mom and Dad did not run this business just for the money. They love it as their daughter has come to love it, and they are good at what they do. The answer for them is not to sell but to rethink the problem. The following model detailed in this paper is designed to help such families do this.

Measuring the Worth of the Business

This rethinking begins with considering how they measure the worth of their business. Unlike its publicly traded cousins, this business and these owners do not gauge their success on the market value of their stock. Profit, long-term profit, and good day-to-day livings for themselves and their employees are the benchmarks with meaning in the lives of family business owners. So why should the amount paid by a mythical ready-and-willing buyer for this business be the only measure of what the business is worth to this family? (The "price" would be its fair market value defined by our government shortly after the passage of the 1954 Internal Revenue Code in Revenue Ruling 59-60.)

The simple answer is that the institutions that purport to govern this economy all seem to push in that direction. Responsible succession planning certainly requires employing some measure of fair market value if for no other reason than it is the benchmark the Internal Revenue Service (IRS) uses. But it is only a benchmark; it is not an absolute truth.

There are almost as many opinions on what constitutes "fair market value" for a family business owner as there are appraisers ready to ply their trade and buyers ready to bid. A competitor may pay one sum because of the company's customer base or unique proprietary product; venture capitalists may pay another amount because they are not as familiar with the industry and, hence, must rely heavily on the business's management team; a large chain may pay yet a different price simply to remove this competitor from the marketplace; and the large public company may offer still another amount for the company's distribution network and physical locations. Fair market value is in the eye of the beholder: What a buyer will pay per share for 51% of a firm's stock may be 40%, 50%, or even 60% more than would be paid for only a 10% block of the stock.

Unless the owner/manager of the family business is willing to sell the majority of the company in an "arm's length" transaction, the fair market value of that stock can never be known. But who cares, anyway (except the IRS)? Everyone wants to keep it in the family, so what is required is some planning that works for both the family and the corporation.

A New Transition Yardstick

Fair market value, as traditionally defined, is a poor measure of the worth of the family business for the purpose of a successful intrafamily succession of ownership. A more realistic and even more accurate transition yardstick, however, may be NEED together with ABILITY TO PAY. This approach, which is the foundation of our model, is designed to help the senior generation prepare for the transition and provide the opportunity to talk about the coming change.

Balancing NEED with ABILITY TO PAY results in flexibility. Without such flexibility, the two generations may have to ultimately pay much more in terms of higher transition costs, such as income and estate taxes. Perhaps even more im-

portant, when the senior generation is forced to remain in "fiscal control" too long, that leaves little or no margin for error, thereby depriving the successor generation of the opportunity to make mistakes, an opportunity the senior generation had when it was starting out.

NEED is therefore a twofold concept. Monetarily, it is the sum of money the senior generation believes it "needs" to maintain the lifestyle it enjoys and to achieve its financial objectives in terms of community stewardship and "rough justice" (Ayres, 1990) for family members who have chosen not to participate in the business. NEED, however, also has a powerful social component that ties the vocational and social identification of the senior generation to the business during its transition plan. It is important to remember that NEED is not a cookie jar from which the senior generation can pull out whatever it wants, whenever it wants. Planning both the total economic harvesting and the period during which it will be done are critical because without such planning, the business cannot define its future.

On the financial side, the NEED concept begins with a private conversation between husband and wife about how much is enough. Wanting to be helpful, advisors often attempt to define this number for their clients and soon discover that they have offended the very people they are trying to serve. There is no way to get into other people's heads and make this judgment for them; they must answer this question for themselves. Advisors can, however, help set some goals, provide some tools to work with, and then get out of the way while the clients define this benchmark for themselves.

In some cultures discussions about money are some of the most sensitive, third only to those about sex and death, making many people very uncomfortable, even with trusted advisors (McGoldrick, 1982). They may fear the advisor will judge them if their expectation is perceived as too high, or they may even feel shame about their success when comparing it with other people's or even their parents' lot in life. This delicate matter requires sensitivity from an advisor who must respect clients' discomfort (even when cast in bravado) and avoid judgment when clients finally begin to share their financial needs.

One approach is to talk about the economics of succession and the needs of the business. Our intent with clients is to bring a reality check to the process that subtly sets some boundaries on the NEED definition while respectfully limiting unrealistic expectations. Next, we define a process clients can use to quantify the cash demands of their lifestyle in net worth terms. The goal here is to arrive at an annual or monthly dollar figure for maintaining their lifestyle, along with a date on which they will turn over leadership (we avoid the loaded word "retire"). Finally, we help them expand those results with their other economic goals. Some people may find parts of this process presumptuous, but our experience is that clients understand and appreciate it.

Defining NEED

Defining NEED involves five steps. The first step is a conceptual, not qualitative, discussion about the economic needs of the business. This includes some dialog on the competitive nature of the industry and how it relates to salaries, benefit packages, and training. We also discuss the position of the business in the industry relative to market share, how that has changed over the years, and what is needed to sustain (or re-energize) the company's growth. We review the debt burden the company carries, the status of personal guarantees, the need for working capital, and the need for what we call "energy capital"—the capital the company needs to stay technologically current, retain its proprietary products, sustain vitality, and grow. We try not to get too analytical at this stage because the clients must focus initially on their own NEEDS, not on those of the business. Ideally, after they have defined their own needs, they will initiate (or at least commission) a strategic planning effort from the corporate point of view that is not prejudiced by earlier assessments of corporate worth.

In the second step, we help clients identify

their economic goals for their family and community, emphasizing their children and grandchildren; this is done in general, rather than specific, terms (see Jaffes, 1991). The economic "fairness" discussions occur at this point, and we get to glimpse their dreams for grandchildren's education and community stewardship, as well as their concerns for an aged parent, a favorite niece, or even an old and trusted friend. Keeping this discussion general often makes it easier to quantify these special needs once their own economic needs are better defined. The goal here is to learn how they feel about treating their children equally (ensuring that they understand the inherent contradictions in that phrase; see "Rough Family Justice," ibid.), what they see as their children's capabilities, and what they believe they want their legacy for their family and their community to be.

In step three, we introduce them to a budget-driven planning model and show them how to use it. Whatever the model, it should start with current living expenses and then move on to help them define what they NEED to accumulate outside the business to sustain that lifestyle after the succession. Using a comprehensive budget worksheet is an easy, often quite revealing way to capture current expenses: People at the higher socioeconomic levels often have no real grasp of how much they spend each year and on what. This process should be simple, as well as private.

In addition to filling out the worksheet, we want them to define what their post-succession lifestyle will look like. To do this well, they must think only about themselves for a little while. So many clients have lived such responsible lives for so long that even though they have no problem discussing the needs of their business, their children, or even their communities, they struggle to articulate what they personally want out of this transition. It is often helpful to ask them to define what their ideal job would be like after the succession; where they dream of living or traveling; how often they want to be in contact with the business; what they have always wanted to do but never had the time; and what non-economic needs the greater family or even the business may have that they would like to finally have an opportunity to address.

Table 1. Questions to Consider When Determining NEED

1. What assets do you have outside the business? This information is readily available from a current financial statement, which most clients in this situation already have.
2. What do you believe the rate of inflation will be during your retirement, and what rate of return would you like to use on your traditional investments?
3. What do you see as a target date for succession, and what, if anything, would you like to do for the company post-succession? If you do not see yourself with the company post-succession, will you still be working? If so, at what? Have you discussed these issues with your board of directors?
4. Do you have children or others who depend on you for economic support?
5. Which of your children do you envision being involved in the business as shareholders and/or managers? Has the family determined how children enter the business, and has the business determined how the children will be evaluated and promoted?
6. If all of your children are not destined to own the family business, what would you like to do for those children? How do you equate this with the economic opportunity afforded to the children who are involved?
7. Where do you intend to live, will you be buying a new home, and what will you do with your current residence?
8. Do you have any special goals you would like to meet regarding the community? Would you like to involve your greater family in meeting those goals? Have you discussed these issues with your family?

This "dreaming" is critical. Without it, the economic analysis will be fatally flawed because neither the advisor nor the company will have the data necessary to consider these special concerns. More important, unless the clients believe that the succession plan will work for them personally (both financially and emotionally), it simply will never get done.

The fourth step is the "sharpening and polishing" phase. Once the clients have done their dreaming and their lifestyle research, it is time to put all the NEED pieces together. Here, using their own work product, we help them extrapolate a vision of tomorrow. Economically, the result will be a post-succession lifestyle amount sufficient to also meet their planning goals. Emotionally, this will be a picture of what their role in the business will be like after the succession. To form a realistic picture, additional information may be needed, which can be drawn out by using such questions as those in Table 1.

Many of these questions will trigger for the advisor and, hopefully, the client the realization that some fundamental homework has yet to be done. Nevertheless, bringing this NEED analysis to as complete a conclusion as possible is advisable before starting the unfinished homework. The goal is to develop a sense of the doable for people who for years may have felt that short of selling the family business, succession planning was simply not possible. Both the senior and the successor generations need definable goals to develop the emotional energy necessary to sustain the process of succession through to completion. Assumptions naturally will change as family and business homework gets done, but without those initial believable goals, it is simply too easy to just go back to work with the intent of facing up to these concerns some day that all too often never comes.

The final step in the initial NEED process is to run the numbers. Whatever model is used, it should result in a figure that represents how much the client needs to set aside in nonbusiness assets to meet these basic needs:

Need 1: Maintain the lifestyle they have worked so hard to achieve.

Need 2: Attain the desired level of personal economic freedom.

Need 3: Leave the business confidently.

Need 4: Have sufficient resources to meet their special family and community needs.

In addition and equally important, we want a vision that can be articulated in business terms, of what the senior generation's involvement, if any, in the business may be after the succession.

Before moving on to the second half of the NEED-ABILITY TO PAY equation, it is important to acknowledge that this paper and the economic model presented here deals with the easiest part of the succession process—the economics of the transaction. For this or any other model to succeed, the truly difficult work of creating a shared family vision for the future of the business must come first, especially when the departing generation takes from the business significantly less than the fair market value. This implies the need for a cultural shift from building personal net worth to building corporate net worth. For this to happen, a certain threshold of personal wealth must already be achieved and the business in the future must have the capacity to provide future generations of owners with a reasonable return on their family business stock.

Rarely is this shift completed in one generation; it takes time, wise governance, good management, and perhaps some luck before a business and a family can progress from "professional" to "institutional." But the process must start somewhere. A look at the truly "institutional" family enterprises proves that one generation must see this status as an attainable goal, limit their own personal financial gain, and set in motion the process of building a family value system that says, "This will be our economic and social centerpiece for generations to come." The model presented here is an attempt to show how this process might get started.

Determining ABILITY TO PAY

Moving to the other side of the family-wealth, business-prosperity equation, the issue is one of balance. Once the NEED of the ownership generation is determined, the questions become, does the business have the ABILITY TO PAY? Can it afford to meet that NEED? ABILITY TO PAY is determined by the answers to the following questions:

1. Can the business generate sufficient resources for ownership succession to finance the ownership generation's NEED, while still meeting its own capital requirements?

2. Will lenders, suppliers, and other equity holders allow existing credit relationships to shift to the new ownership team without the personal guarantees from the senior generation?

3. Is the successor generation willing to suppress their own financial ambitions so that the "harvesting" of this NEED might take place?

ABILITY TO PAY is based on the future, not the past. Succession planning so that the business can afford to meet the ownership generation's NEEDS must be rooted in the fundamentals of long-term financial success. These basics are too often overlooked in traditional approaches to succession that focus on only the corporation's historical numbers and do not consider what the business should look like in the next generation. Basing ABILITY TO PAY entirely on the past violates the principle that the corporation is the engine that will make a prosperous future possible. It also violates the principle of stewardship to the corporation by both the ownership and successor generations. In this sense, the business is like a forest: If the cutting (or harvesting) is not selective, the forest will be lost.

Long-term business vitality centers on the ability to foster what we call "innovative development," which involves attracting and holding talented and motivated people and having access to sufficient capital to sustain long-term growth. These fundamentals are vitally important and all too frequently ignored by families in business together.

To continue to grow, to keep its manufacturing and distribution processes competitive, and to attract and hold skilled and motivated people, the corporation must have financial resources for: labor and management, marketing and selling, capital for new equipment, startup costs for new products, working capital investment, and research and development and modernization.

Innovative development is a type of modernization that has two equally important pieces: the creation of new tangible products or services and the creation of new processes that support that development. Innovative development can involve new tooling, new products, new operations, new uses for current products, new incentives for sales or manufacturing forces, new space—in short, a new approach that could lead to reinventing the business.

Most of our clients are not grounded in this aspect of business. They have instead capitalized on a highly valued work ethic, a commitment to customer service, and an intuitive wisdom that allowed them to make quick decisions to thwart problems before they ran out of control or to capitalize on new opportunities while others were still studying the problem. In other words, they have put their focus elsewhere. Likewise, many of our clients are still using 1950s or 1960s technology to fabricate their products or run their management information systems. Others are relying on a product that has been in the stream of commerce for more than 20 years. With the margins common in today's global market and with product life cycles measured in months rather than years, many of these clients are operating on borrowed time. Such organizations must now look to new distribution channels and at their manufacturing margins or risk falling by the wayside. This reality can be difficult to face from both a planning and an emotional perspective because many of

these companies are driven by an entrepreneurial ethos that says, "I've always been successful doing it my way, and no one is going to tell me how to run my business." A serious problem also arises when Dad or Uncle Bill is the only innovator/inventor, and the next generation has neither those skills nor perhaps even an appreciation of their value. For such companies, the questions are, "Where is the new product to come from, and who will represent these sentiments in the planning arena?"

Attracting and holding talented and motivated people also require planning as well as money. All too often, the succession process comes at the same time that clients are struggling to convert their family businesses from traditional, entrepreneurially driven enterprises to more differentiated, managerially driven companies. These businesses are being affected by a variety of previously unused or at least underused disciplines, ranging from strategic planning to organizational development. All of this comes when there is a great deal of competition in the marketplace for people (both family and nonfamily) who can lead these businesses through these dramatic changes. The question often becomes one of how to attract and hold young talent in an organization still run by a dictator, no matter how benevolent.

One of the hallmarks of many of our successful clients is that they run "lean and mean" and are proud of it. This is not necessarily bad—even the public sector is trying hard to get back to the basics; but for many of these clients, this is more than a business strategy, it is part of their culture and deeply embedded in the owner/manager's need for control. But many of these businesses have simply grown beyond the ability of one person to make all the decisions. In addition the next generation of leadership often recognizes, as they attempt to go from an owner/manager model to one with multiple sibling or even cousin ownership, that a serious element of distrust (usually unspoken) arises when they are unwilling to subject management to the discipline of professional governance by a functioning, well-staffed, and impartial board of directors.

To maintain technical competitiveness, adequately staff the organization, and sustain growth, the business must also be able to obtain access to sufficient capital. Most clients' histories of capital use falls at one or the other end of a continuum. In many companies whose owners grew up during the Great Depression, debt is an evil to be avoided at all costs. Although one could argue credibly that the debt of these companies has not disappeared but rather has taken the form of diminished owner compensation or shareholder financing, the emotional reluctance to use debt financing remains powerful.

At the other extreme, everything is leveraged and always has been, and shareholder personal guarantees are a way of life. These companies, while not at all frightened by the prospect of discussing the use of debt financing, will often have little or no cash reserves, plan very little (perhaps because the prospect of facing this situation is so frightening), and believe with real conviction that anything is possible if one just has the guts to try. To make things work on both sides of the NEED-ABILITY TO PAY equation, we must address not only the corporation's ABILITY TO PAY, but also the willingness of the senior generation to slow down or even eliminate its own personal debt-financed deals.

At either extreme, the task is to analyze what is truly possible in an atmosphere where change is inevitable. Nothing speaks louder for the need to begin this process early and to make it as inclusive as possible. It will take time to dig out the facts. Start slowly until confidence in the new methodology is gained, and sell the process to the company's principal stakeholders, not the least of which are its bankers, key suppliers, and major customers. In starting to estimate future levels of growth needed to sustain the company's goals, it is important to recognize that this is not a "go-go" time. Rather, it is a time to consolidate, strengthen the fundamentals, and give the principals in both generations breathing room to let all of this happen. Although no growth is probably a killer, growth must be kept under control and key stakeholders must know that this is exactly the plan, to avoid having a slowdown in growth look like a fundamental weakening of the business.

We have had significant success in getting both lenders and major franchisers to shift or even eliminate personal guarantees when we include them in this process. Once both generations feel good about the succession plan that has been laid out, we coach them on how to present this plan to their key stakeholders at the very outset of the implementation process and *before* any fundamental change in the underlying relationship is needed. These stakeholders are gratifyingly receptive to requested changes when such requests are conditioned on predictable events that are expected to occur *in the future*. For example, we encourage our clients to ask lenders to eliminate the personal guarantees of the senior generation or convert lending security from personal guarantees to an asset base only *after* the family has installed a new professional board of directors, strengthened their management team in key areas, upgraded their basic technology, and demonstrated an ability to sustain profits (even at a more modest level). Lenders, after all, are almost as terrified as their customers at the uncertainties of the succession process. But it is hard for the lenders to balk when the clients voluntarily offer this information along with an outline of a plan that trades increased compensation to the owners for a limited period of time for eliminating the potential for disastrous transfer tax liabilities. The key, of course, is to inform lenders early on about the company's intentions and to get *current* promises of *future* action only after the company has demonstrated its ability to attain the stated objectives.

Implicit in this model is the willingness of the senior generation to pass their equity (stock) on to the successor generation at little or no cost as this harvesting process becomes a functioning reality. In payment for this equity shift, the successor generation is willing to restrain their own economic demands on the business during this transition. Trust becomes a critical part of this equation, and such trust is best nurtured with the aid of a well-thought-out strategic plan that contains agreed-on targets for such NEED payments, the timing of corresponding gifts, and clearly understood benchmarks to ensure that the fiscal health of the business remains unimpaired.

Balancing the NEED-ABILITY TO PAY Equation

More often than not, owners and successors are surprised to learn that on this basis the business truly does have the ABILITY TO PAY. Even for companies that are a little soft on ABILITY, if this process is started early enough and supported by solid planning, many are capable of growing into this solution. The real trouble occurs when this process is delayed too long. If this happens, there simply may not be enough time for the senior generation to harvest sufficient resources without crippling the company with debt or forcing it into questionable quick-fix strategies. When the NEED-ABILITY TO PAY equation truly cannot be balanced, it is probably time to sell. But even this result is preferable to alternatives that are often marked by a clash of economic needs and feelings of entitlement when an economically realistic transition either cannot or does not occur. Even when a family business uses this process to discover that NEED actually does outstrip the corporate ABILITY TO PAY or that only a full fair market value harvesting of the equity buildup will satisfy the personal goals of the senior generation, uncovering these realities in a respectful, inclusive planning process is better than ignoring them until the successor generation becomes tired of waiting or the business is sold in a panic occasioned by ill health. Like so many concepts embedded in the art of family business consulting, this model simply provides another way to invite the family into a focused dialog about something that seems difficult to discuss: their wants, needs, and goals about money and all that it symbolizes.

The objective is to create additional, non-business net worth for the successor generation over time to eliminate their dependence on the corporation to meet their NEEDS. Note that if the senior generation is still on the corporation's debt as personal guarantors, negotiations with the lenders will probably be necessary to eliminate or shift those guarantees to the successor generation before the senior generation can be expected to part with significant stock.

As the company initiates such a plan, actual

equity must begin moving between the generations as the determined benchmarks are reached. This is important not only because it will enhance the level of trust between generations, but it will also send a strong signal to lenders, suppliers, key customers, and employees that the transition is moving forward on time and as planned. Like it or not, these key stakeholders are watching, and the success of the next generation in retaining their loyalty will have a lot to do with how smoothly this transition takes place.

From a transfer tax perspective, both generations would like this series of transfers to be as predictable and uneventful as possible. Prolonging the stock transfer to the next generation risks not only losing the use of earlier years' annual exclusions from the gift tax but also the accuracy of the valuation made for gift tax purposes, which may understate the IRS's view of the value of the enterprise. Because the IRS is still using the "fair market value" concept to value these transfers, delaying the shift of ownership may make the new structure more stable and hence subject to higher taxes on the stock being gifted. Discounting techniques, such as family limited partnerships, can and probably should also be used to help depress tax valuation throughout this process, but time is really the client's best ally. Get started early, make the transfers in small denominations, keep it on schedule, and avoid, if at all possible, a large transfer at the end of the transition. It is also probably a good idea for the shareholders to adopt a valuation mechanism or formula that can be consistently applied throughout. In so doing, however, it is vital to ensure that this mechanism addresses not only the parameters articulated by the IRS but also those unique to the business and its position in the marketplace.

The day is probably not far off when the valuation assumptions of Revenue Ruling 59-60 can be more realistically recast for the valuation of family-owned and closely held businesses. The essence of that ruling, and the appraisal art that has evolved to implement it, is that publicly traded companies already have taken into account through the actions of the public market all the variables that affect a given company's profitability and hence its value. Accordingly, as the theory goes, the best we can do is attempt to equate private companies with their publicly traded cousins. This, of course, has given rise to the appraisal methodology of determining dividend paying capacity through a series of simplistic profit and loss (P&L) and balance sheet adjustments (compensation norms, excess cash, inflated rents, etc.) and then comparing those results with supposed comparables that are publicly traded. Although this may do rough justice in some cases, particularly with the application of appropriate discounts for lack of marketability and (when applicable) minority interests, it is still overly simplistic and fraught with potential error.

The harvesting model described here is in its infancy and was designed as a planning tool, not as a valuation device. It may contain, however, the kernel of an approach that arrives at a more accurate "fair market value" of a private concern. The essential difference in these two approaches is that rather than looking just at excesses on the private company's financial statements for the purpose of determining "dividend paying capacity," we have attempted to dig a deeper, and, hopefully, more substantive trough that considers the fundamentals of long-term *future* success more accurately than by focusing only on short-term compensation and cash.

The Model Process for Guiding Family Businesses

At a small number of businesses with which we work, we discover that their internal financial people and senior management are conversant in and capable of documenting their conclusions on the topics that must be addressed in the ABILITY TO PAY part of the equation. They are usually in the process of setting a strategic direction for their firm that considers both the human and the economic realities of ownership succession. In such situations, we can quickly determine whether the equation can be balanced. If it can, we move on to determining how and when the harvesting should take place. Table 2 outlines a

few techniques that might be used to help push additional resources into the hands of the ownership generation once ABILITY TO PAY is ascertained.

Most of our clients, however, do not have the internal expertise to determine their own harvesting capability or corporate ABILITY TO PAY. In those circumstances, we need a focused, respectful process to help guide the family and their business toward something they can confidently implement. The actual analysis of a client's situation is more sophisticated and customized than any simplistic model or outline we can offer at this point, but hopefully a discussion of the simplistic issues this planning encompasses will prove helpful.

One approach is essentially a four-step strategic-planning process that comprises numerical analysis as well as organizational and governance concerns. All these factors are inter-related, each having both financial and emotional components. Broadening the discussion to include all of these factors will bring up a wide variety of styles and points of view.

Step One, Bring All the Concerns Together. We try to make this process as inclusive as possible with representatives from senior management, the independent directors (if there are any—and, by the way, this is a good excuse to recruit a couple), sales, manufacturing, and human resources, along with the senior financial people, both internal and external. One of the side benefits of this process is that it provides an opportunity for the outside accountants to demonstrate in very real terms how some of their analytical skills also might be used in upgrading the company's basic management and financial tools.

Step Two, Gather the Expertise. This is a multidisciplinary exercise, because no one person or discipline has all the answers. Some consider it financial overload to have three or four outside consultants around the table during this process, but it is important to keep everyone informed about the progress and when and how the different skills of the consulting team can be helpful. We try to have everyone present at an initial planning meeting where we develop a pri-

Table 2. Techniques for Giving the Ownership Generation Additional Resources

1. Increase compensation so that it's geared for a specific transition period to profits or sales to limit concerns about it being unreasonable.
2. Defer compensation and back it with a "rabbi trust" to provide the confidence that the dollars will be there.
3. Increase rents on (or even corporate purchase of) outside-owned real estate or equipment used by the business.
4. Set aside consulting compensation for post-succession assistance to the corporation and/or lump-sum payments for noncompetition covenants.
5. Upgrade pension and retirement benefits, perhaps including a limited employee stock ownership plan.
6. Change corporate form to enhance short-term cash flow to the senior shareholders.
7. Repay old shareholder debt.
8. Use the senior generation's unproductive or underproducing assets to fund split-interest charitable vehicles to increase cash flow and create a tax-absorbing charitable deduction.
9. Create passive income streams with equipment partnerships, royalty income, and directors' fees.
10. Use an end-of-process, limited corporate redemption to put the plan over the top.

mary planning team and identify when specific expertise will be needed as the process unfolds. For example, I might facilitate the primary planning effort with a team of four or five inside people and the outside accountant.

Typically a lawyer will not be there but knows what is going on and is prepared to modify estate planning and corporate compensation and benefits documents to dovetail with the process. Similarly, a consultant on the social sciences side is usually moving on a parallel path with a series of family council meetings to provide the family with the emotional confidence to allow this process to be supported by both generations involved.

Step Three, Encourage Dialog. With the permission of the senior generation, we try as early as possible to reveal both our underlying methodology and the implicit deal that we are trying to broker; that is, to let the senior generation harvest to a level that will sustain their own personal goals. In exchange, they will come to the table with whatever gift planning tools they can marshal to get this stock into the hands of the next generation at little or no cost. This dialog has the benefit of allowing the senior generation to share some of their most personal dreams with their own children (and it is truly amazing how seldom this occurs), but also of providing the planning team with a doable target for their efforts.

It is important for both sides to acknowledge that this harvesting process, if successful, will have been made possible through solid planning, restraint on what the senior generation could have taken from the business had they chosen to sell it, and the willingness of the successor generation to lead the corporation toward this goal while holding in check their own personal financial ambitions. There is plenty of credit to go around; do not forget to say it out loud.

Step Four, Run the Numbers. Although not strictly a numbers-driven process, it needs to be grounded in the numbers. This is where the abstract meets reality and where businesspeople develop their level of trust in the outcome. Next we examine how our basic ABILITY TO PAY model works.

Basic ABILITY TO PAY Model

Gathering Financial Data. We begin by gathering at least the last five years of financial statements, including balance sheets, income statements (P&Ls), cash flow statements (if available), and corporate tax returns. If we are fortunate enough to have industry statistics on debt ratios, profit margins, salaries, growth rates, and product life cycles, we pull in that information as well.

Analyzing Cash Flow. To start, we extrapolate from the raw data the firm's After Tax Cash Flow for those five preceding years. An easy task when cash flow statements are available, but even when they are not, it is not too difficult to rework the P&Ls by subtracting the noncash deductions. Regular debt financing should also be in this figure, as should a rough determination of annualized borrowing power if the client has never used their debt financing capability. We also add back any amounts that go to off-balance-sheet entities that might be pulled back into the corporation during a reorganization, as well as the support of any family projects (for example, a subsidized hobby farm) that will be sold during this transition. We subtract from the available cash flow any amounts that have not been adequately serviced over the years, such as loans due shareholders. The average of this modified historical series (adjusted for any abbreviations that might have taken place in a single year, such as a major casualty loss or strike-enhanced revenues that spiked earnings) gives us our starting point and our first data entry number for our model.

Determining Research and Development Budget. The next number is one of the hardest to determine for any enterprise, but it is particularly difficult for growing family businesses: the Research and Development (R&D) budget. Few of the companies we work with have R&D departments to begin with. We use this term to include new product development as well as manufacturing and MIS process modernization. As a very rough starting point, we look at the last year's balance sheet entry for the accumulated depreciation figure and note how that figure has grown over the last five years. Even though this will not

give us a final answer, it does provide some idea of how old the technology is and how long it has been since this sector received attention. If this figure is very crude, that recognition should give the group some impetus to dig a little deeper. We often find that after some dialog with our internal sources, it is most time- and cost-efficient to bring in an outside expert to estimate what and how long it will take to keep plant and equipment current and competitive. The external accountant usually can provide data on MIS. This investigative process gives us our second data entry number.

Analyzing Financial Status During Proposed Transition. Now we move on to Management (and, as necessary, governance) costs and attempt to predict what the organization will look like as it moves through this transition over the next several years. Growth will have a strong impact here, as will the need to provide more management depth for an organization that has traditionally run very lean. It is important to keep in mind here the cost of any outside help that is needed during this period, particularly in the areas of training and technology upgrades. If the client is an organization in which innovation has always been the sole responsibility of the senior generation, then a major hiring or engineering outsourcing commitment may be necessary. The end product translated as the new hires and the related cost of bringing them up to speed is our third data entry number.

Analyzing Cost and Impact of New Products. Akin to R&D, but not as difficult for the client to grasp, is the New Product Cycle Cost. Most clients have gone through the pain and expense of bringing a new product into production or adding a major new line to the sales inventory. As we explore this area, we take care to ensure that we have a sense of the research costs, what it takes to retool production facilities, train personnel, and how much time is involved. While many of our clients fail to adequately plan, this is one area where they probably have done some recent investigations. Even if they have not, a lot of good information is available from suppliers and industry sources. The cost and frequency of bringing new and upgraded products on line during this time frame is our fourth data entry number.

Determining Other Programmed Expenses. Every such analysis needs a space to add in the expenses that are unique to the particular company. Here, under the label of "Other Programmed Expenses," we add in any new strategic expenses the company sees itself investing in during this transition. Included here might be such things as a plant expansion, new sales outlets, or the continuation of a program of acquisitions. The cost of debt financing is included if it, too, will be a new element during this period. Other Programmed Expenses is our fifth data entry number.

Determining Available Resources. Our final raw data entry number looks at any balance sheet "Excess Cash," marketable securities, or other investment assets (not used in the operation of the business) that would be available for distribution or could be used to finance operations as a part of this succession plan. It is important not to overlook any loan covenants that may require that some or all of these "excess" resources remain on the balance sheet as security for the corporation's debt package. In some cases, it may also be prudent to look at the amount of inventory and/or raw material that is kept on hand and determine if some cash could be freed up by strategically cutting back in these areas. Finally, a review of receivable collection and payable cycles should be made to ensure that lazy or simply old habits are not unnecessarily delaying the receipt of (or distributing) needed working capital already due (or owed by) the company. This Excess Cash figure is our sixth and final raw data entry number.

Predicting Growth. Our next step is to add growth (or decline) percentages to these raw data entry numbers as the planning team believes appropriate. A positive percentage figure in cash flow will translate directly into increased revenues, so it is important to be sure that this relationship fits estimates of future performance. We find it is better to use modest percentage adjustments or no adjustment at all if we are unsure of how actual performance will track with our raw

data. As a quick check, we use as guidelines historical sales, profits and return on asset ratios—information that we already have available. If the application of a positive percentage adjustment produces a result that significantly exceeds the historical figures, it is probably time to rethink the appropriateness of the adjustment.

In some areas, such as R&D and Other Programmed Expenses, it may be preferable not to add a percentage increase if they are short-term modernization expenses that probably will not reoccur during this succession process. In some cases, the entries for New Product Cycle Costs and Excess Cash even dictate a negative percentage adjustment. The effect of a negative percentage adjustment is simply to spread the cost of a large, up-front expense over a number of years (i.e., the larger the negative percentage, the faster the expense will disappear as time goes by).

Determining Harvesting Capacity. When all these data entry numbers and their corresponding percentage adjustments (if applicable) have been determined to the satisfaction of the planning team, they are then simply balanced out. The result is a Harvesting Capacity number (the amount of cash available after forecasted costs, over time); or what the company has the ABILITY TO PAY the senior generation annually in excess of the senior generation's current compensation and benefit package and still sustain profitable operations during this transition. When this figure is compared with the NEED analysis produced by the senior generation, it will very quickly be obvious if the equation can be balanced.

Three Illustrations

A Balanced Equation. Mom and Dad, ages 54 and 55, respectively, determined that in addition to their current, nonbusiness holdings, they needed to add $150,000 in after-tax savings annually to meet their personal NEED objective within the next 10 years. The corporation's ABILITY TO PAY calculation showed that the business could continue to maintain a modest 5% annual growth, modernize as needed, and still distribute an additional $185,000 annually to the senior generation. This equation was in balance, and the corporation had a modest cushion with which to work.

An Equation Out of Balance. Mom and Dad, ages 67 and 66, respectively, determined that in addition to their current, nonbusiness holdings, they needed to add $625,000 in after-tax savings annually to those holdings to meet their personal NEED objective within the next three years. The corporation's ABILITY TO PAY calculation showed that the business could continue to maintain a modest 3% annual growth, modernize as needed, and still distribute an additional $200,000 annually to the senior generation. This equation is out of balance. Even if the senior generation were willing to stay involved a little longer, there simply was not enough time to make up the difference. As frequently happens, this family waited too long to get started, and the senior generation probably failed to take enough money out of the business over the years to build an adequate nonbusiness nest egg. Here, the realistic options might include finding a new equity partner; doing a part-gift, part-sale transaction with the successor generation; splitting off an operating division and selling the balance; or simply selling the business outright.

An Equation Brought into Balance. Mom and Dad, ages 58 and 60, respectively, determined that in addition to their current, nonbusiness holdings, they needed to add $325,000 in after-tax savings annually to those holdings to meet their personal NEED objectives within the next five years. The corporation's ABILITY TO PAY calculation showed that the business could continue to maintain a 6% annual growth, modernize as needed, and still distribute $175,000 annually to the senior generation. This equation was initially out of balance, but in subsequent meetings of the planning team, Mom and Dad determined that they would remain involved for an additional two years and assist the company in a consulting capacity for three years beyond that date. The corporation also reworked its calculations and determined that it could maintain its marketplace position at a more modest 4%

annual growth rate, thereby freeing an additional $50,000 annually to distribute to the senior generation. With these adjustments, the equation was brought into balance.

Conclusion

Even when it ultimately proves impossible to balance the equation, in our experience this process promotes an essential dialog among the three constituents of the transition: the senior generation, the successor generation, and the business and its stakeholders. This fosters an understanding of the business fundamentals that are involved in a succession. This understanding takes a great deal of the mystery and, in some cases, the personal hurt out of a transaction that simply was not meant to be. When the equation does balance, the results are more predictable: Everyone feels good about the contribution that they have made to the process, and the business has taken a giant step toward becoming a long-term economic centerpiece for the family and a commercial institution.

It is my hope that the process presented here will help ensure the capital integrity of your client firms while satisfying the needs of both the senior and successor generations so that what is ultimately passed on is the future, not the past.

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