Management Succession in Family Businesses

~ Michael J. Wilson

It is easy to find stories of family businesses struggling with leadership transitions and corporate governance. The New England grocery chain, Market Basket, faced employee and customer protests and lost $583 million in sales as two cousins—one the CEO, the other a board member, and both grandsons of the founder—publicly vied for control of the company. Fiat, the Italian auto group run by the heirs of Gianni Agnelli, burned through five CEOs and three chairmen in two years before bringing in a non-family member to run the business.

While there are many success stories regarding family business succession, these are the exception and not the norm. According to the Family Business Institute, 30 percent of family businesses last into the second generation, only 12 percent make it to the third generation, and a scant 3 percent survive to the fourth generation or beyond. No wonder business succession is a significant issue for many family businesses. The 2012 Family Business Survey conducted by PwC found that succession was a top-three issue for family businesses. In our experience, proper business succession planning greatly improves the odds for a smooth and efficient business succession.

Despite these challenges, family-owned businesses, large and small, play a significant role in the global economy. It is estimated that family businesses account for 80 percent of companies worldwide, and they are the largest source of long-term employment in most countries. In the United States, they employ 60 percent of the workforce and create 78 percent of new jobs. Many family businesses are large. Families control a significant share of one-third of Standard & Poor's 500 companies, 40 percent of the 250 largest companies in France and Germany, and 60 percent of large companies in East Asia and Latin America.

Ownership Succession Versus Management Succession

When family business owners, their advisors, and business writers discuss business succession, they are most often addressing ownership succession and its related issues. Family ownership and family ownership succession are the primary ways a business identifies itself as a "family business." However, besides ownership succession, there are many other facets to a family business succession plan (also known as an exit plan or transition plan), including management succession, exit strategy planning, strategic planning, contingency planning, and leadership development planning. As a business owner, you should become familiar with all the components of both ownership succession and management succession to protect your business now and in the future.

Management succession planning and related issues are key elements of a complete business succession plan. Management succession can be even more important than ownership succession, because if you appoint the wrong person as CEO—or you have a rocky CEO transition—it can have a profoundly negative impact on your business and your employees.

Management succession and ownership succession can involve different individuals, and management succession may not even involve family members. PwC's 2014 Global Family Business Survey found that 32 percent of family businesses anticipate transitioning ownership among the family group but transitioning management outside the family group (up from 25 percent in 2012). Similarly, we have had many experiences where the founder of the family business views ownership succession as dynastic but management succession as meritocratic. For these latter types of family businesses, management succession may skip one or two generations, and management may be transitioned to non-family professional managers from either inside or outside the business. Another common scenario is to bring in outside management to bridge a gap between when the current generation will cease being a part of the management team (for example, they will still be owners and sit on the board of directors but will not be involved in day-to-day management) and when the next generation has the skills and experience to assume the reins of management.

Management Succession Issues

Despite a trend toward transition of management to non-family managers, we find that most family business owners contemplating a management transition will first consider whether one or more family members have the experience and skills for the role. If you are contemplating a management transition to your children, there are basic questions to ask:

1. Do your children know what your plans are for the transition of the business? How will these plans impact the family business and family relationships?
2. Do you believe your children have the experience and skills to take over the business? If not, have you discussed with them what skills and experience they need to take over the management of the business?
3. Have your children earned the respect of the key employees of the business that your children will one day manage?
4. Have you discussed with your children the timing and plan for the transition?
5. Are you giving your children the support they need, privately and publicly, to ease the transition at the right time and to address any credibility issues?

Just as those of you who are the current generation of managers must ask and answer basic question, so do those who comprise the next generation. They will have many factors to consider before agreeing to accept a management transition, whether in the near-term or over a longer period of time. Some basic questions for the next generation to ask when contemplating a management transition for themselves are:

1. Have you analyzed what skills and experience you need to manage the family business?
2. Do you have a plan to fill whatever skills and experience gaps you may have?
3. Have you had an open discussion with your parents and siblings about the transition of the business?
4. Have you shared your vision for the future of the business with your parents or other family business owners?
5. Have you earned the respect of the key business personnel so that they will accept your leadership and buy into your vision for the business?

Besides identifying the best candidate (whether he or she is a family member or not) for the management position, it is also critical for successful management transitions that you have in place a well-developed corporate governance structure. This is critical in maintaining family harmony and addresses thorny control issues that will inevitably arise. Good corporate governance can even facilitate planning for management succession and identifying the best candidates.

The Role of Corporate Governance in Successful Management Succession

Governance of a family business, especially in the early years, is typically consolidated in the founder who often acts as the sole arbiter—and may be the sole board member. As the business grows, becomes more complex, or prepares for transition to the next generation, corporate governance becomes much more important. Governance of your family business must evolve for the business to continue to succeed and to transition smoothly.

Having an active and engaged board of directors (or similar body, depending upon the legal entity involved) with the right mix of family members and independent directors with excellent business acumen, judgment, leadership experience, and other key credentials is vital to good corporate governance. The board, not the shareholders (at least not directly) or the family, should set the direction and policies of the business. The role and function of the board should be clearly expressed and defined in the bylaws or other governance documents for the business.

It is not uncommon for a family business to have a board comprising the founder, other family members, members of management, and other individuals that the founder knows well, such as an outside lawyer, accountant, or other business professionals who guided the founder while building the business. Despite having outsiders on this board, the founder typically has sufficient influence over these board members to retain decision-making authority. This board may work fine for some family businesses, but over time, many successful family businesses, especially larger ones, have boards that have evolved to include independent directors with no ties to the business or its founder other than their role as directors. Boards with strong, independent directors can add tremendous value to your family business by performing functions that:

- separate the financial needs of the business from the family's financial needs to help ensure the financial viability and growth of the business;
- leverage the separate experiences of independent directors with other businesses and industries and their networks;
- aid the CEO by looking beyond day-to-day operations and thinking strategically about the family business;
- establish clear goals and hold the management team accountable for their performance;
- bring more objectivity and independence into the governance of the business;
- assist the CEO with management succession planning for the business, which includes contingency planning and identifying the best candidates (internal and external, family and non-family) for management positions;
- smooth ownership succession to the next generation by providing continuity and guidance to the next generation; and
- plan and advise on exit strategies for the business, such as a sale or merger.

In our experience, independent directors can be especially helpful where the founder/CEO struggles to transition out of management. A far too common scenario we have encountered is one in which the founder transitions out of being CEO and retains his or her role as chairman of the board of directors but continues to cross the boundary into the management role he or she previously held. This behavior can lead to a blurred chain of command, a loss of morale among employees, and the departure of management personnel. A director directs, but does not perform, a company's activities.

Independent board members don't come free. Good independent board members will be highly skilled, have exceptional and relevant experience, take their roles seriously, and invest many hours into their position. To get and retain them, you will need to compensate them fairly. Expect to pay them a fixed, annual cash compensation, additional payments for attending meetings, and their travel expenses. In addition, many businesses will want to align the interests of the independent directors and the shareholders, and this is typically accomplished by granting to the independent directors equity-based compensation, such as a restricted ownership interest, options, profits interests, or phantom equity interests. A discussion of each of these equity-based compensation structures is beyond this article's scope.

Besides having independent board members, the family should be represented on the board of directors, especially after the founder retires or passes away. These family members can personify the corporate identity and the values and vision of the family business and its founder. They also take a longer view and focus more on the next generation and legacy instead of on the next quarter's earnings report.

Without a solid corporate governance structure in place, second-generation family members serving in management positions may find their ability to lead is impinged without the clear boundaries on roles and responsibilities that good governance provides. A good governance structure is also critical for a family business seeking to recruit top non-family executives. Without it, recruits are more likely to have apprehensions about blurred lines of responsibility, hidden agendas, nepotism, irrational decisions, and a lack of independence for them to perform their roles effectively. It is critical that the board, management, shareholders, and any family council or similar organization cooperate, coordinate, and have clear boundaries and guidelines. Comprehensive bylaws, shareholder agreements, buy-sell agreements, and other appropriate governance documents and agreements that are custom-tailored to your business and family dynamics are essential to establishing clear boundaries and guidelines and having a solid corporate governance structure.

A well-functioning board can also be supplemented with an advisory committee that can serve multiple functions. Next-generation family members being groomed for a future board or management position can have a formal role now (albeit without authority) within the governance of the business by serving on an advisory committee. From this perch, they can learn more about the business and corporate governance, and accelerate their formal integration into the family business.

With larger families, especially those with complex business ownership structures, an advisory committee can also be a formal structure for family representatives to receive updates on the business and to provide input more frequently than at annual shareholder meetings. Sometimes the scope for these meetings is broader than just the family business, and in those circumstances, a family council with regular meetings and even multi-day retreats can be created and utilized in addition to or in lieu of an advisory committee. Family councils can serve as valuable vehicles, not only for providing information and obtaining feedback on the family business, but also for organizing and managing family projects unrelated to the business, such as chronicling family history and resolving family issues. A good corporate governance structure does not mean you and your family will lose control over your business. Instead, it is a vehicle for enhancing your business and ensuring its profitability and long-term success.

Management change and transition, particularly in the CEO suite, can be very turbulent for a family business. It can affect not only business performance but also family relationships and dynamics. In our experience, the family businesses that manage succession the best are those that plan ahead (at least five to seven years ahead); practice good corporate governance with the proper structure (including the right corporate governance documents and agreements), the right people, and with clearly established roles and boundaries; and invest the time to identify the right people for the management transition.

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