COMPASS POINT
FAMILY BUSINESS STRATEGIES

Five Life Events that Derail Growth

WOULD YOUR BUSINESS & LEGACY SURVIVE?

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LET'S START WITH A FAMILY BUSINESS STORY

A father owns 100% of the business. He is in his late fifties. He has some life insurance, but not an amount that takes into account where the business is today or what his wife and children will need to keep the family business going in his absence. Although the company shows a profit, the father has an inflated view of its value. There have been "discussions" between the father and his eldest son. The "plan" is they will work together for another 7 years, then the son will buy the business; basically funding his father's retirement with a 10-year note.

Sound like a plan? It's not.

This is a classic scenario that plays out in far too many family businesses. Discussions and plan is in "quotes" for a reason. It is a plan that reflects the current CEO's ideal outcomes and does little to preserve the next generation's ability to continue a legacy. There are conversations left unspoken. Conversations regarding money, time lines, ownership or other family members entering – or not entering – the business.

It's an undeniable fact. **100% of owners WILL leave their business.** Yet only 50% of those exits are voluntary. Meaning that 50% of exits were NOT on the owner's terms or part of their plan.

Life is inherently messy. There are life events that can throw a wrench into even the most open transition and succession plans. Just like the guy in the Allstate® commercials, these things come along and create "mayhem".

We call them the 5Ds:

- Death
- Disability
- Divorce
- Distress
- Disagreement

Families that don't take the time to address the 5Ds BEFORE they occur – and I mean sitting down to write, discuss, and agree on a succession and transition plan – **are almost always destined to meet with heartache.** Misunderstandings, disagreements and unintended consequences litter the highway of poorly executed family succession plans.

Would your business – and family – survive the 5Ds? Let's take a quick test.

5Ds REALITY CHECK

These are YES or NO questions.

Be honest. If you find yourself wavering or trying to rationalize a YES answer with, "well, if I do this…" or "I've been thinking about…" than answer NO. **If you do not have a clear, vetted plan in place the answer is NO.**

Check the box ONLY if the answer is a firm YES:

- In the event of **Death…**
  - ❑ Is it clear who is going to run the company if you don't show up tomorrow?
  - ❑ What if it is your spouse, partner, other family member or key employee?
  - ❑ Do you know for a fact that person *wants* to run the business?
  - ❑ Will the bank continue to support the business with you gone?
- In the event of a **Disability…**
  - ❑ Can the business continue to pay your draw while you recover?
  - ❑ Do you have a plan if it is a permanent disability?
  - ❑ What if the disability happens to your spouse, partner, other family member or key employee?
- In the event of **Divorce…**
  - ❑ Do you understand the laws around martial ownership?
  - ❑ Do ALL the married family members with ownership have an assets agreement?
- In the event of **Distress…**
  - ❑ Is your customer base balanced so no single client is more than 30% of revenue?
  - ❑ Have you thought through how a natural disaster (or pandemic!) could disrupt cash flow?
  - ❑ Could the company withstand a product recall?
  - ❑ If you burn out, can you afford to exit?
- In the event of **Disagreement…**
  - ❑ Do you have a partners' agreement?
  - ❑ Do you have governance in place to deal with family and/or board drama?

So what's your final tally? ______ YES check marks out of a possible 13.

- If you answered YES to all, congratulations on your preparation.
- If you answered NO to one or more of these questions, then read on.

Here's the reality check… that event could come tomorrow. Life comes with no guarantees. It is a thin thread that can break with any one of these events and all the good intentions in the world will not protect the business or your family. Time to turn the page and dig deeper into each of the 5Ds and how they impact our family's story.

THE IMPACT OF THE 5Ds

Let's go back to our opening story and look at the impact these five life events can have on a family business.

DEATH

If the father died today, the plan is for the company to purchase 100% of his stock with the life insurance proceeds from the existing policy on the father's life. The plan also calls for the mother to have sufficient assets to live for the rest of her life.

However, if the company purchases the father's stock under current ownership, the mother has both the life insurance proceeds and the company, which doesn't sound like good estate planning for anyone. The mother would have liquidity – and no interest in actively running the business – while the son would be in a position of having to purchase the company from her with no insurance money to assist him in the sale. This result would be unfavorable to the son and would create unplanned estate tax issues for the mother.

What's more, the son is in a position of having to purchase 100% of the company at a point in time when he should have a significant interest in it already because of the time (a.k.a. sweat equity) he has put into the business over nearly two decades.

This topic also is not only about your death. How would the death of a spouse, partner, other family member or key employee impact the business?

WHERE TO START...

- **Worst case scenario needs a clear action plan.** Have open discussions with the whole family, both those working in and outside the family business, so everyone impacted knows there is a plan in place. Making decisions in the midst of grief is unfair to those left behind.
- **Understand the time line of events.** Even a well-planned estate will take at minimum of 15 months to be settled. Insurance is the only piece that is distributed immediately upon death.
- **Review insurance policies and beneficiaries.** If your business represents the majority of your income and assets this MUST be a priority. This your opportunity to take care of those you love.
- **Recognize that your heir apparent may NOT be a family member.** Determining that as soon as possible allows time for mentoring and acceptance by other family members with ownership.
- **Consider whether a sale to a third party or private equity should be an option.**

DISABILITY

Same family, but now the CEO/father is faced with a serious disability and is out of the company for the next 6 months. The son now has the responsibility of running the company. There was no disability insurance, so he is working 24/7 to keep the business profitable in order to keep the father's salary going out every two weeks. **Once again, the son is leading the company without the benefit of any ownership.**

And if the disability takes a turn for the worse, the son is back in the scenario outlined under Death.

What does disability look like? It could be a car accident, work-related event, a mishap on vacation or a heart attack. It could be you or aspouse, other family member or key employee. I had a colleague who went from the picture of health to contracting an auto immune disorder that left her hospitalized for 2 weeks and another 6 weeks in a physical rehabilitation facility to learn to walk again. Even upon release, it was another 3 months before she could work a full day in her business. Scary stuff.

She and her business recovered. Would yours? **Can your company keep generating revenue if you were unable to work for months?**

WHERE TO START...

- **Evaluate how critical you are to the sales process or daily operations.** If you have significant responsibility for either of these functions, start building a plan and a team to limit or even remove your role.
- **Are you the signer or cosigner of company checks?** Do you have a POA in place should you not be able to write that signature?
- **Do you have short-term disability insurance?** This takes some pressure off the business.
- **What if your need to be away has nothing to do with you,** but rather a family member who has a health crisis? Do you have someone in place that could keep the business moving if you need to take time away to focus on your family at home?

DIVORCE

This is going to get uncomfortable.

We all go into marriage a bit blinded by love and who wants to dampen that spirit by talking about what could go wrong. Yet, when there is a family business standing at the altar, the impact of divorce can be catastrophic for more than just those that fall out of love.

So how does this all play out?

The son, who is still holding the short end of a lop-sided succession plan, is now learning that his parents are divorcing. The company was started after the couple was married, so in most states the wife owns half the business even if she did not work in it, unless there is a legal agreement to state otherwise. If the business ends up being sold or leveraged as part of the settlement, the son's future hangs in the balance.

Despite having put a decade into the business after college, the son is left looking for a job or working under significant debt.

WHERE TO START...

- **Have the conversation.** Believe it or not, it's easier to have the conversation when emotions are not raw. Hopefully, everyone recognizes the need to put the family first and work through the "what ifs".
- **If you have children, nieces, nephews or grandchildren with ownership** in the business it is prudent for them to have agreements in place with spouses in the event of divorce.

DISTRESS

This "D" can take many different forms. Distress is anything that puts the business at risk and strains its cash flow. It could be a product recall, a natural disaster, a fire, sustained loss of power or loss of a critical client.

Here are some sobering examples of distress:

- Samsung's Note 7 product recall, and eventual production halt, resulted in BILLIONS of lost revenue, not to mention pending lawsuits from injured consumers
- According to the U.S. Department of Justice, ransomware attacks quadrupled to 4,000 per day from 2015 to 2016
- FEMA estimated over 2.1 million businesses in Florida were impacted by Hurricane Irma
- In March of 2020, the United States and the world shutdown due to COVID. Some for two weeks, others for a few months, and some never opened again.

WHERE TO START...

A Business Contingency Plan (BCP) is a valuable tool to have in place should a distress event occur to your business. Even a little planning can go a long way. Some things to think about:

- **Power Supply:** Does the company have an alternate power source to run essential activities should the power grid fail?
- **Insurance Needs:** At least once a year it is recommended that a company review its existing insurance policies. Will the coverage be adequate to pay for the damages resulting from floods or some other natural calamity? Be sure you know what is and is not covered, then fill any gaps.
- **Checklist:** Create a BCP checklist with required tasks and who is responsible for that task. Cross-train personnel to create an extra measure of security should a key staff member be unable to execute their tasks.
- **Communications**: How will you get in touch with your employees if the normal channels are down? Do you have alternate phone numbers for each of them? If your place of work cannot be used, do they have what they need to work from home?
- **Data Storage & Recovery:** If there is a fire in your office building, how many years of data do you stand to lose? Make it a practice to regularly create a back-up of all your financial records, employee details and customer particulars that live off-site.
- **Remote Working/Technology:** What systems and technology gaps did you discover that you did not realize you had until to the pandemic hit?
- **Build Cash Reserves:** Rainy days will come – be prepared.
- **Get a LOC Now – when you don't need it:** Banks are much more cooperative when you are healthy and strong.

DISAGREEMENT

As I noted before, ALL owners will leave their business. It's just a matter of whether it is on their terms or someone else's. The number one reason that owners want to exit is their love of the business has faded. And disagreement among family or board members can erode the love of the business quickly. Yet this is also one of the most avoidable of the 5Ds.

Let's look at the impact of disagreement by the numbers.

A study by the Exit Planning Institute (EPI) underscores the problem:

- Family business owners have 80% to 90% of their financial assets based in the business itself, yet...
- 88% had no written plan to transition from the current owner, including 66% with no plan at all
- 80% had never sought professional advice about developing a transition plan

WHERE TO START...

- **Establish governance. TODAY!** Governance is a set of guidelines around how the family and business will co-exist. The sooner you create this document, the better. It's easier to establish the guidelines before there are family members in the business. If you are beyond that point, you need to make this document a priority as it will truly help the family and your non-family employees understand how someone is hired, promoted and earns ownership.

- **Start de-risking in your 50s.** Transition plans can take 5-7 years to fully execute. This runway gives you the time you need to select and groom your successor. They may NOT be in the business right now.

- **Take time away from the business.** Taking that well-earned vacation is a great way to identify performance gaps and any underlying management issues that may bubble up when you are not there.

- **Take an insightful 42 question survey** that can uncover your level of owner readiness and business value in 8 key areas. Click here to send us an email requesting the survey and we'll send you the link. It will be worth the 12 minutes of your time it takes to complete.

A DIFFERENT "DISCUSSION"

Now you know a bit more about the 5Ds – the five life events that can derail growth for a family business and their potential to destroy a business and its legacy. Let's circle back to our father and son, and talk about how they can handle things differently.

By slightly modifying the father's plan and transferring some stock to the son, the potential for long-term success for both management succession and ownership transition increases dramatically.

For instance, the father might consider gifting or selling some stock – say 20% – to the son, at which point there would be two owners. If the father works for another seven years, the son will be working with him as a co-owner. That decision would do two things:

- Increase the likelihood of retaining the son's interest over the transition period
- Set the stage for a more equitable transfer or purchase

In the event of the father's death in the interim, "the Company" would repurchase the outstanding shares with a life insurance policy created just for that purpose. The life insurance proceeds would flow to the mother to buy out the father's shares; and the son would have the company, fully paid for, which would provide more flexibility to help his mother as necessary in the future.

This modification would engage the son as an owner in the business and it would provide protection against unintended consequences. Additional components of the succession plan might include the following steps:

- **Father starts building financial assets outside the business**

  The worst thing a family business owner can do to the next generation is have all their net worth tied up in the business and require the next gen to create liquidity. This puts tremendous financial pressure on the business, and leaves the owner at high risk. The goal is to 'de-risk' in your 50s.

- **Obtain an independent valuation**

  The valuation would reflect a realistic value for the company and provide a benchmark for the amount of life insurance needed. It would also help to set the price at which the father could sell a minority interest to the son and avoid gift tax consequences.

- **Develop a buy-sell agreement between the father and the son.**

  The father and son could use the above valuation as the basis for creating a buy-sell agreement, should a trigger event occur. The parties could decide if it would be necessary or appropriate to purchase life insurance on the son's life as part of the buy-sell process, as well as assess the reasonableness of the existing life insurance on the father's life.

- **Revalue the business at least every other year**

  The valuation would provide a basis for updating life insurance needs and for resetting the price for the buy-sell agreement. Recurring valuations provide numerous other benefits for shareholder planning, investment monitoring and transparency for all family members.

- **Operate under this plan for a year or two, then reevaluate**

  After a year or two under the new ownership plan, both the father and son would have a better idea regarding whether the plan to sell the company to the son to fund the father's retirement is workable. Regardless, both father and son (and mother too) would have better knowledge about the likelihood of things working out. If things are not working out, better to find out after a year or two than after seven years when available options will be minimal and likely not favorable.

- **Adjust the plan over time, as needed**

  Dad might even have the flexibility to retire early if all is going well. The son's ownership could be increased over time to minimize the difficulty of a future buyout of the father's shares. This provides an opportunity for the father's advisors to stay involved, and to encourage following through with the new plan.

What we have learned from our many years of experience working with family businesses is that hope and good intentions are not a good enough plan for disaster. The only way to build an effective succession plan is to physically start committing your thoughts to paper.

It's imperative to have a written, communicated and properly funded plan that benefits everyone – father, mother, children, employees and company. Otherwise, everything you have worked so hard for can be derailed by one of life's unexpected events.

Get started now. Mayhem may be around the corner.

*Tom Garrity is the managing partner of **Compass Point Family Business Consulting LLC** – a business strategy & leasdership training firm working with family-owned companies who want to grow, care about the legacy of the business and want to protect their financial future. He works primarily with companies in the manufacturing, construction & professional service industries. Tom can be reached at 610.336.0514 or tgarrity@compasspt.com*

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At Compass Point, we provide family business owners hands-on business coaching and leadership training through practical, actionable tools that drive growth, next-generation development and an operating system that identifies – then closes – the performance gaps within the company.

SIX PILLARS of your FAMILY BUSINESS FRAMEWORK:

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