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The Challenge of Family Business Transition

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Planning for the transition of a farm or small business is necessary if the family wants to pass on the legacy of the business to the next generation. For the more than 20 million family farms and family small businesses operating throughout America today, transition planning is no small challenge. Agriculture is on the forefront of this issue due to the aging of the farm population. The average age of the American farmer is 55, indicating that a significant turnover of management and farmland will occur within the next 20 years. Ownership of approximately 70 percent of United States farmland, the largest asset on farm balance sheets, is expected to change hands over this same time period.

In March 2001, Alex White and David Kohl, Virginia Tech, held a seminar on family business transition. This seminar was unique in that it paired students from a senior-level problem solving course at Virginia Tech with agricultural families from the Winchester, Virginia area. The students, under the guidance of White and Kohl, acted as facilitators to help each family with the main issues, potential problems, and possible courses of action related to family business transition. The main goals of the seminar were to discover transition planning issues and to help agricultural families base their transition plans on their life cycle rather than traumatic events such as death, disease, or disability. This seminar was sponsored by Valley Farm Credit, Rural Economic Analysis Program (REAP), and Virginia Cooperative Extension.

The objectives of this article are

? to identify the major challenges facing the older and younger generations in family business transition

? to provide a sequence of planning steps that can be used in intergenerational transfers of business, and

? to outline the implications to the agricultural industry and small business owners based upon facilitated discussion during the seminar.

The Generation Paradox

Dialog from the seminar clearly indicated that each generation had differing business and personal goals. This "Generation Paradox" can lead to significant goal clashes during the transition phase. The conflict can be seen in the concerns of each generation.

Older Generation Concerns

1. A common theme throughout the seminar was the conflicting goals between generations. The older generation was concerned about entrusting "their" business, the business they have built and managed, to someone else: "Would the next generation able to run the business as the older generation thought it should be run?"
2. Another common theme was whether the business assets would be able to generate sufficient income to support the older generation throughout their retirement years.
3. Other concerns of the older generation included developing a transition plan that treats all of their children fairly and equitably. This issue was particularly prominent in families who had children who were not directly involved with the family business.
4. Finally, lifestyle issues such as health care, living arrangements, and preserving the legacy of the family business were uncovered as concerns for transition planning by the older generation.

Younger Generation Concerns

1. The younger generations had slightly different concerns about transition planning. Their main concern was the economic viability of the existing business. Would the

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family business be able to support both generations at the same time? Are significant changes to the existing operation necessary for its continued economic viability?

2. Several of the younger members of the seminar expressed concerns over whether they would be treated as partners or as hired labor after the transition. What amount of managerial freedom would they have? Would they be able to implement new ideas or make significant changes to the operation?
3. They expressed concerns about the stress of high debt loads necessary to maintain or expand the current operation and the possibility of having to buy out senior and non-business family members.
4. Communication of transition plans by senior members, management responsibility, and possible time away from the operation were also frequently mentioned.

A Typical Farm Family and Their Operation

The following typical farm family scenario was developed to facilitate discussion of the importance of organized transition planning. While the concerns and solutions would apply to *any* small business, an agricultural operation is used because the audience was predominantly comprised of farmers.

The farm is a third generation 100-cow dairy operation. The farm is very productive, has good soils, a top producing herd, and is in an area surrounded by many large dairy and crop farms. It is located outside a town of 500 people and is about 18 miles from a city of 30,000 that is supported by a large military base. The farm business has $780,000 in assets, $75,000 in liabilities (mainly on machinery). The average net farm income over the past 5 years has been $63,000 before taxes. Their lender's analysis of the operation indicates a strong equity position, but marginal profitability and working capital for a sustainable family farm business supporting two families.

The mother (Jill) and father (Jack) are 65 and 62 years of age, respectively, and are in the process of retiring. Aside from the farm, each has driven a school bus over the years, which provides Jack with annual pension income of $16,000 and Jill with annual pension income of $5,000. Jill expects to receive Social Security benefits of $5,000 per year, while Jack should receive annual benefits of $9,000. Jack and Jill both want to be actively involved in the farm during their retirement years. Jill, with the assistance of an accountant, keeps the books and does the associated paperwork. She also does some farm chores and runs errands for the farm. However, they both have health problems, which are a concern to each other and the children.

The farm is operated by their son Joe, who is 33 years old. He is married to Julie (age 32). They have three children. Together they own half of the cows and machinery and draw living wages and benefits from the farm. Julie has an associate degree in community service and is currently employed off the farm. Joe's oldest sister, Mary, is also employed off the farm. She is divorced and has a questionable credit history. Mary's son occasionally works on the farm. Joe's younger brother, Mike, farmed in partnership with Joe and his parents until a medical condition prohibited further involvement in the farm. Mike now has a very successful agricultural spraying service. He recently married. The youngest, Cindy, lives in Atlanta and is married to a successful computer consultant. Cindy has two sons who love to visit the farm during vacations.

Joe and his wife are concerned that they will lose the remaining parts of the farm to other family members because of the lack of a will and a formal estate plan. Furthermore, when Joe and Julie told his parents that they would like to start a trail riding business (horses are their hobby), a disgruntled Jack indicated that they would have to pass it by Jill for final approval.

What Next?

This business transition challenge is not atypical of those observed at the seminar or of farm families and small businesses throughout Virginia. As can be seen in this case study, some things, typically taken for granted, could lead to potentially disastrous consequences. The following points need to be considered.

Business Goals of the Parties Involved

Are Joe and Julie interested in continuing the operation in the current manner? Would they rather phase out the dairy operation in favor of the horse operation? Can the current operation easily support Joe and Julie, as well as Jack and Jill? These questions must be answered in a transition planning process. The owners and managers (and their spouses) must have a clear vision of the future of the business. This vision will greatly simplify transition planning by providing direction for the future of the family business.

Personal Goals of All Parties Involved

Personal goals can get sticky. Suppose Joe and Julie want to phase out the dairy operation or decide to quit farming altogether. While getting out of farming may fit Joe and Julie's personal goals perfectly, how will Jack and Jill react to seeing the farm they helped build close its doors? Or Cindy's kids who love to visit the farm? If these issues are not discussed

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in a calm, clear, open manner, someone's feelings are likely to get hurt, which can lead to severe family problems. All parties involved, including the spouses, children, and non-business family members, need to honestly communicate with each other to develop a transition plan that works for everyone.

Transition Plans Help a Family Face Harsh Realities

One of the immediate questions the family will have to answer is, "Who will help support the surviving parent, now that part of the pension income has been lost?" If Jack dies first, who will help support Jill? She cannot live on $5,000 per year pension and a small Social Security income. Does she move in with Joe and Julie and their children, or Cindy and her family, or Mary, or Mike? Or does Jill move into a retirement community, so that she will not be a burden to the family? If she goes to the retirement community, who will help her pay the $40,000 annual expenses?

Without a transition plan and a formal will, the disposition of the farm assets owned by Jack and Jill is fairly straightforward. Assuming the deeds and titles for these assets are in Jack and/or Jill's name, the farm assets owned by Jack and Jill will be split evenly among all five children, as per Virginia intestacy laws. Along with the distribution of the physical property, decisions will have to be made about the management of the business. Will Joe have to pay rent to his siblings so that he can keep the farm in production? With five owners in the business, who will be the primary decision maker? Will Joe have to purchase his siblings' share of the farm so that he can manage it as he has in the past? Many of these potential problems can be avoided or minimized by developing a comprehensive transition plan for the family business.

As the situation in this case now stands, the problems will start after a shock to the family (death of the parents); at that point, it is too late to start transition planning. Typically, families who start the transition planning process before the shock have the family businesses that successfully operate from one generation to another.

Simplifying Transition Planning

Transition planning can be a complicated and sometimes confusing process. It involves personal goals, concerns, and financial and legal issues. The following three steps can simplify the process:

1. Recognizing the Potential Problems

The first step is to attempt to get the family to recognize that potentially serious problems may be related to business transition. Sometimes a seminar, article, or book with related anecdotal situations can be the motivational force that starts the transition planning process. Without this recognition, the typical transition occurs after a shock to the family or business. Typical traumatic events that lead to belated planning include death or disability of a family member, divorce, or unplanned termination of the business. Waiting until the occurrence of this "trigger" typically leads to emotional decisions that may spell financial disaster for the family.

2. Building a Transition Management Team

The second step is to develop a Transition Management Team (TMT). The services of a facilitator or project manager can help build the TMT. The facilitator should be a good listener, quick to understand the business and family conditions, patient yet firm, and able to remain neutral. The facilitator will be instrumental in determining commonalities and points of departure in the goals, problems, concerns, and challenges of all interested parties (including spouses and non-business family members).

The TMT might include an accountant, an attorney, a financial planner, and a lender. Other individuals, such as crop/livestock consultants or other specialists can be added as circumstances warrant. All TMT and family members should be present at meetings so that the exchange of ideas and potential solutions can be facilitated. Formal minutes should be kept from each meeting and distributed to each member.

The facilitator should establish a timeline for the process. It should include specific accomplishments and expectations for each individual. Ground rules should be established up front. The process usually takes between 3 to 15 months, depending on the complexity of the plan and the schedules of those involved.

3. An On-going Process

A transition plan is not something that is written once, filed away in a drawer, and forgotten until it is needed. It is a work in progress that needs to be revised as the business and family grow. Transition planning is an investment in the future of the family. Investments in transition plans may range from as low as $2,000 for a basic plan to over $15,000 for complex cases. Many people think the costs too expensive to justify; however, the cost of not having a transition plan or of having a poorly devised transition plan, is much greater.

Implications

The seminar and case study provided a logical format to analyze the concerns and issues of intergenerational transition planning. First, a methodical planning process, with

professional assistance and an investment in time and money, has a positive cost benefit to the family, the industry, and the Commonwealth. In the future, agricultural and small business owners will be challenged to obtain resources from the Cooperative Extension Service, educators, and leading agricultural groups. This creates a need for personal or web-based assessment tools that can be used as motivators in the transition planning process.

Second, seminar participants walked away with a heightened awareness that coordination of facilitators and professionals is essential to ensure that planning activities are carried out in a timely fashion. These groups should be identified and made available to the public, such as with the Service Corps of Retired Executives (SCORE) in the small business arena.

Third, assessment and diagnostic tools need to be refined, based on the complexity of the case. For example, a large business may have a different set of criteria and challenges than a smaller business.

Finally, seminar and course evaluations make it apparent that undergraduate and graduate students, as future leaders of the industry, need to be exposed to the complex, real life issues facing agricultural and small business owners.

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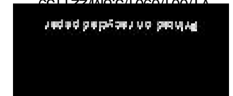
****New from REAP:** *The Influence of Residential Development Patterns on Local Government Costs and Revenues* by Kurt Setphenson, Cameron Speir, Leonard Shabman, and Darrell Bosch. This report investigates if and to what extent more land-intensive housing patterns are compatible with the fiscal incentives of local governments.

****Rural Virginia Prosperity Commission**: see what the Commission is doing at *http:\\rvpc.vt.edu*.



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