

# Should You Transfer Your Business to the Next Generation or Sell It?

By David Ryan

The majority of business owners will exit their business or professional practice in a way that will lead to its failure. The demise of a business can dramatically impact the owner's retirement and the family's financial security. The purpose of this article is to show owners of small to medium sized businesses how they can maximize the value of their business when it comes time to sell or transfer the business.

*Small businesses play a crucial role in America and affect all of us.* Eighty percent of all new jobs are created by small business and more than 50% of the United States gross national product is produced by small business

We have all heard the statistic that more than half of all new businesses fail during the first year. But what of those businesses that survive? Approximately 97% fail by the fourth generation (an 80 year time span). As you will see, it doesn't have to be that way.

If you consider the fact that 90% of all businesses in the United States are family owned or controlled and the country is faced with all time high number of business owners nearing retirement, you can see that the economic health of our nation will be impacted by the growing number of businesses that fail.

## The Purpose of the Business Transfer

In most cases, it takes many years and much hard work to build a business or professional practice. At some point in his or her life, the business owner decides it is time to sell or transfer the business so that he or she can pursue other interests or retire. In some cases, illness requires that this decision be made sooner than it would otherwise be.

A business transfer has many different purposes. Of course, most business owners wish to obtain cash or regular payments which will guarantee them financial security and comfort. Another purpose of the business transfer is to insure that the business will **continue**. If the business owner just wanted cash, he or she could, in some cases, sell or liquidate the assets of the business. However, if you wish to insure that employees keep their jobs and that the business continues to thrive, an orderly transfer must be arranged.

Dr. Donald Moine, an author and well-known business consultant states, "The purpose of a business is the creation of wealth". He goes on to define wealth as "the optimal combination of financial success and personal satisfaction as defined by the individual business owner." No matter how you define wealth, the business will provide you the resources to create that wealth.

Ultimate wealth for the owner of a business is also achieved through community recognition, civic leadership, industry acknowledgment, charitable causes, personal free

time for travel or recreation, the ability to provide financial security for children and grandchildren or any combination of these elements. I have helped dozens of business owners sell or transfer their businesses and have found that a common goal of business owners is to create **personal financial security** for themselves, their family members and key employees.

### **Transferring a Business to Family Members**

An entrepreneur invests tremendous amounts of personal time, emotion and money to create a business. Eighty percent of business owners want to transfer the company they have created to the next generation. While this is an admirable goal, it is not easily accomplished.

Over the past twenty years, I have seen a number of different methods used by owners to try to transfer the family business to the next generation. Perhaps the most common is the “**assumptive method**” of just assuming that the next generation will take over the business. Without formal plans in place, this method, unfortunately, often ends in disaster.

Before attempting to transfer a business to the next generation, you must ask yourself several key questions. The first is: will the children have a **passion** for the business? Most businesses are started by people who do have a passion and a vision for the business. Unfortunately, your children may not have the same passion for the business that you possess. Without that passion, *will they be willing to work the long hours that are sometimes necessary?*

If your child wanted to become a veterinarian or to start an Internet business, will he or she be happy working at your company? When a child has to give up his or her dreams to run a family business, that business is often doomed for failure. This is an extremely serious issue you must consider.

Secondly, does your child have the **management talent** or **technical talent** needed to keep the business running successfully? Some people do not have the personalities or temperament to be managers or owners. Will your child be able to make objective hiring decisions? Will he or she be able to fire an employee when necessary? Without these skills, the business will not succeed.

Third, do your children have the **work habits** necessary to keep the business a growing concern? If your business was successful, your children were probably raised in a nice home and probably attended fine schools. You were probably able to buy them a nice, comfortable lifestyle. Do they now have the discipline to work the long, hard hours that all businesses require at different times?

## **Transferring Your Business to Employees and Family Members**

Some business owners contemplate transferring their businesses to employees. Sometimes, a business is transferred to a combination of employees and family members. In general, transfers or sales to employees are usually more successful than gifts of a business to the next generation.

However, all of the above concerns still apply. The new owners must have a passion for the business, they must have the management and technical skills necessary to make it a success and they must have the work habits required.

Special challenges arise when transferring a business to a combination of employees and family members. Specifically, *how will one of your children feel if an employee gets a promotion or a high level position before that child does?* On the other hand, will employees feel that favoritism is being shown toward the children of the former owner? These issues can lead to resentments between employees and the children of the founder of the business.

The problems can be solved but it is necessary to bring in a skilled consultant or business broker. Addressing these complex issues is not a “do it yourself” job. If these problems are not addressed hear-on, the result will be poor morale, inefficient execution of new ideas, constant conflict and an inability to compete effectively with other companies in the industry.

One of the best solutions is to structure the transfer of the business as a sale. That is, the new owners, whether children or employees, should be required to buy the business. As we all know, something that is given away is frequently not highly valued. There are many ways of structuring the sale, ranging from an all-cash deal to cash and a note, cash and a mortgage, earn-outs, structured buy-outs and many other options.

You can also structure the sale so that the buy-out takes place over several years and during that time, if you would like, you can gift parts of the business to your children or forgive parts of their notes or payments. This solution makes use of the best provisions of a **sale** and of **gifting**.

### **Case Studies**

One of the greatest challenges in transferring a business to the next generation is deciding which of your children shall be in top management positions. Frequently, business owners find it extremely difficult to make hard decision between siblings.

One company that I work with had two sons; the older son had more experience in the business yet the younger son was more adept at management. The parents where unable to decide which son should be president of the company. Instead of making the decision they needed to, they split the company into separate entities and made each son president of one company.

The problem was that these two “separate companies” were in fact one single company operating out of one facility. In short the company had no leadership, no vision and constant conflict. The father had to stay involved three days a week and was unable to retire. His presence further confused the leadership hierarchy. No one knew who was in charge!

I was able to successfully solve this problem by selling the business to a major company. The father was able to retire with total financial security and both sons had high-paying jobs in a stable company in which they were able to retain some ownership interest.

### **Other Key Issues in Transferring Your Business**

There are many complex issues in transferring or selling your business. However, do not be put off by this complexity! Many business owners are surprised by how much money their business can be sold for if the sale is properly structured and promoted. For example, one business owner told me his business was appraised as being worth about \$1 million. I was able to structure a sale that brought him and his family nearly \$10 million.

If this business owner had simply given his business to his children, there is a good chance the business would have failed. The business needed capital to grow and the children could not raise it. The optimal solution was to bring in new owners with deep pockets. That is what I did.

One of the issues to examine if you gift a business to your children is that of **gift taxes**. Another issue is **estate taxes**. If a sale is not properly structured, the business owner or his estate may lose up to 70% of the value of the business to taxes.

You also need to look at **psychological issues** if you sell or gift a business to family members. As the creator and seller of the business, you become a creditor when you sell it to your children. Your children will become debtors to you. “Mom” and “Dad” suddenly become “the people we owe money to.” How will they feel about that?

Another issue you need to look at is **vendor and customer relationships**. All of the people and companies who do business with you trust you and are accustomed to doing business with you. Will they have the same level of trust with your children? Are you sure? What would happen if one or two of your major customers decided to take their business elsewhere? This could be devastating to the business.

One alternative that I do not have time to cover in depth here is to sell part of the business to a **private equity company**. This solution can provide the owners with the money they need to retire and it can also provide the business with the money it needs to grow. In addition, your children can maintain ownership of a significant portion of the company.

Many families have successfully transitioned their business from one generation to the next by utilizing private equity to help fund the family’s financial security. There are

thousands of private equity companies investing in every sector of business and industry. Some will fund even the smallest companies, those with sales of under three million dollars per year. Others specialize in medium-sized to larger deals.

I have found that another benefit of using private equity companies is that they can provide cash for a business owner to diversify his or her wealth. We have all heard the adage, “Don’t put all your eggs in one basket.” When you have your net worth wrapped up in a business, you have all of your eggs in one basket. If that business gets into trouble, your net worth can decline precipitously or, in some cases, be wiped out.

You can use some of the cash you receive from a private equity company to invest in real estate, stocks, bonds, mutual funds or other investments. When you have a diversified range of investments, even if one investment declines in value, the chances are that other investments will be rising in value. Diversifying your investments helps insure that your wealth will benefit many generations.

A final major benefit of selling your business or bringing in a private equity investment company is that you will be better able to protect some of your wealth from creditors. Businesses are especially vulnerable to lawsuits. In fact, all it takes is one major lawsuit to destroy a business and a lifetime of hard work. On the other hand, the cash you obtain from selling your business or from bringing in private equity investors can be placed in trusts, corporations or limited liability companies in such a manner that it is shielded from lawsuits. You will then have the peace of mind of knowing that your wealth will always be there to maintain your lifestyle and that of your family members.

As you have learned, there are many benefits to selling your business or bringing in private equity investors. For all of these reasons, you should carefully consider how you want to sell or transfer your business for you to maximize its value not just for yourself but also for future generations.

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