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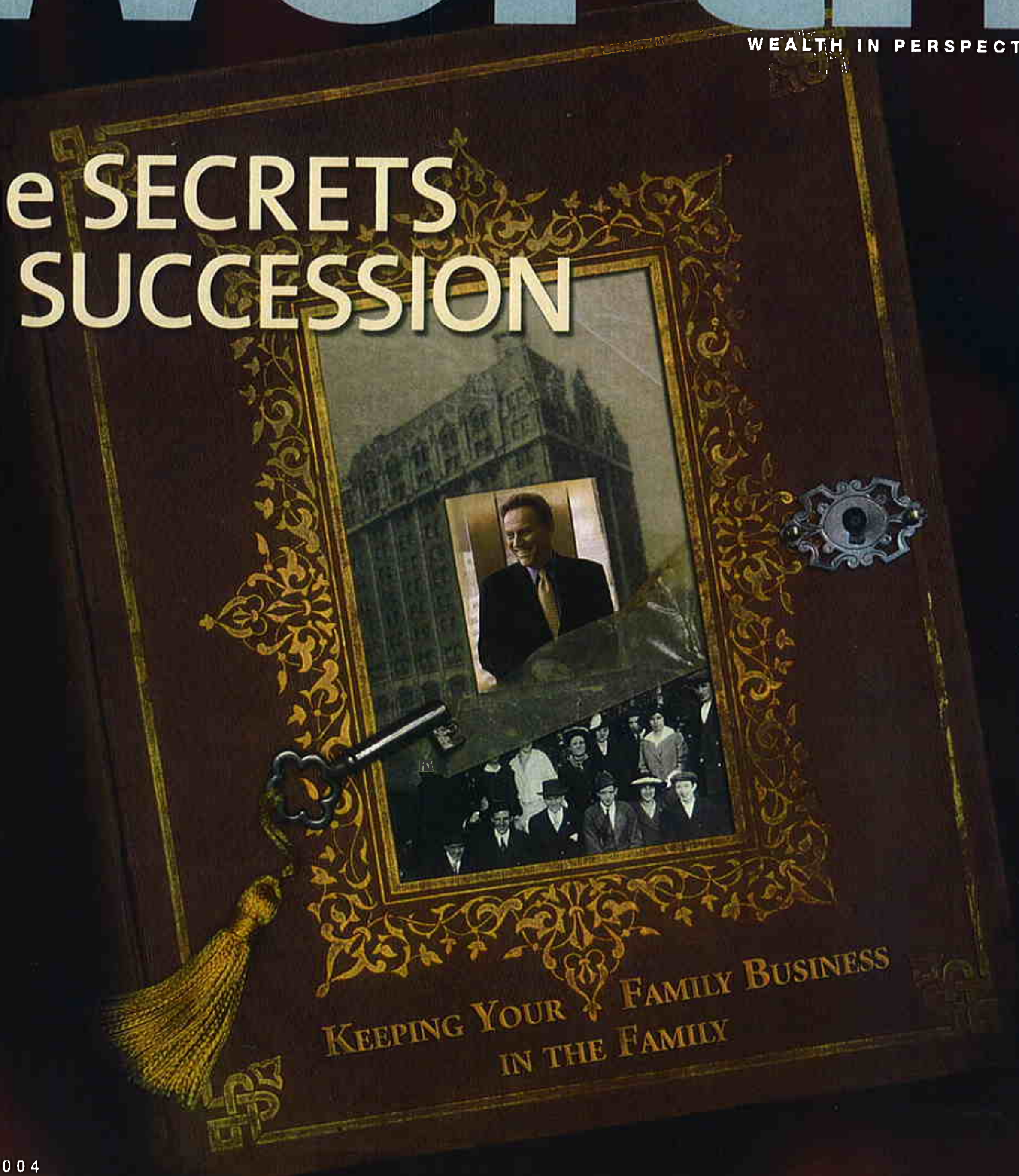

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Top View

Most family businesses do not survive the transition to a second or third generation, often because the family is unable to reach a consensus that balances the needs of an individual with the needs of the business. Those few that thrive are often backed by families with a common view of the purpose and principles that drive the enterprise.

COMMERCE AND CONSENSUS

Finding a balance between family and business needs is crucial if either is to flourish.

By Dwight Cass

WHEN DAVID MOLINA, founder of Long Beach, Calif.-based Molina Healthcare, died after a short illness in late 1996, his family faced the enormous task of deciding how to take the private and rapidly growing family business forward. "My father was the sole shareholder, chairman of the board and CEO of the company," explains Mario Molina, who, like his father, is a doctor and now the company's president and chairman. "He owned it lock, stock and barrel, and he did what he thought was best, how he chose to do it."

Hands-on control, combined with a strong strategic vision, is often the hallmark of entrepreneurs who build successful companies. The late Dr. Molina was by all accounts of this caliber—a man who devised a successful business in an underserved niche with an innovative strategy. His firm, Molina Healthcare, provides health care services to low-income families and individuals who qualify for Medicaid and other government health care programs. From its roots in California in the early 1980s, Molina Healthcare has since expanded to Michigan, Utah and Washington, posting nearly $650 million in revenues in 2002.

Upon the death of the patriarch, the Molina family faced a number of hard business decisions, but with no individual wielding full control, the family had to work hard to reach a consensus on business issues.

"I ended up being one of many responsible for running this company," Mario Molina says. "It's really owned by my family—my brothers and sisters and my mother—and I didn't have that omnipotent position my father had, in which I could just do whatever I wanted. I now had to negotiate with everybody as to what we were going to agree to do."

This conundrum of control is widely blamed for the demise of many family businesses. Family members often pursue different agendas—some want to cash out, others want to build the business, some perhaps are looking for a comfortable sinecure. If the family is not tight-knit, or if it has no family council or creed to guide it, the business can slip into a decision-making paralysis. These companies, stripped of a founder's guiding vision, often suffer as market opportunities pass them by and competitors gain ground.

Consultants often quote the (perhaps somewhat apocryphal) statistic that only one in four family businesses survives to the second generation. While that may be an exaggeration, family decision-making issues were of sufficiently pressing importance to Molina Healthcare to prompt the family to seek some outside expertise.

The Molinas hired a family business consultant who helped them realize that they needed to focus on the business side of the family-versus-business equation. "There's nothing magical about a family business," Molina says. "You still have the same issues, it's just that some of the people that you're dealing with now are also your relatives. What are we going to do for capital? What's our strategy going to be? How are we going to compete in the marketplace?"

"THE SUCCESSFUL FAMILY CREED HELPS YOU BUILD A FRAMEWORK, BUT DOESN'T GIVE YOU EVERY NAIL." GERRY MURAK

The Molinas realized they needed to set aside personal agendas to ensure that their company remained successful because, in the end, it was the family's core asset and the mechanism for pursuing its family (and corporate) mission: to provide health care to the poor.

But maintaining the value of a family business often requires difficult staffing choices. As Molina Healthcare grew, it became apparent that it needed professional managers. Family members who worked in the business, but did not have best-of-breed skills or experience, needed to recognize that for the sake of the business, they had to make way for outsiders. "That was a little bit of a difficult transition, because I think some people got their feelings hurt," Molina admits. "But, eventually, they got over it."

They got over it in part because they realized that each family member in fact played several different roles, Molina adds. "Sometimes you are an owner, sometimes you are an employee, and sometimes you are a family member. The trick is to understand what role you are playing at any particular time." Those who stepped aside in favor of professionals understood that although they might be losing the opportunity for advancement as employees, they would benefit as owners, and the family overall would benefit.

COMPASS, FLASHLIGHT, MAP

Gerry Murak, a family business consultant who practices in the Buffalo, N.Y., area, says many families can profit from establishing a written framework for making these types of decisions. This family business constitution, which Murak calls a family creed, is similar to the family mission statement described in our December issue (page 59), only this document focuses on goals, values and decision-making principles specifically geared toward the family business.

Murak observes that, as in the Molino family's case, it is often a succession or liquidity event—be it the death or retirement of a patriarch or matriarch, or the sale of a large interest in the company—that forces the family to take these issues in hand. "Family businesses keep their cards close to their vest," he notes, and the often-secretive nature of these private entities, combined with the desire to avoid discussion of family matters with an outsider, often delays action in the absence of a succession or liquidity event.

This delay can greatly complicate the task, Murak explains. "There's a mathematical problem with family businesses, and that problem is logarithmic: It's the birth rate," he says. "If the founder has one or two children, and they have a couple of children each, within a few generations, you wind up with significantly more people looking for high compensation positions in this prominent family business. Then it is much tougher to establish the criteria for entering and exiting the family business." If left too long, the welter of competing parties, each of whom may own a share of the company's equity, may make it impossible to reach a workable consensus on these issues.

THE CRUCIBLE

Devising a family creed can be a long process, and it requires buy-in from the entire family. According to Murak, the first step is to bring all the family members together, even those not employed by the business, along with their spouses. "Now, you may think that is like assembling six kegs of dynamite, all with very short fuses, but it's done for a good reason—all the members of the family, whether they are involved in the business or not, talk about it all the time and are in some way involved with it," he says. For example, children who do not work in the family enterprise can still influence it by lobbying their parents or siblings. "It's best to start out with everyone," advises Murak.

This family council then works to establish a family creed. "The family agrees to criteria for entry, exit and the purpose and role of the family in the business, and what do they want to do with the asset. Do they want it to grow, and if so, do they want to fill it with family members or the best people available in the market? How does all that happen, and how are conflicts resolved—that's all decided up front," Murak says.

One of Murak's clients, the Wach family, had the foresight to tackle these issues well before a change in control occurred. In 1969, Gene Wach founded EGW Personnel, a temporary employment agency with offices in upstate New York and North Carolina. As his four boys—and his firm—grew, some of his sons expressed an interest in joining the firm. He realized he needed some type of family progression strategy.

It required a commitment of time and energy. "We probably spent two or three years meeting with Gerry and our whole family to iron out all of these things—succession planning and things of that nature," says Wach, who retired about eight years ago. "We'd have a meeting with the 10 of us. And then Gerry would, in a sense, give us homework, things to work on, to think about, and what have you. We'd meet again in another couple months. It was drawn out, but it was very useful and necessary," Wach explains. "We did different things to evaluate where we were going, who we were, and why we act the way we do."

The EGW family creed that emerged from this process is a six-page document that serves as a touchstone for all the firm's actions by articulating an overarching family mission and philosophy. It also details eligibility criteria for those in future generations who wish to become employed by the firm. Specifically, they must complete at least four years of college, plus two years of successful non-EGW work experience, or complete a total of six years outside EGW, and demonstrate progressive recognition for positive job performance. It also provides criteria for those who wish to serve on the family council, the body charged with implementing the creed.

An inflexible family creed will serve succeeding generations poorly as it becomes increasingly irrelevant or restrictive. Indeed, the key to success of any business is flexibility, and the family creed must provide latitude for change, especially if it is meant to function for generations. The EGW family creed, for example, explicitly notes that it may be revised by a two-thirds vote of the family council. "Where you can go overboard is having a document that dictates too much rather than being a guiding and flexible document," Murak points out. "That's the beauty of our Constitution. The successful family creed helps you build a framework, but doesn't give you every nail."

THE BUSINESS OF FAMILIES

Overlooked in many case studies of successful family business control transitions is the important role of the family itself. Wach notes: "One of the things I really believe is that if you want to have a good family business, it's important to have a good family!" The Wach family meetings involve some time for everyone to blow off steam, have some fun and catch up. That time is especially important because two of his sons live in Buffalo and two live in Raleigh, where the firm has its North Carolina office.

It may seem obvious, but given the often-fractious state of many families, the health of a family's relationships is the crucial factor in the success or failure of any family business. If, for example, the Molina family was not a cohesive group of individuals who respected one another enough to listen and consider different points of view, assembling the consensus necessary for its most recent transition—into a public company through one of the first successful initial public offerings of 2003—would have been all but impossible.

"I think the fact that our family was able to hang together and work through all the issues really has a lot to do with our parents and the way we were raised," Molina says. "Not all families are going to be able to do that, and, in fact, it's at these transition points that businesses tend to fail—when you go from the first generation to the second generation in a family business, or when you go from the second generation to the third. A lot of credit goes to my brother and my sisters for hanging in there and being willing to fight it out. Everybody stuck with it, worked hard, and, as a result, the company did very well. I think that it was that dedication to making sure that the company succeeded that maintained my father's legacy."

The importance of preserving a legacy of community service and high standards of work is a common refrain among family businesses that have successfully weathered generational changes. One particularly long-lived example is another of Murak's clients, Magavern, Magavern & Grimm, a Buffalo-based law firm that traces its roots back to 1825. Three generations of Magavern family attorneys managed the firm through the 20th century, until about five years ago, when Thomas Schofield was named its managing partner.

The rapid pace of change in the field of law in recent years, especially technology advances, forced the firm to ascertain whether a new generation of management would be better suited to take it forward, or whether a merger or

"IF YOU WANT TO HAVE A GOOD FAMILY BUSINESS, IT'S IMPORTANT TO HAVE A GOOD FAMILY!" GENE WACH acquisition was a better idea, Schofield says. Making such a change at a firm with such deep roots might have been wrenching. But Schofield notes, "The secret here is the partnership agreement. It is structured in such a way to protect the continuity of the law firm. The other factor is that the founders have been extremely generous—there isn't what you see in so many law firms where the founder's family takes the lion's share. We've had a very equitable partnership in terms of distribution of income. The generosity of the founding families allowed us to maintain our collegiality and independence and work through the succession issues." The firm supports and participates in many of the region's cultural institutions and activities. The partnership agreement, not unlike a family creed, supports these initiatives.

BARBARIANS AT THE GATE

One of the events in a corporate life that can truly test a family's decision-making cohesion is the sale of equity to third parties, either via an initial public offering or a private equity investment.

"I think that it was definitely a learning process for everybody," Molino recalls of the discussions leading up to his family's mid-2003 IPO. "We would occasionally bring everybody together, maybe go in the boardroom, and hash things out. The people who were really involved in the decision were myself, my four siblings and my mother—the principal shareholder group—and we really went back and forth for a long time looking at the private equity versus the IPO option. We came very, very close to negotiating a private equity transaction."

The private equity deal was less attractive because the veto rights being sought by the investors would have tied the family's hands, despite their not selling a majority stake in the company. "For our culture, the kind of company that we were, it would not have worked," Molina notes. "We would not have been happy. So that's why we decided to go public." The family has retained a 70 percent stake in the company.

Preparing for an IPO or, in some cases a private equity acquisition, may require painful changes to the company roster. One of the first things an investment bank will advise an entrepreneur looking to go public is: Fire your family. Institutional investors do not like to see a corporate hierarchy stuffed full of brothers, sisters and cousins. Board independence is also a pressing issue, especially with corporate governance being such a high-profile topic with investors.

Richard Morgner, a managing director and head of mergers and acquisitions at Chanin Capital Partners, an investment bank that advises family businesses, notes that the extent of the purge required really depends on the buyer's strategy. "If the buyer's a competitor, it may want to eliminate management. They're not buying your business for the management or the family expertise; they're buying it for its customers, its assets. But if it is a private equity firm, it may need a management team. In many situations, there is a great CEO [in place], but the buyer needs to bring in professional finance and accounting staff."

The loss of family members' job security is often a barrier to consensus over a sale. "There may be members of the family who just worked there, who are not true owners, and who therefore will not benefit as much from a sale. Our advice in those situations is to think about it up front, before the transaction," Morgner says. Some families give employment contracts to their members before the sale, but this is obviously not welcomed by buyers who want to make their own staffing choices. "Sometimes it just means that someone in his 30s or 40s is going to have to find a job working for someone else for the first time."

AN EXIT OR HALLWAY?

Even those cohesive families with creeds in place and their decision-making apparatus fully functional may find their greatest challenge is knowing when to sell. Ted Beringer, who runs a Bryn Mawr, Pa.-based firm that advises family businesses on exit strategies, says he sees more willingness to sell now than in the past. "When I first started, most people were keepers. Now most people don't know." A partial explanation is the enormous increase in valuations of family businesses during the 1990s. Another is the different mind-set of the baby boomer generation. "The guy who came out of World War II said, 'I got to give this to my kids.' It's not that way with the baby boomers," he notes.

This is not necessarily a bad thing—especially if it prompts the family to exit a business sector in decline. It can also allow the family to take the liquidity from a sale and view it as the new family asset. In other words, managing the family money becomes the family business. "Just because you sold all or part of your business does not mean you don't still have a family business," Beringer says. "If you run the money like a business, it involves all the benefits of a family business, like keeping your kids around and involved."

Richard Morgner of Chanin Capital Partners says families have some latitude to ask for unusual terms when selling their firms, as long as they are not too unreasonable. Chanin recently represented Country Road Communications, a telephone company, in its acquisition of Evans Telephone in California. The Evans family matriarch insisted that whoever purchased the company continue to sponsor the local Little League team. Since the amount involved was trivial, Country Road was glad to agree to backstop the team. "You know," Morgner recalls, "I think we also wound up winning partly because Country Road's CEO is a West Point grad, and he played extremely well with the family's matriarch..."