

Virginia Cooperative Extension

Knowledge for the Commonwealth

Ten Rules of Transition Management

Farm Management Update, June 1996

David M. Kohl, Alex White, Dixie Reaves, and Amanda Wilson

The issue of family business generational transition is a major topic of discussion as farm businesses are positioning themselves for success in the late 1990s. Growth is the number one reason businesses fail, and this is because of under-capitalization, inadequate preparation in human relations and communications, and insufficient income generation. Sixty percent of all farm and small businesses that enter bankruptcy were profitable in previous years. The following are some rules that are generally used in successful business transitions.

Rule 1: Revenue/Net Income

Bringing in a new partner takes an estimated \$150,000 to \$250,000 in gross revenue, or \$40,000 to \$70,000 of net profit for a successful business transition. Violate this rule and you set yourself up for guerilla warfare, where family members or partners fight over scarce resources (including net income) to meet their standard of living.

Rule 2: Three-to-Five-Year Rule

Agricultural business transitions are twice as likely to be successful when the family member or potential business partner works for someone else for three to five years. Allow them to make mistakes with someone else's money! A recent study found that the farm businesses that allowed entering partners to work for others for three to five years found their business to be four times more profitable. A college education is not part of this experience; however, military and summer work experiences are part of the experience base.

Rule 3: Six-Year Rule

If a new partner is brought into the business, make sure you allow him/her to move into management and decision-making within six years. Farms and businesses that fail to do so are twice as likely to have an unsuccessful business transition and are less profitable. This past winter in a seminar in Wytheville, an 85-year-old gentleman, after the seminar, indicated that he needed to turn the books over to his boy. Well, his boy was 65 years old! The old adage is you either teach or share with the younger generation, or you destroy the business.

Rule 4: Ripple Effect

When making changes to a growing business, you should over-estimate capital needs by at least 25 percent to avoid being short on working capital due to unexpected costs. For example, if you need

\$200,000 to expand the business, then \$250,000 should be estimated and used to determine whether or not the growth is financially feasible. It is also wise to over-estimate the time needed to complete the change by 25 percent.

Rule 5: Don Shula Rule

Many managers and owners, like Don Shula, stay too long before turning over the business. The optimal time for ownership and management of a business is 30 to 35 years. Owners and managers who fail to heed this rule run into the trap of continuing to do "business as usual" without changing for the times. In order for managers to maintain the cutting edge, they must either follow this rule or surround themselves with new members who will bring renewed energy and new resources into the business.

Rule 6: You Can't Treat All Children Equally, But You Can Treat Them Fairly and Equitably

One of the most profound challenges in estate planning and transition management for farm businesses today is what to do with children who move away from the business. Usually, they have little interest in the operation. When the parents die, the business interests of the children who have moved intensify because proceeds from the estate can be used to pay off mortgages or fund their children's college educations. The most successful transition plans have the business assets transferred to the child managing the business, and insurance policies to cover estate settlement costs and cash settlements for children who are not interested in the business. This strategy allows the children involved with the farm to continue to function without requiring them to buy out the non-farm children's shares, and also have sufficient cash to pay estate settlement taxes. This strategy is simple and objective.

Rule 7: Non-Business Spouse

An increasing challenge in businesses is incorporating the non-business spouse into the family and business management process. Many more families are finding this incorporation a challenge as there are more non-business or non-agricultural spouses, and that spouse frequently does not understand erratic business schedules, time management, and prioritization problems that can occur. An operations agreement including time expectations, goals, responsibilities, and accountables can resolve many of these issues.

Rule 8: Getting Out of Business

A plan that covers dissolution of the business is critical in establishing a family business transition. Included is an operations agreement, a buy/sell agreement, and a time line for an orderly transition. Partners who are not willing to discuss these issues initially frequently find that getting out of business is more difficult than getting into business.

Rule 9: Transition Team

All businesses need to have a list of advisors or a transition team. This team includes a lender, a lawyer, an accountant, a financial planner, both spouses, and all partners. Annual team meetings with all members present are critical. Outside professionals need to be placed on retainer rather than on an hourly fee structure.

Rule 10: The Nike Principle

Just do it! The biggest concern with family business transition plans is procrastination. Day-to-day matters frequently take priority over the planning process. A transition plan often takes two to three years to formulate, and must be updated at least twice a decade.

Visit [Virginia Cooperative Extension](#)