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Navigating the challenges of ownership vs. management

How to structure the financial benefits for owners and those for managers—and educate your family members about the differences.

By Bobby Stover

Family businesses that continue to prosper from one generation to the next often do so because they have robust governance structures and processes. Unfortunately, many family businesses have not given enough thought to governance. They instead have a carefree attitude toward issues such as succession, ownership and management, and they wait until one of these issues becomes an unavoidable problem before attempting to address it. But that is often too late, and the business suffers as a result.

One of the more common and difficult issues that can arise within family businesses today relates to the differences between financial ownership benefits and financial management benefits. Family conflict may arise over matters such as compensation (salaries and board of directors' fees), stock dividends, stock ownership (including purchases and sales of stock) and stock redemptions.

Outside of these matters, families are often focused on estate and wealth transfer planning. Many do a good job of engaging outside advisers to develop well-thought-out plans to transfer the legal ownership of the company to future generations. They also consider leadership, developing an outline and process of who will lead and run the family company and how they will compensate that person for continuing to grow the family's wealth now and in the future. Families that are able to develop a framework and process for dealing with these issues set themselves apart by not leaving the legacy of their business to chance.

A far-reaching problem

Consider the problem faced by two third-generation family business members. The business was in the process of transitioning from the second generation to the third. A second-generation sibling team—a brother and sister—had run the company as CEO and president, respectively, for 30 years with great success. Each had four children, three of whom were in the business and one who was not. Two third-generation family members, one from each side of the family, had been identified as future leaders and tapped to take over as CEO and president. They wanted to know how to get everyone paid.

The company currently paid dividends to all shareholders. The outgoing CEO and president were paid top salaries that they did not want to give up even though they were transitioning out of day-to-day operations. Some of the salaries paid to the children in the business significantly exceeded the market-value compensation for their roles and responsibilities. As a result, the children who were not in the company were questioning the lifestyle of their employee siblings and cousins. This problem isn't unique—it happens in many family businesses and can cause a rift in both the company and the family.

Family members may not understand the financial benefits of business ownership or management. According to the National Financial Educators Council, only 30% to 40% of Americans are financially literate. In other words, most Americans do not have the knowledge to make basic financial decisions. Even fewer are able to understand more complex matters, such as company financial statements, including footnote disclosures. Therefore, any discussion related to family business finances may become especially complex, as it involves emotional connections to family and money combined with various levels of financial literacy and the complexity of formal business financial reporting. While there is no one-size-fits-all solution, the right framework and tools can help a family assess their unique issues and successfully navigate these rough waters.

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Framing the question

According to *"In harmony: family business cohesion and profitability,"* the global survey report from EY and Kennesaw State University, family cohesion leads to business growth. In their survey of more than 500 of the largest family businesses in the world, the researchers discovered that a surprising 35% of the variance in return on equity for these businesses can be predicted by a combination of the family's cohesion, its growth ambition and a focus on sustainability and family business branding. Sustainability and branding are two large factors that help reinforce cohesion, which, through growth ambition, lead to profitability (as measured by ROE).

Therefore, it is important to have a framework of common language and definitions when discussing financial matters. A common language can often help create cohesion within a family and help avoid the pitfalls that could lead to one or more of the following:

- Unaligned expectations.
- Disparate family interests and values.
- Inability of successors to grow the business.
- Communication breakdowns.
- Lack of transparency or trust.

As a family works to create the right framework for a financial discussion, they should define stakeholder groups, delineate common goals and objectives, and gather benchmarking data.

Define stakeholder groups. Understanding the key stakeholder groups and their benefits, roles and responsibilities can help the family discuss these family financial matters.

One tool that is commonly used to identify key stakeholders and roles in family enterprises is the three-circle model, developed by Renato Tagiuri and John Davis. The model depicts the relationships among three stakeholder groups within a family business:

1. Business.
2. Owner.
3. Family.

The model further expands these groups and provides a framework for how these groups intersect and overlap—in other words, "What hat are you wearing?" In addition to the roles above, the family must understand which family members are employees and, further, which employees hold leadership roles in the company. For example, within the employee group are rank-and-file employees, business unit or division managers and C-suite members (see Figure 1).

As part of helping the family understand what hats they wear, it is also important to make sure that the family and the company have summarized the roles, responsibilities and expected benefits of each group.

Delineate common goals. In many family businesses, goals are discussed generally, with no real framework outlining whose goals they are. For example, shareholders who are active in the business can have goals that are very different from those of inactive shareholders.

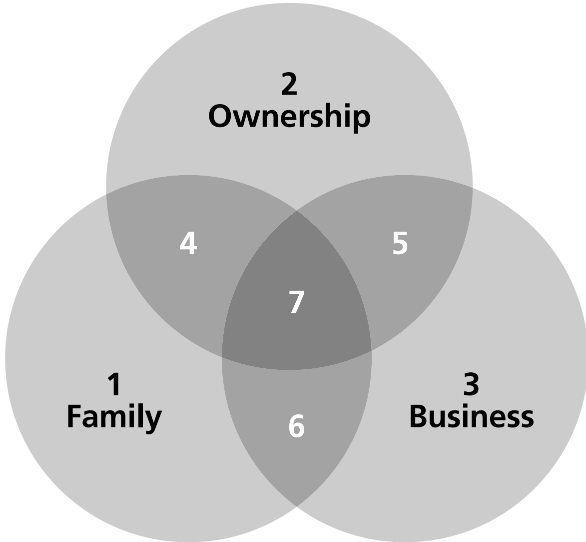
Inactive family business heirs may focus on:

- How to generate income from their stock ownership, such as dividends.
- Stock appreciation with realizable high value.
- Short-term outlook on company and goals.
- The fact that there are no "employment perks" of stock ownership for an inactive shareholder.
- Distribution of earnings.

Active family business heirs, by contrast, may focus on:

- Income from wages (deductible income).
- Maintaining a low stock value for estate planning and other purposes.
- Long-term outlook for the growth of the company.
- Benefits of management and being an employee, which others may view as perks, such as corporate car, corporate travel or other common benefits provided to company executives.
- Reinvestment of earnings to continue to build and grow the company.

All of these are a mix of business goals, personal goals and financial and non-financial goals. A shared vision matrix can be helpful to summarize and frame the goals for each of the key stakeholders separately and collectively (see Figure 2).



1. Family non-owner, non-employee
2. Non-family, non-employee, owner
3. Employees only
4. Family owners
5. Non-family owners, employees
6. Non-owner, family employees
7. Family owner/employees

Figure 1: The three-circle model (R. Tagiuri and J.A. Davis, *Family Business Review*, 9[2]:199-208,1996).

	Monetary goals	Non-monetary goals
Business goals		
Personal goals		

Figure 2: A shared vision matrix.

The shared vision matrix is both an individual and a group tool. We often have each key stakeholder complete the matrix and reflect on the results. We find that they tend to confuse business and personal goals. For instance, a secure retirement is often a business goal for a family member in the business and a personal goal for family members who are not in the business. This can open the discussion about what constitutes fair compensation, what type of retirement programs the company should offer, and the fact that retirement is not only a function of what you earn or what retirement programs you have, but also of personal choices such as lifestyle and spending habits.

Gather benchmarking data. Most families are well versed in the "business of their business." They know what gives their company a competitive advantage, what items affect margin and profit, and the areas in which the business can improve. They also know where they can outpace their competitors and what effect changes in the economy will have on the business.

But when the conversation changes to matters of compensation and stock returns, there is little or no information readily on hand. Family members may be hard-pressed to answer questions such as:

• What constitutes fair compensation for the CEO role based on duties?

• What is a fair return for a company of our size in our industry?

• What is the dividend policy of public companies in our space?

Families often "go it alone" on these matters, or they have the information and are not willing to share it with all of the shareholders or family members. This may be due to past emotional issues or conflicts that they do not want to deal with. But the reality is that benchmarking tools (e.g., compensation studies, public company stock data, Dunn & Bradstreet) are available to help frame this discussion around fair compensation based on duties and roles.

Leading practices

The goal of these tools is to allow a family to gather data and then begin to frame a discussion, starting with the roles of family member, owner, business manager, employee and leader. Once the roles are defined, the family will be able to determine the goals for each role, and then to discuss and formalize each role's responsibilities and the appropriate financial benefits.

The most important part of this process is agreeing on a framework and definitions before applying them to actual family members. For example, it would be detrimental to start with what an individual family member is paid and then to back into his or her goals.

Families should also consider the following leading practices to help address financial benefit issues:

Education. Education of family members is a key component to the success of engaging in financial discussions with the family. Members should understand:

1. The family's responsibility to all shareholders.

2. Stock financial ownership rights, which are generally a right to the appreciation of the stock and/or dividends paid by the company.

3. Stock ownership control rights, meaning who has voting rights with regard to stock ownership and what decisions are controlled by voting members vs. what decisions require the input of all members, including non-voting.

4. That family members, company employees and leaders who perform services are rewarded through compensation and benefits in addition to stock ownership.

5. Financial wellness, which can encompass both business financial literacy and personal financial literacy:

a. Business financial literacy includes an understanding of the merits of retaining earnings in a business to grow (capital appreciation) vs. distributing business earnings (dividends and current shareholder income) and the advantages and disadvantages of both and how they can work together.

b. Personal financial literacy and planning includes an understanding of how to make personal financial decisions and how to live within one's means.

Compensation. When determining compensation of family member employees and leaders, leading practices include:

1. Setting a policy that compensation will be based on job performance, ideally at the same rate as an unrelated employee.

2. Using benchmarking and other studies as third-party validation of fair compensation based on roles and responsibilities.

3. Determining family compensation with input from unbiased parties, such as an outside board, compensation committee within a board, or independent employee review committee.

4. Maintaining transparency in reporting to the family on the roles, responsibilities and compensation for leadership positions such as CEO and president, similar to public company practices.

Family employment. The family must establish policies related to family employment. Common understandings must be developed:

1. Defining employment vs. leadership:

a. Under what circumstances can family members be employees?

b. Under what circumstances can family members have leadership positions?

2. Defining eligibility for stock ownership and family membership: bloodline descendants, adopted children, in-laws, divorced spouses, etc.

3. Defining evaluation criteria:

a. Education level expected.

b. Age limits to join and to retire from the business.

c. Experience outside the family business—how much, what type.

d. Experience within the family business.

e. Employment conditions—reporting responsibility, pay, perks.

f. Performance evaluation—by whom, how often.

Shareholder report. Several studies have shown that family businesses failures are more often a result of a lack of communication and trust rather than poor planning by outside advisers. A comprehensive shareholder report helps create transparency, which builds trust. A shareholder report may include:

1. Audited financial statements.

2. Growth ambitions and strategic initiatives.

3. Comparison of company growth and dividends to market competitors and public company benchmarks.

4. Shareholders' current return on their invested capital.

5. Company philosophy on current and future dividends.

Stock ownership and liquidity. The family must also clearly outline the benefits and responsibilities of stock ownership and provide a clear understanding of the financial benefits. The following are some leading practices to consider in this regard:

1. Transparency regarding the ownership of stock, including:

a. Financial rights.

b. Voting rights.

c. Minority shareholder rights.

d. Eligibility (bloodline, in-laws, employees, etc.).

2. Definition of family members' financial responsibility regarding:

a. Estate planning.

b. Estate liquidity.

c. Financial well-being.

3. Fiduciary responsibility of the board of directors and the company management to the shareholders

4. Establishment of a stock redemption policy that includes:

a. Eligibility (e.g., death, mutual agreement, forced separation).

b. Requirements (e.g., specified dates, age, life event).

c. Terms.

Addressing financial issues rationally

Compensation and benefits are an emotional issue for many, and these emotions are only heightened when combined with the relationships among family members within a family business. To address these financial issues rationally, it's important to establish a common language, define the various stakeholders, delineate objectives and seek out benchmarks. Each of these processes promotes fairness and transparency regarding roles and responsibilities, allowing family members within and outside the business to avoid common pitfalls and enjoy the benefits of cohesion.

Once a family has undergone the work to put in place a framework and process to deal with these complex issues, the next step is to look toward the future. This includes building a framework to allow evaluation of the process, as well as changes in the future when needed. As we all know, circumstances may change; therefore, if the family's desire is to continue together in business for generations, a process for innovative change will help ensure the family's legacy. FB