

FAMILY TIES

Build Unity With a Family Council

Achieving multi-generational success as a family owned and managed business is a fairly simple matter. All the family has to do is: eliminate potential sources of animosities and dissension; ensure that all family stakeholders – those who are passive shareholders as well as those actively involved in management – have a clear understanding and appreciation of individual goals, values and expectations; have clearly stated ground rules that outline the relationship between family members and the business; and have clearly defined their goals and expectations for the business, the partnership and as a family in business together.

Just the simple, relatively straightforward application of common sense and any family business can span multiple generations like the Molsons, Irvings, Sobeyes, Westons, Shaws, Bronfmans or Reitmans – or any of the family owned/controlled businesses that comprise 30 per cent of the Financial Post 500.

Some business families have obviously been successful in avoiding the animosities and dissension that can complicate a family business and, whether they're the Molsons or Joneses, families

A Family Council in one form or another incorporates:

- A regular meeting schedule.
- A co-coordinator.
- Minutes (especially important for keeping track of decisions).
- A means of communicating between meetings.
- * A role in the structure for every member of the family.
- Projects that engage individual commitment, and make a real contribution to family and business goals.
- The family's collective values, traditions, sense of history and humour.

that are successful in business together have a lot in common when it comes to handling family relationships, governing their decision making and running their businesses.

Through instinct or conscious planning, successful business families have – under one name or another – a family council and a set of family rules and policies to ensure regular communications, common goals, shared values and a clear understanding of what membership in the family means

in terms of the relationship between individuals, shareholders and the business.

The ground rules are the family's mutually agreed upon policies covering such issues as: who actively participates in the business (do sons/daughters-in-law or second cousins count?); how leadership succession is determined (first born, by gender, favoritism, maybe ability?); stock ownership (equal shares, only participants, voting trust); and compensation.

In establishing ground rules – a Family Creed, Philosophy, Constitution or Charter – the question is not so much what is decided, but that the decisions are clearly stated and clearly understood. For many years, one family had a strictly enforced family rule that activity in the business was restricted to male descendants – sons-in-law were specifically excluded (if you married the boss's daughter, you were out of a job). Right or wrong from a business point of view, everyone in the family knew the rule and lived by it.

The ground rules that allow families in business to achieve a workable balance among business, family and personal needs are established by compromise and consensus – and consensus is reached through talk. Lots of talk about everything that affects them as individuals, as family, as shareholders and the business in the context of a Family Council.

Some successful families started their Family Council with meetings around the dinner table with founders talking about the business, listening to their offspring's' comments, ideas and criticisms – in effect, informally preparing the next generation for participation in the business. It is not purely business or purely family, but a balance of both for a family in business together.

While this informal system may appear to work quite well, it depends on proximity for success when the successor generation reaches adulthood, marries and begins raising families of their own.

An informal system can't accommodate sib-



Aron Pervin, CMC

lings and cousins (and their children) who aren't active in the business or who no longer live in the immediate area. The informal system's effectiveness is also limited by everyone's commitment and willingness to participate.

The council develops: a common understanding and approach to the direction, purpose, stewardship, and ownership of the business; the relation of individuals to the family and the business; the family pride of ownership; and the policies it suggests and advice it gives management.

The most common way of starting a family council, however, begins with a one or two day retreat (see web site for article titled Retreat to Win) led by an independent facilitator to frame ground rules, develop a family mission/aspiration statement, identify areas of concern, schedule future meetings and begin working toward solutions. The facilitator usually continues with the family through the first year or two of council meetings and then remains 'on call' as an expert resource in problem solving and policy-making.

A Family Council is a common sense solution to ensuring continuity of family ownership/control and management.



Accidents will occur in the best regulated families..

Charles Dickens, David Copperfield (1850),
Chapter 28, Mr Micawber

Family Ties® is a periodical newsletter published by Pervin Family Business Advisors Inc. to inform business family members of trends and information that they may find beneficial to their businesses and to their families.

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Ask the Expert

Dear Mr Pervin,

We are a second (third on the threshold) generation Canadian family business that is thriving and growing beyond the expectations of my father, the founder who, although inactive, still enjoys the role of president. My brother and I run the place (our sisters are not involved) but we all own shares. There are specific roles and functions that family members play as in any business but there are certainly problems that have arisen because of the blood closeness and lack of objectivity in decision-making.

We attended one of your workshops years ago and have read your articles on the family council and especially on the advisory board, which includes people outside the business family, but nothing ever gets done. We are not comfortable asking our lawyer or accountant. Could you please elaborate on how to structure such a board in a family business like ours?

From RJS, Ontario

Dear RJS

At your stage of business growth and family/shareholder development, it is clearly time to look more closely at the value of good governance. Congratulations!

Here is one idea on how to develop your advisory board. You and your partners should first consider the kind of independent advice you feel you are missing. This is often hard to do in isolation (let alone on your own). Therefore, some type of planning for the future often helps make this clear. I usually recommend that partners consider developing both a partnership plan and a company plan. At this stage, these plans do not have to be full blown, but the overall goals and visions of these two plans should be reasonably thought out, complementary and integrated. An often skipped step, but critical in my opinion, is to now stop to explore how your shared ideas on the future match your long term intentions regarding family participation, business growth and owner value. With this information, the type of independent advice often becomes easier to quantify.

The next idea would be to explore the most practical method to gain this advice, which leads to the key question, "what would you and your partners want from a board and what skills and talents are required"?

With partner agreements and this foundation in place, the rest of the process is somewhat mechanical. I usually encourage partners to develop a criteria for membership (including compensation), a process for choosing members and a document to attract prospective members.

These first two items are critical. Skipping

these steps typically leads to misunderstandings and ultimately to an unsatisfying experience. I call the document a Board prospectus. For the company section, it includes information such as industry, vision, mission, market, organization and ownership structure, at a minimum. In the Board structure section, it includes information that is specific to participation and membership.

Based on the established criteria and process for hiring, this document is sent out to your potential members and interviews are arranged.

Once the members are chosen, the next step is to stage your first meeting. This is often an emotion-laden experience for the uninitiated as they open their books and management style to the scrutiny outsiders. In addition to an agenda, it is usually helpful to develop a board background book, which is distributed to each member prior to this meeting. The typical content reflects the history, direction and purpose of the family and the firm, including what you stand for and where you plan to go. Other information includes biographies of the key business participants, a business plan, financial information and other relevant documents, at a minimum.

Usually, the first two meetings are focused on getting comfortable and getting to know each other and the process. So, persevere, others will confirm it's worth the journey.

Address your own letters to Aron Pervin, apervin@pervinfamilybusiness.com, or the address at left.



"Then it's moved and seconded that the compulsory retirement age be advanced to ninety-five."

Tax Strategies for the Family Business



Karen Slezak,
CA, CFP

When I meet family business owners, I often ask them about the strategies they are using to reduce their taxes. Many concede that they have been caught up in the day-to-day issues of running the business and dealing with their families and that a strategic tax plan is long overdue.

As their tax advisor, I help them focus on the creative planning opportunities that are available to a "business family". Let me illustrate how a few tax strategies incorporated into the operating plans of a business helped yield significant tax savings for a family.

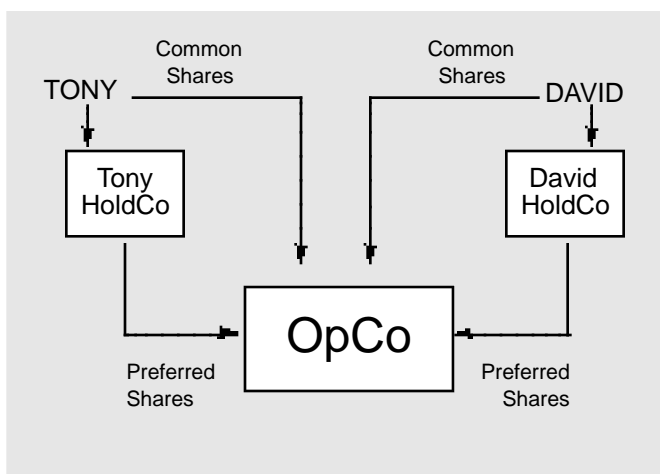
I was introduced to a father and son, (I'll call them Tony and David), who had been managing a successful wholesale business (OpCo) for a number of years. Both were married. David had three teenaged children. Due to their business ingenuity and unique knowledge of their product lines, OpCo was prospering. Not only had there been sufficient cash for working capital and to pay Tony and David good salaries, but the company had been able to set aside \$200,000 of excess funds in short-term deposits.

As we talked, Tony and David revealed that the family had been spending a considerable amount of time deciding if they should expand into a new retail operation. Both Tony and David's wives were looking for a challenge. They wanted to try their hand at running a retail store. Everyone was concerned that the expansion should be done in a way that minimized the risks to the current business and its term deposits. The families were also concerned with the amount of tax they were paying. We worked with them to assess their options and implement the following tax-effective struc-

ture.

First, Tony and David incorporated holding companies ("Tony Holdco" and "David Holdco"). We helped them reorganize the shares of OpCo and to transfer the new shares to their respective holding companies on a tax deferred basis. Tony and David then purchased new common shares of OpCo. Afterwards, the business structure looked like this:

OpCo paid tax-free dividends to the two holding companies. Tony and David were then able to decide independently how to invest the \$100,000 dividend their holding company received. This solved an ongoing dispute between them about how the funds should be invested. It also ensured that the \$200,000 was not exposed to the financial risk of OpCo. Moreover, if OpCo required additional funds, each holding company could advance the funds to OpCo as a secured creditor by registering the loans under the Ontario Property Security Act (PPSA).



The structure was also designed to preserve Tony and David's future ability to claim the special \$500,000 Capital Gains Exemption (CGE). The CGE is available when an individual disposes of shares in a small business corporation. Such a disposition could occur either upon an actual sale of the shares to a third party, or in the event of the death of a shareholder.

In order for the OpCo shares to qualify for the CGE, OpCo must meet a number of tests including one that requires at least 90% of OpCo's assets to be used principally in its active business carried on in Canada. Before moving the term deposit up to the holding companies, it would have been seen as an "inactive asset" and

the OpCo shares would have been rendered ineligible for the enhanced CGE. The company was now "purified" and a structure was in place to ensure that OpCo would continue to meet the active asset test.

For the new retail venture, we recommended that it be operated through a separate company (RetailCo) owned by Tony and David's wives. As the women wanted to actively operate the new business, it made sense to have a new corporation created so that the income from this business would be eligible for the "small business deduction". Essentially this is a preferential rate of tax on (at least) \$200,000 of the company's earnings. OpCo already enjoyed this preferential tax treatment. The separate company would allow the family to double the resultant tax savings (over \$50,000 of savings per year). The wives would also draw salaries from the business, providing additional tax savings for the family through income splitting.

We also learned, when discussing the financing for RetailCo, that David had excess cash that he was investing. He was thinking of using \$100,000 of his funds in the new venture. At our suggestion, the family established a family trust for the benefit of David's children. David then loaned \$100,000 to the trust at the prescribed interest rate. In turn, the trust loaned the funds to RetailCo at commercial lending rates. The loan was secured under the PPSA. RetailCo obtained funds to start up the new business venture. In the future, the trust would earn income on the interest rate spread. This income would be spent on the children's sporting equipment, clothing, and other specific expenses of the children.

Best of all, no income tax would be payable on the "spread" interest. Because this income would be paid out on the children's behalf, they would be taxable on it, but would use their personal tax credits to offset the income tax.

By focusing on appropriate tax strategies, we were able to provide solutions that complemented the operations of the family business and provided the family with significant current and future tax savings.

Karen Slezak, CA, CFP, is a Senior Tax Manager with Soberman Isenbaum & Colomby LLP

Outsiders on the family board can make a difference

Recently, a family business owner was advised that his company could really benefit from an outside board of directors. He resisted the idea. If we had a board, it would have told us not to do the outrageously risky things we did to become successful, he said. His comment highlights two problems with the growing family enterprise. Success often substitutes as evidence of good planning. And family patriarchs and matriarchs are usually accountable to no one – and like it that way.

A board of directors could offer a solution for both dilemmas. Unfortunately, boards are usually an unused appendage. For most family businesses, boards of directors are made up of family members and the companies' lawyers.

Surveys by Pervin & Co. in Canada in 1998 and by MassMutual in the United States in 1995 indicate that more than 60 per cent of family businesses have a board of directors or advisory board. But both surveys suggest that more than 80 per cent of board members are insiders – family and close associates only.

These boards exercise little authority. Less than half of the survey respondents believed that their boards made a contribution. It seems members' principal function is to affix their signatures in the proper place to signify that a legally ordained meeting was held, even though it never took place.

Should things be any different? After all, the boss generally is the controlling shareholder. Why would the people with the most at risk want to be accountable to outsiders who would question all major decisions?

My own experience suggests three reasons why they should.

First, an independent board lifts the family business owner's aspirations, confidence and commitment. Its mere presence signals to employees and potential financiers that the family remains interested in keeping and expanding the business.

Second, effective boards stimulate action on essential but taboo family issues. Too often, such topics as estate planning, succession, family compensation and bene-

fits, dividend policy, and authority of family members – all loaded issues with family consequences – are set aside for more proper or more comfortable consideration. A board considers these to be routine points of business discussion.

Third, managers gain professionalism and momentum by reporting to a board. When internal family disputes arise over the business – a time when communications in family businesses may become undignified – directors act as the voice of reason.

Making sure a board succeeds in a family business environment isn't easy. Family managers have to break out of old habits of authoritarianism and secrecy. They should also provide some guidelines for the board, such as a written mandate and clearly defined boundaries to set off their responsibilities from those of shareholders and management.

The family will also have to give up some of its sinecures. Everyone who sits on the board should be a contributing member, which means honorary positions are abolished. This can be troublesome when the chief executive officer's spouse, or a passive owner who understands little about business and does not work in the firm occupies the honorary position.

In fact, most insiders don't belong on the board – neither key employees, family members nor the company accountant or lawyer, whose advice the business already has. Getting inside directors to leave can be a delicate matter. If insiders' board membership constitutes their chief source of company information, they still need to be kept informed once they're off.

Directors also have to make adjustments. They should appreciate that family-run firms are different from other businesses, and sometimes impose special demands. For instance, family businesses often embody deep-seated values or religious feelings that family members consider important. There may also be specific financial considerations for the family with respect to money it withdraws from the firm.

It's the family's job to forge a consensus on these matters and give board members a clear mandate. A board cannot function without family consensus, and perhaps the company can't either.

To work with an outside board, the fam-

ily CEO's chief prerequisite is to have enough confidence to relinquish a degree of control. The leader must be convinced that the benefits justify surrendering some control.

If this condition is met, the CEO can learn to live with the board by following a few rules:

- Treat the board members as if they represented shareholder control of the business, whether or not this is the case. Competent board members will not stay unless they believe their decisions carry weight.
- Define the board's mandate, functions, responsibility and authority in writing.
- Encourage board members to learn as much about the business as possible and to improve any skills that would aid in the decision making process.
- Share business problems. Remember, everybody has them. The board cannot help unless it knows about them.
- Prepare for board meetings. The agenda and all additional relevant information should be sent to each board member in advance.
- And prepare minutes for each meeting, summarizing action plans and timetables.

The owner who is willing to make the giant leap from sole decision maker to accountability may find that an independent board provides a valuable source of business experience. It's a first step to making sure future successes don't depend on outrageous risk.



Upcoming Events

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What you need to know to be a better Director,
May 31, 2001

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Communicating in the Family Business
June 7, 2001.

Who's Going to Drive the Bus?:

Best Practices in Succession Planning
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