FAMILY TIES

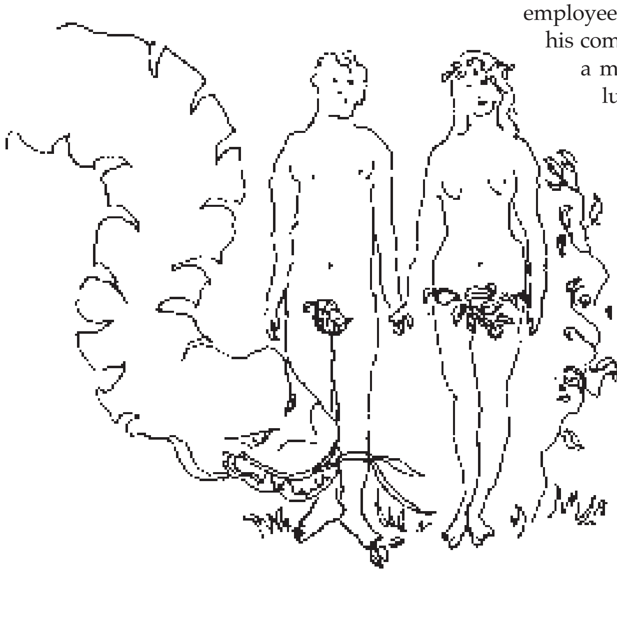
How Values Affect the Family Business

by Aron Pervin, CMC

Company culture is a difficult term to define, but somehow we just know it will be more of an issue in the family business. And, of course, it is. What is this thing called company culture? I've found that it's really three separate things: It's the symbols that go with the business – the address, physical layout, company jargon and, definitely, the legends behind the family's revered "warriors", usually the founder and subsequent heirs.

Assumptions and beliefs play a big part in culture. Are people basically "good" or "untrustworthy"? What decides the natural pecking order – age, gender or performance? Is privilege a right? Is truth relative or absolute? Then there are values. These are frequently an expression of the organization's beliefs. "Serve the customer", "Be honest", "The business exists to serve the family" and "Don't trust outsiders" are a few examples.

Families often talk about their "family values", so let's focus on this single aspect of family culture. Perhaps one of the most preventable reasons for the disintegration of the family firm is that family members hold differing and unclear operating principles. It's what I call "misaligned values", and it's as debilitating and insidious to a family business practitioner as misaligned vertebrae are to a chiropractor. It causes all kinds of other problems, and it just gets worse if it's not corrected.



Since actions speak much louder than words, the first step is to distinguish between the ideal values of a family business and the real values. This is one good reason why a neutral outsider is usually a better judge of its values than are the family members themselves. I once witnessed a meeting where the owner of a four-star restaurant showed his son his view on service, quality and honesty: "We've run out of veal," he said. "Use lean pork; no one will notice." Another owner told me he would share his wealth with his children only at death. His reason? "It's good to hold onto the money – it keeps the kids in touch." Both of these owners would have done things differently if they had taken the trouble to write down a family creed that could guide everyone and act as a reference point.

Take for instance the founder who said his employees were fundamental to the success of his company, yet fought his daughter for over a month over whether to set aside a staff lunchroom. Only after long arguments did he recognize the gap between his concern for staff members and his willingness to allocate "business" space. They now have a lunchroom.

There is certainly a flexible reality that surrounds values. That's why successful business families discuss and document them. Talk alone will not work, because history and observation can turn it into noise. Nobody remembers what was said. Written values guide family interaction and behavior. Sometimes, however, "family" values are in apparent conflict with "business" values. Or one gets confused with the other. Families, for instance, tend to place a high value on respecting elders, parents loving their children and everyone protecting the weakest member. These values can cause problems in a business context.

In one case, a company founder with two sons had set up a system of performance review for compensation purposes. It was a genuine review with real parameters. But the wife of one son called her father-in-law and told him he would never see his grandchildren again if didn't give the son an immediate raise.

A mother in another family believed that family members should be compensated according to their need, not their duties. Therefore, she paid her daughter, who had two children and required a nanny, more money than she paid her son, who did a similar job but had no children. Again, these cases raise the question of value alignment. It's not just a matter of everyone having some values, but of having one set of agreed-upon, appropriate family-business values that translate into deeds.

All successful business families need this glue to unify their partnership. To them, it makes a lot of sense. But as Will Rogers is often quoted: "Common sense ain't necessarily common practice."

10 Ways Family Values Affect The Business:

- Work ethic
- Attention to issues
- Down-the-line decisions
- Who reaches the top
- Relationships with suppliers
- Relationships with staff
- Willingness to Change
- Risk-taking
- Business planning
- Sharing information

FAMILY TIES

What's Your Ownership Perspective?

An inheritor
You have received the business shares as part of your family legacy and are rather ambivalent about the whole experience. Discussions about "keep or sell" shares are not important as the shares typically provide an emotional connection whether or not associated with a financial reward (although it would be nice to receive something). Your interest in decision-making is low and rather passive unless it directly affects your values or the viability of the firm.

A steward You have a commitment and an obligation to maintain, preserve and improve business family life and the family legacy, some say; to pass it on in better shape than it was received. These unwritten obligations often address the role and contribution of the individual, the interaction of the family, the management of the firm, who fits/belongs as well as the establishment of helpful governing structures, systems and guidelines to perpetuate and better organize the family, business and ownership arenas. Your interest is to keep the shares for the benefit of future generations whether or not associated with a financial reward (although it would be nice to receive something). Your interest in decision-making is negotiated but typically it is at the strategic level as your wish is to provide guidance to the operation, not meddle, and monitor direction and performance with respect to the marketplace, profits and community contribution.

An investor You view your family legacy as you might any other investment. There is no clear connection to the shares or to decision-making, other than to influence a return on the investment (if or when possible). You expect and demand that the firm operate at a high level of performance and governance, and expect a return that equals or exceeds your investment strategy for that time period.

An owner/ manager You view your family legacy as the opportunity to get involved and contribute in a meaningful way in the operation. You wish to be involved in all aspects of planning, decision-making and governance, and ultimately make your mark. You sometimes confuse ownership with management as you strive to use the business as a platform to act as a "founder". Money is seldom the driving force. Share ownership and influence (and the votes) is often mandatory, but second to control, prestige and power. Your interest in sharing decision-making is typically very low, and you typically request that other owners (if they exist) trust your wisdom and decisions unconditionally.

Understanding your ownership perspective means clear and decisive thinking in discussing family business matters. Please read the article on Shareholders Agreements in this issue of Family Ties.

"Daddy, does this mean we're poor now?"

Volume Two, Number One

"Never acquire any business that you don't know how to run"
- General Robert Wood Johnson, president of Johnson & Johnson, 1938-1963

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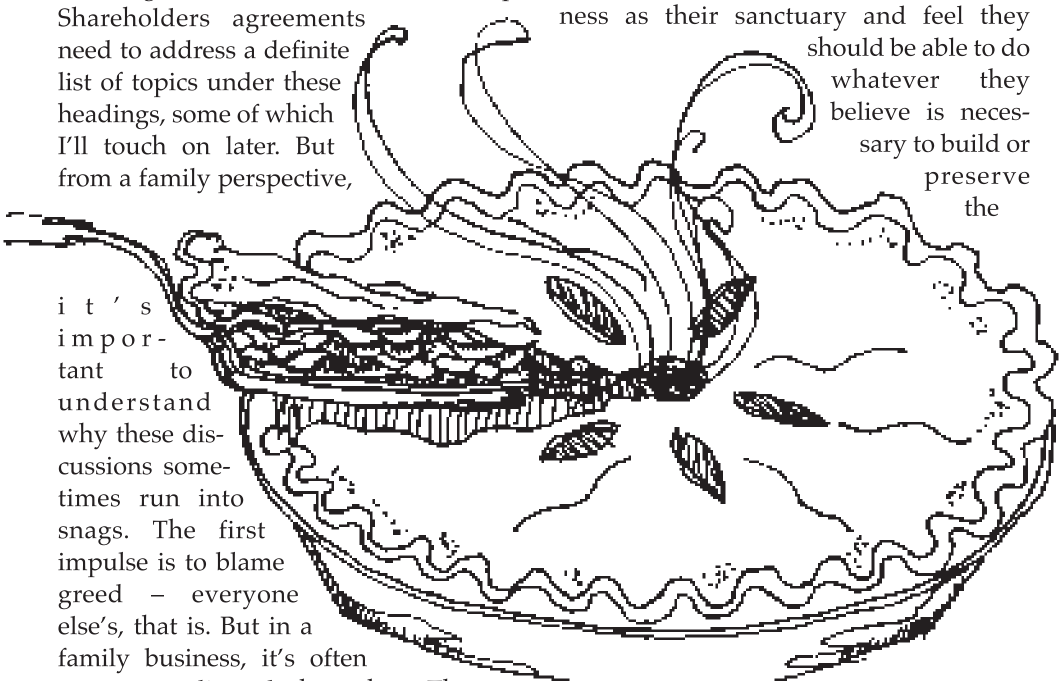
The Shareholders Agreement

by Aron Pervin, CMC

Many family business owners declare, "I own, therefore I manage." It's strange how the ownership and management issues get entangled like this, especially at the next generation stage. People who have jet planes don't say, "I own, therefore I'm the pilot!" The shareholders agreement is supposed to be the place to address matters of ownership. But the shareholder discussion often doesn't even address the inalienable right of owners to work in the firm, much less the numerous other landmines in the battlefield of ownership.

Every family partnership should include an agreement that spells out what it means to be an owner: the definition of shareholder versus management concerns, as well as the prerequisites, obligations, rights and conditions of ownership. Shareholders agreements need to address a definite list of topics under these headings, some of which I'll touch on later. But from a family perspective, it's important to understand why these discussions sometimes run into snags. The first impulse is to blame greed – everyone else's, that is. But in a family business, it's often more complicated than that. The problem is that many family shareholders don't recognize that their fellow owners can legitimately have conflicting interests that are exacerbated by family history and relationships.



I recently met a second-generation family that demonstrates these diverse viewpoints. Four siblings equally inherited the firm from their parents. The eldest son runs the business and believes only he knows how to lead the business to prosperity. He has teenage children. His sister is divorced, has no children and would like extra income. A second brother does not work in the business, but would have his children participate if they wish. The youngest son works in the business, has young children and plans to stay for the long haul. Can you imagine drawing up a buy-sell agreement and expecting it to help these four people – each with a valid but divergent interest in the business – live and work together? Without considering their ultimate intentions, it's nothing but an instruction booklet on how to carve up the company.

The four points of view in this real family are typical of the main "roles" that a shareholders agreement must satisfy: owner-manager, investor, inheritor and steward.

• Owner-managers usually view the business as their sanctuary and feel they should be able to do whatever they believe is necessary to build or preserve the family's wealth and prosperity. After all, the buck stops with the top manager.

• Investors seldom work in the firm but are rarely passive. They expect an annual return on their family holdings and typically urge the operators to declare a dividend – and lobby for a mandatory minimum dividend policy as part of the shareholders agreement. When this doesn't happen, they usually want an easy way to sell.

•Inheritors view their shares as a legacy. They see the value of the company as a nest egg, and have little interest in business performance as long as the business is a going concern. They usually see employment as a right they can seize upon if necessary.

• Stewards view share ownership as a sacred trust that they must preserve for future generations. While shares are in their possession, they feel obliged to maintain and increase owner value. They usually butt heads with owner-managers and investors.

In shareholder negotiations, the family's business lawyers and I try to clarify the role or roles that each member plays. Once we understand their relationship to one another and to the business, we can usually get each to be more specific about what they would like the shareholders agreement to do. From there, it is a matter of finding the common ground – ensuring effective decision-making – and deciding how to govern the areas that are in dispute.

But first, our four shareholders will have to step over some hot coals – the burning questions of every shareholders agreement. Let's see how different types of shareholders see things from entirely different perspectives:

Who can work in the family firm? Inheritors will want any owner to be able to work in the firm if they wish. Investors want only competent family members who can add to growth and profitability. Stewards agree with investors but usually want a more structured regimen for entry, staying and exiting. Owner-managers believe employment is an operational issue for senior management (usually one person) to decide.

Who can hold stock? The inheritor wants everyone to own shares, while the owner-manager believes only those who are active in the firm should hold shares. Actives usually argue that good management needs a manageable ownership group, while inactives hold that management decisions can be separated from the benefits of ownership.

How will the buy-sell section be structured? The investor argues for an open buy-sell arrangement giving family members the right of first refusal before a sale to a third party. The steward wants to keep the shares in the family and lobbies for a majority – even a large majority – vote among shareholders before allowing a third-party sale. At the third-generation stage, everyone might wish to establish an internal stock market so that no one feels locked in.

How will disputes be resolved? Owners and investors who suggest a shotgun clause – where one shareholder can make an offer to buy out partners but must sell at the same price if the partners invoke the shotgun – are often opposed by stewards and young, active shareholders who could not hope to buy out their family members.

All kinds of other ownership issues come up – each of them with a similarly molten core that can spill over at any time. In every case, it's fascinating to observe how diverse opinions spring from different interest groups, whether it's about use of funds, who can inherit shares or how shareholders who are active managers should be compensated. So if you're stuck with your shareholders agreement, take a step back and discuss what everyone would like to happen over the next couple of generations. You'll be surprised how it can sift out what's impossible or unacceptable in your agreement.

And if you or your family partners find difficulty coexisting with one another's desires and ambitions for the business, maybe you can at least find a way to allow one another to leave gracefully.

....take a step back and discuss what everyone would like to happen over the next couple of generations

Other hot potatoes for the Shareholders agreement:

- How are ownership and management decisions defined? Are key ownership decisions made by shareholders, directors or a combination of both – and do they require a percentage vote other than a simple majority? Will any shareholders have a veto power?
- How many inactive shareholders can sit on the board – if any?
- Can spouses own or inherit family shares? Who else cannot inherit shares?
- When can transfers be made, and can they be forced?
- How will financing decisions be made?