Takin' Care of Business...and Family

Navigating the Intersection of Family, Business, and Ownership

As the age-old saying "never go into business with family" suggests, working with family has its challenges. Yet family-owned businesses account for half the country's employment and half of the US gross national product.[1] Some of the most prosperous businesses are family owned…and the families themselves remain happy, healthy, and wealthy. What's their secret? Strong family governance paired with transparent corporate governance.

Every entrepreneurial family has its own culture, characteristics, and conflicts, along with strengths and shared history. And while businesses tend to grow geometrically, families typically expand exponentially. The family tree continuously extends its branches, incorporating more members along the way. As a result, differences in interests, values, and relationships emerge.

Solid family governance and shared core values can fortify family enterprises. As family businesses grow and conversations move from the dinner table to the board room, it is critical to establish a formalized process for joint decision-making covering the family, the business, and the intersection of the two. Corporate governance refers to the structures and processes families use to organize themselves and guide their relationship with the business. A well-designed corporate governance structure can limit conflict, create systems, and improve clarity around:

- The goals, values, and direction of the business, ownership group, and family;
- The roles, responsibilities, and rights of stakeholders; and
- Appropriate decision-making processes and ways to resolve issues.

Structure also helps family members agree on leadership choices, succession issues, and other potentially divisive topics. As a result, the family unit can function more efficiently and in a way that reflects agreed-upon values, mission, and goals. Most importantly, integrating family and corporate governance systems enhances collaboration and information sharing, which can further secure the future of a family business.

In this paper, we discuss the family business system, the different roles and components of family and corporate governance, how they work together, and why a family needs both to successfully navigate business succession.

The first paper in our governance series, Ties That Bind: How Sound Governance Supports Family Success, explores family governance as a framework for communication and decision-making. It provides a road map to organize families and guide their wealth transitions, along with transmitting knowledge and values. Many of the components of strong family governance referenced herein are discussed more thoroughly in *Ties That Bind*. But that's merely a starting point. To ensure effective governance, each family must establish its own policies and procedures, and base its structure on shared family values.

1 https://hbr.org/2021/07/do-most-family-businesses-really-fail-by-the-third-generation

Understanding the Family Business System

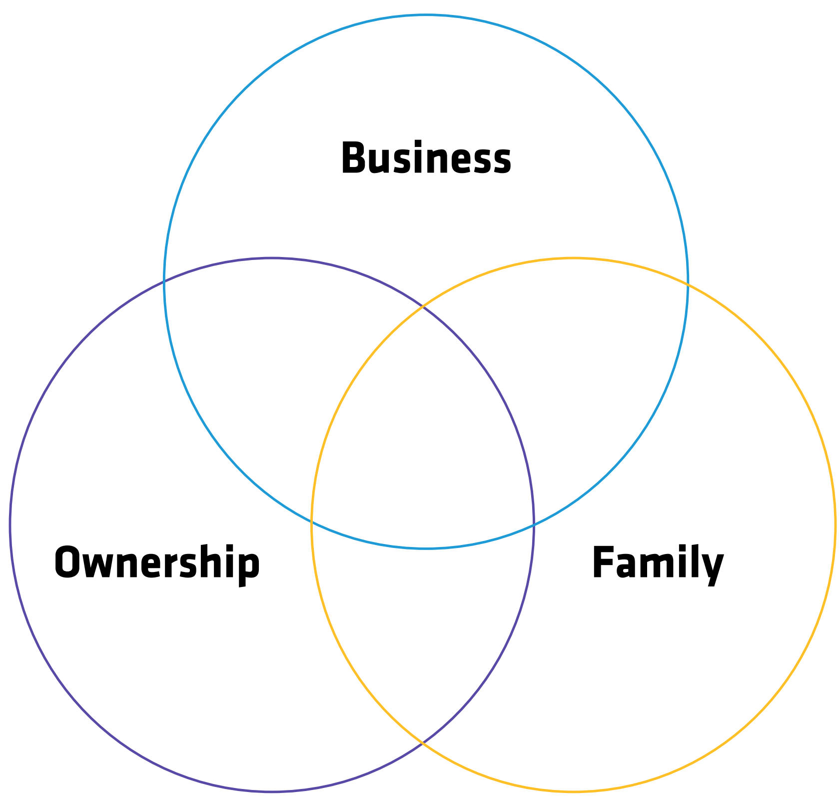
The nature of governance in any given family enterprise will depend on the answer to the following questions:

- What is the generational stage of the business? And what is the impact of wealth on each generation?
- What roles and responsibilities do family members play?
- How large is the business?
- How many owners does it have?

The Three-Circle Model of the Family Business System—developed by Renato Tagiuri and John Davis—is an excellent place to start looking for answers (**Display 1**).[2] The framework, which captures three interdependent and overlapping groups that comprise the family business system, is a straightforward tool to help participants understand the larger system and their place within it.

By examining where members fall in the system, families gain clarity around their own personal perspectives and those of other participants. Start by considering roles. If a member plays just one, he or she will occupy a single circle. But those with two or more positions will belong in overlapping spheres. For instance, a family member who does not participate in the family business (and resides only in the family circle) may have very different motivations, concerns, and responsibilities than one who is an owner currently employed in the business (sitting at the intersection of all three).

DISPLAY 1: THE THREE-CIRCLE MODEL OF THE FAMILY BUSINESS SYSTEM



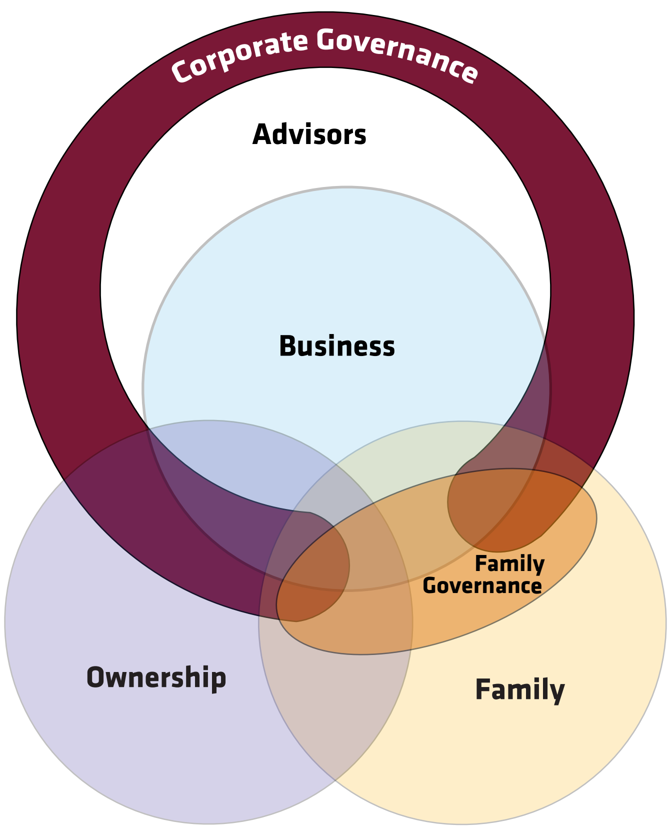
2 Tagiuri and Davis (1982).

Overlaying the Governance Dimension

A stakeholder map that includes corporate and family governance expands on the well-known three-circle model (**Display 2**). The governance structures embedded in these three systems can further broaden family members' perspectives while promoting communication and decision-making.[3] Governance provides a framework for explaining how each system interacts with and supports the other systems. In addition to pinpointing where each participant belongs within the system, the stakeholder map has the added benefit of suggesting where they may transition to, capturing how a family evolves over time.

A growing, shared business can be the impetus for families to organize and establish the framework to communicate with one voice. To support the ongoing success of the business, families should think about each circle and governance structure, develop internal policies, and formulate guidelines that best suit their needs.

DISPLAY 2: STAKEHOLDER MAP© OF THE FAMILY BUSINESS SYSTEM



Corporate Governance

- Oversees the business while intersecting ownership and family.
- Ensures accountability for those involved.
- Approves corporate strategy, reviews business leadership and succession, and is responsible for understanding and advancing shareholder interests.

Family Governance

- Serves as a link between family, business, and ownership.
- Provides a platform for decision-making and communication among family members.
- Establishes a forum for discussion and problem solving as the family relates to the business—and vice versa.
- Family governance structures guide the family and intersect with business and ownership.

Advisors

- Feature prominently as they can help craft governance structures, define roles and responsibilities, and provide regular review of existing systems.
- Occupy the only space on the stakeholder map that does not overlap any of the other systems, highlighting that trusted advisors should remain unbiased and avoid playing multiple roles.
- They cannot simultaneously be in the family business and be independent advisors.

3 Based on Three-Circle Model, Taquiri & Davis 1982. Used with Permission. Copyright © 2005 Douglas Baumoel.

Family Governance

A well-developed family governance structure builds trust and communication among family members both inside and outside of the business. It can also help families:

- Clarify roles, rights, and responsibilities for family members in all roles;
- Encourage family member stakeholders in all roles to act responsibly and exemplify family values; and
- Regulate representation of appropriate family members regarding business discussions and decision-making.

Several key governance structures—such as a family constitution, family assembly, family council, owners' council, and family office—can support the family and create a framework for effective communication with the family enterprise.

Family Constitution

A family constitution is a formal, overarching document that includes the agreements, policies, and expectations that govern family interactions and decision-making. Its purpose is to articulate intentions and provide a road map to achieve the family's goals. Critical components include:

- Family mission, vision, and purpose;
- Code of conduct;
- Family institutions, including the family assembly, family council, and family office;
- Expectations for family members serving on the board of directors (or board of advisors, if one exists);
- Family member training and development guidelines;
- Compensation policies for family council members;
- Guidelines for family member employment, transfer of shares, and CEO succession; and
- Dividend and distribution arrangements (the board of directors approves the dividend/distribution policy, but it's the family's responsibility to let the board know its expectations).

Notably, the constitution can detail linkages between the family and enterprise's values and culture. Though not legally binding, this document instills accountability. For instance, it may include a section on family values stipulating how the business should represent itself in the marketplace and specific ideals to be upheld by any family member employed in the business. Those values can be so vital to the culture and reputation of the family business that the president of the company (and directors) may face dismissal for not adhering to stated expectations.

CASE STUDY: Establishing Family Employment Policy

A year into their tenure running the family's business, a brother and sister realized that the constitution (created by their parents) failed to outline a clear employment policy. As the family continued to expand and more members showed interest in taking on a role, the siblings grew concerned that the company could end up with more employees from the family than it needed. They wanted to be proactive and avoid adverse business decisions simply to ensure everyone in the family had a job.

With an eye towards formalizing employment policies, the broader family unit worked together to create clear rules about the terms and conditions of family employment within the firm. Together, they outlined the requirements for joining, staying, and leaving employment in the business. The family agreed on a minimum level of education, experience, and age that individuals must attain before joining the firm.

Once finalized, the family amended the constitution to include the new rules and distributed the document to all members. Via the family council, they also conveyed their desire to the company that non-family members be held to the same standards. The siblings hoped that by looking to the future and establishing the policy before it became critical, they could continue growing their business by attracting and motivating the best talent.

Family Assembly

A family assembly is a regular gathering of all adult members, their spouses, and children over a certain age. Its core purpose is to keep the family informed and create bonds to help preserve and build four types of capital, particularly as a family grows (see below: Honing Capital at Family Assemblies).

The assembly may consist of a multiday retreat or forum to explore issues and enjoy events while promoting cohesion. For enterprising families, an assembly agenda may include family members from the company sharing critical business updates: insights on management, industry trends, dividends, or a recap of employment requirements. There may also be education sessions for emerging family business leaders to learn crucial skills and hear firsthand from current heads of the enterprise.

Honing Capital at Family Assemblies

Research shows that families who have managed to remain successful across generations share a different definition of wealth—one that encompasses more than just financial capital (**Display 3**).[4] By focusing on developing the types of capital that replenish financial assets, such as human, social, and cultural capital, they create an additional layer of stability and support for family members.

Family assemblies can be an opportunity to enhance these other types of capital through curated educational, business, and personal development activities that enable members to work together and refine skills. More importantly, an assembly allows for different generations to contribute ideas and build on how the family views, prioritizes, and grows each pillar of capital.

DISPLAY 3: WEALTH IS MORE THAN FINANCIAL CAPITAL

HUMAN CAPITAL

Health
Knowledge
Emotional Resilience

- What makes our family members unique?
- Are family members thriving?
- Are they purpose driven and productive?

SOCIAL CAPITAL

Relationships
Community
Philanthropy

- How do we demonstrate what our family stands for?
- Are our connections strong? Is conflict well managed?
- Do we have the impact we desire on our communities and the world?

CULTURAL CAPITAL

Values
Family Identity
Mindset

- Do we continue sharing our family's heritage and traditions?
- Do we face the world as a unified family?

FINANCIAL CAPITAL

Capital Assts
Business Interests
Real estate

- Is the enterprise strong and secure?
- Does wealth entitle, control, or empower us?
- Do we have a multigenerational strategy?

4 James E. Hughes, Jr. , *Family Wealth–Keeping it in the Family: How Family Members and Their Advisors Preserve Human, Intellectual, and Financial Assets for Generations* (Bloomberg Press, 2004) and *Continuity Family Business Consulting.*

Family Council

A family council may be comprised of the entire assembly or a sub-group of members elected by the assembly. The council usually meets more frequently and will report back during the annual meeting, informing the broader family of various initiatives and decisions.

In families with an enterprise, the council makeup, structure, and responsibilities will differ from one family to another. However, the role of a typical council may include:[5]

- Serving as the primary link between the family, board of directors, and senior management;
- Considering candidates for board membership; and
- Crafting and updating family policies, including those covering family employment, compensation, and family shareholding.

The council also adds value by communicating essential information about the enterprise to all family members, prompting discussions about critical decisions, and training future leaders. Often, a family council creates education programs that cover family business history and values, philanthropy, and the basics of financial literacy. These programs create a shared understanding of purpose for both the family and enterprise, while enhancing stewardship—and as a result, increases the likelihood of multigenerational success.

Owner's Council

When a business is family controlled, an additional structure which sits alongside, or under, a family council can be useful in managing member relationships and motivations. Known as an owner's council, this entity is also useful when there are other owners besides family members. In this situation, the owner's council conveys the family owners' interests in an organized way to the corporate board.

Family Office

Some families form a family office to centralize and manage the family's administrative functions, including reconciliation of bank and investment statements, payment of bills and taxes, preparation of financial statements, handling of insurance needs, among many others. The family office also supports the family's vision and legacy, ownership transitions, leadership changes, and successful wealth transfers. A family office accomplishes this through leadership training and education on values, financial literacy, and stewardship.

There are many motivations for forming a family office, including:

- Keeping personal and family interests separate from company interests;
- Protecting family wealth and promoting harmony by applying business practices to the management of the family's personal wealth;
- Providing structure and controls to maintain rational, objective, and forward-looking processes; and
- Reducing conflict or mismanagement by employing skilled professionals to protect and grow family wealth.

It is not uncommon for a family office to play an active role both in the family business and developing a business continuity plan. Strong family and corporate governance working in tandem promotes accountability. It also provides a framework for the family office to manage decisions to the family's satisfaction and to grow both the business and wealth for future generations.

Governing the Business

Sound corporate governance helps navigate the intersection of family, business, and ownership while focusing on unity and family member employment. As a foundation, understanding leadership structures within the family business is vital. At the helm of any family business is the board of directors, which sits between the owners and management and oversees the company's leadership and direction. Members of the executive team (CEO and president) report to the board. Board members are responsible for hiring and firing the CEO, determining compensation, and weighing in on other C-suite hires as requested by shareholders.

In the case of an early-stage family enterprise, the C-suite may consist of owners, or often one controlling owner could be president or CEO. In this case, the board of directors would serve a limited purpose. Nonetheless, as the company grows, maintaining a fully staffed board of directors adds expertise in decision-making and can serve as a forum for managing conflict within the leadership group.

5 Ivan Lansberg, *Succeeding Generations: Realizing the Dream of Families in Business* (Harvard Business School Press, 1999); Fred Neubauer and Alden G. Lank, *The Family Business: Its Governance for Sustainability* (Routledge New York, 1998).

As discussed, the family council also plays a vital role by informing the board of the family's wishes on employment, distributions, and dividends. However, while the council conveys the family's wishes, decision-making and execution rests with the board of directors or shareholders (as applicable).

Corporate Governance Documents

The bylaws and shareholders' agreement govern the structure of the company's board and shareholders, respectively.

- **Bylaws:** Adopted by the board of directors, these founding documents serve as guidelines, defining how directors are nominated and elected, and how the board governs the entity on behalf of its shareholders.[6] They may set forth high-level requirements such as the number of board meetings and the need for certain officers (e.g., treasurer, secretary).
- **Agreements:** These documents outline who can own shares and how stakes can be transferred as well as the relationship between shareholders and how they make major decisions.[7] A shareholders' agreement ensures that all parties are treated fairly by delineating rights and obligations, enumerating procedures for admitting future shareholders, and providing safeguards for minority owners.[8]

Should family members serve as board members?

Many families wonder whether members should serve on the board of directors or bring in outside directors instead. The optimal answer may be both. Studies have shown that adding non-family members to the board can result in more balanced and productive conversations when formal governance processes are in place.[9]

What if a family wants a family-comprised board but also seeks outside expertise?

The family may wish to establish an advisory board. A family enterprise advisory board is an entity that sits outside of business operations, has no outright control, and provides objective industry and functional expertise.[10] The members are typically focused more on business issues than shareholder issues. An advisory board can complement the family's institutional knowledge by offering independent advice.[11] And unlike a board of directors, the advisory board does not have liability exposure.[12]

Lastly, as a business grows in both size and complexity, a more formal management structure and decentralized decision-making process may become necessary. At that point, it may be desirable to shift the existing leadership from family members to non-family (i.e., non-family president or CEO) or bring in a younger generation from the family. How is this accomplished? By implementing thoughtful succession planning that incorporates governance, communication, and a clear vision for legacy preservation.

Succession Planning

Organized succession planning between generations or supporting the transition from family to professional operations management is essential. Poorly handled succession can lead to conflict, jeopardizing the entity and destabilizing the family. In contrast, family governance concepts can smooth the ride and ensure an orderly experience. Governance involves determining not just who will run the business, but also how to uphold the legacy that the founders had in mind when the business first launched.

Strategic succession planning involves being proactive and planning for a change in leadership several years before the expected transition. If a departure occurs earlier than anticipated, having a plan for the transition will minimize disruption. Yet simply identifying potential talent is not enough. Stakeholders need to cultivate potential successors. Accounting for this development time underscores the need for advanced planning. Any specialized training or education should occur well before an intended change.

Seven Steps to Prepare for a Successful Succession*

1. Involve successor(s) in the business early on.
2. Have successor(s) become a student of the business.
3. Use tailored, internal education to initiate successor(s) into a wider understanding of the business.
4. Encourage successor(s)to gain work experience in other companies.
5. Officially introduce successor(s) into the business.
6. Use a written agreement to regulate the debut of successor(s) into the family business.
7. Be clear about ownership expectations.

*Source: Adapted from Lambrecht J., Multigenerational Transition in Family Businesses: a New Explanatory Model (The Family Business Review, 2005) and Continuity Family Business Consulting.

6 "Why Your Startup Needs Bylaws," www.bhandlaw.com, May 5, 2020.
7 "The Shareholders Agreement," Mike Volker, https://www.sfu.ca/~mvolker/biz/agree.htm
8 Id.
9 "Organizing the Family-Run Business, Part Two: The intricacies of creating a board for the family-run business," www.hbswk.hbs.edu, October 1, 2001.
10 "The Benefits of a Family Business Advisory Board," Travis Dunn, www.bbh.com, March 28, 2019.
11 Id.
12 Id.

Professional advice may also prove desirable to facilitate the transition. For example, the entity's legal documents may need to be updated to accommodate the succession plan. In addition, the family and company management may need to consult other professionals to ensure a successful outcome.

The success of a transition plan largely depends on key stakeholders' acceptance. When vital parties—such as shareholders, officers, or directors—object to the plan, conflict often ensues. Opposition can detract from the enterprise's efficiency while damaging family relationships.

Finally, family offices can also play a critical role in succession planning due to their institutional memory. A family office with strong rapport can provide invaluable insights during the early stages of a transition. And when a family office has oversight responsibility, members can help guide the next generation of family business leaders as they take the reins.

In succession planning, a family-held business faces the dual challenge of managing business decisions and family needs—and the complex ways they intersect. Aligning family and corporate governance assures both the continuity of a family business as well as harmonious family relationships.

Optimizing the Overlap

Coordinated family and corporate governance can enhance the effectiveness of any family business system. The three-circle model lends clarity by illustrating the distinct goals, concerns, and dynamics of each stakeholder. Beyond this framework, a stakeholder map overlaying governance helps convey how the overlapping spheres are incorporated into policies and decision-making. There are two separate but intersecting areas of governance for family enterprise owners: the business and the family in business. A family may establish separate structures—such as a family council—to act as a bridge between the entity and the family or incorporate governance principles in the governing documents of the business. Structure aside, well-created and properly organized family and corporate governance helps set boundaries and instill clarity. Ultimately, integrated family governance and corporate governance help ensure greater cohesion, a more focused business, and smoother transitions between generations.

BER-1921-1222

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