Mastering family business dynamics.

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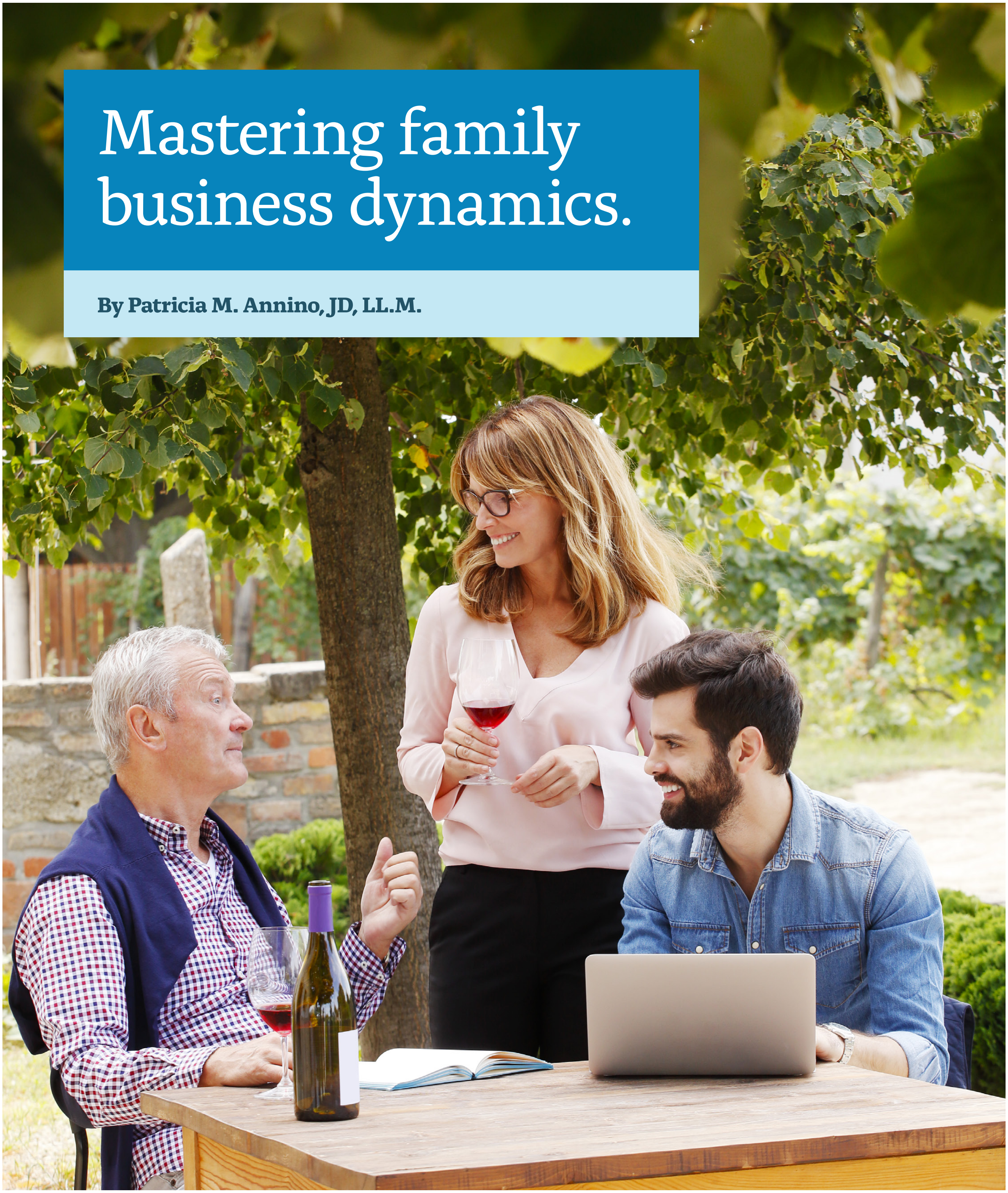

“People will stare. Make it worth their while,” Harry Winston famously said, yet behind the king of diamond’s sparkle lies a cautionary tale for owners of closely held businesses. Family businesses are the lifeblood of the American economy, and successfully managing these enterprises requires navigating the complexities of family dynamics, governance, and fairness. Despite Winston’s success, sibling rivalry and accusations of mismanagement led to 12 years of litigation and unwelcome attention for the renowned jeweler’s family enterprise.

Family came first and is rooted in the emotional context of unconditional love and support. The family business may have been established many generations ago or more recently, but either way, it must be run with meritocracy, competence, and prudence. And that can be hard to do when the managers and employees are also family members.

Family dynamics

Family dynamics have a tremendous impact on the success of a family business and can often be the source of conflict. It is important that the family separate out family issues from business issues, but the reality is family dynamics always lurk in the background. The relationships that define the emotional life of the family can creep over (overtly or subtly) into the business itself. The family and the business must do all they can to keep that elastic boundary between family and business in check. Families must learn to act differently in a business than they do as a family. And when frequently every dinner conversation revolves around what is happening in the business, that’s not easy. Many family businesses that fail do so because of family issues, not business issues. Behind the scenes, any of the following can lead to problems in the family and in the business.

- Founder not wanting to let go.
- Changes in risk appetite among generation levels.
- Sense of entitlement.
- Sibling rivalry.
- Interference by in-laws.
- Infidelity.
- Physical or emotional abuse.
- Failure of past businesses.
- Advisors who are past their prime.
- Alcoholism and substance abuse.
- Confusion about family goals versus business goals.
- Breakdown of trust.
- Selecting the wrong successor.
- Lack of open communication.

So how can a family business address the family dynamics issue? The following practical solutions may help keep business decisions separate from family decisions:

- **Create a code of conduct** for the communication of business matters that fosters positive communication, overcomes emotional explosions, and allows the business to stay on track and focused.
- **Create a vision and values statement** which highlights shared purposes.
- **Openly communicate** the good and bad that is going on at the business level.
- **Address succession** issues fairly.
- **Establish policies** within the business, such as a dividend policy, a family employment policy, and a governance structure.
- **Form a family council**, if appropriate, to communicate openly with those involved in the business and those who are not involved with the business about what is occurring and why.
- **Establish a conflict resolution process.**

Family employment policies

Having family members work in the family business triggers many emotional issues – fairness, favoritism, or a desire to help children. It can create significant issues when a family member is not successful in the business: should he be asked to quit? Be fired? Exit from the business?

It is important to understand that the labor laws, wage and hour laws, and discrimination laws apply to all employees of every business – family members or not. Not adhering to the law and retaliating against employees can lead to lawsuits and chaos.

A family business that employs family members should consider implementing an employment policy for family members. A formal employment policy helps ensure that family members in the business are qualified for their roles and reduces the risk of having to fire or demote a family member. It also reassures non-family members who are working in the business that they will be treated fairly and that the employment process applies to all those employed in the business, whether they are family

members or not. Not having a strong policy demotivates non-family employees.

The family should create formal job descriptions, establish criteria for evaluating employees for purposes of compensation and promotion, and set forth what qualifications are important for each position (experience, education, certificates, skills).

The expectation of working hours and vacation time also should be in writing. Family and non-family employees should undergo background checks.

Many family businesses mandate that a family member work somewhere else for a defined time, such as five years, prior to entering the business. A good practice is to have family members report to non-family management.

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The employment policy also should set forth the measurable goals to be used for future performance obligations.

It is prudent to have an employee handbook, written by an employment lawyer, that details these agreements and expectations.

Fair versus equal.

Many owners of family businesses, when addressing succession planning and/or gift and estate planning, struggle with the issue of fair versus equal. The reality is, equal is not fair, and fair is not equal. You may very well need to be unequal to be fair. A feeling of unfairness is at the bottom of many family disputes and conflicts. What is at stake with that feeling? Money, asset value, status, parental approval and love?

Figuring out what is fair and what is equal can be tricky. Different assets have different characteristics, and even if the assets have the same value, dividing them equally may not be fair. A million dollars of raw land has a different fair-versus-equal value than a million dollars of income-producing, already developed commercial real estate, which is different than a million dollars in an investment account, which is different than a million dollars in a family business.

It is important when considering ownership of the family business to consider fairness, not equality.

Children who have worked in the business for significant time periods may expect to receive a larger share of the enterprise than siblings who did not. Dividing a company into equal parts among children who have been involved in the business and those who have not rarely works out well.

This was played out in several court cases involving the Harry Winston family. The famous jeweler had two sons: one who graduated from Harvard with a degree in chemistry, worked in rocket research, and then entered the family business at the request of his father; and one who dropped out of college and was not interested in business affairs.

Harry wanted to treat his sons equally and he wanted his business-oriented son to be

in charge. He left the business equally to his sons and put his business-minded son and two professional trustees in charge of the share for the son who was not interested in the business. The business-minded son also ran the company.

Trouble began when the business-minded son gave himself significant raises and used the power in the trust document to distribute his share of the company to himself. His brother became suspicious and sued him for a full accounting, charging that he took advantage of his brother's financial naiveté, mismanaged the family firm, and used company assets for his own personal benefit.

This led to 12 years of brother-to-brother litigation in various courts and even more protracted litigation against the professional trustees.

The Harry Winston case raises important questions for the owner of a family business— is it fair to the children who are running the business to have a duty to those who are not, and do not care to be, involved?

Is it fair to the child who is not interested in business to have his inheritance tied up by a sibling who may have justifiable personal gains?

Is there a better way to handle this?

Perhaps the equity issue can be handled by life insurance?

Perhaps the business-savvy sibling should buy out the one who is not interested?

Valuation of the family business.

There are many reasons why a family business should be valued: gifting, estate tax, shareholder redemptions, performance measurement and evaluation compensation, corporate finance decisions, divorce, selling to other family members, and succession planning to name a few.

It is important to understand that no matter what, there will in all likelihood be a tax due — whether it is gift or estate tax or a capital gains tax. It is prudent to model the numbers and figure out the options, and it's especially important to estimate the taxes that will be due under different scenarios.

Many owners of family businesses believe they can set the value of their business on their own; however, both the IRS and state taxing authorities have strict guidelines as to how a business is to be valued. It starts with the premise that the business is worth fair market value.

Fair market value is defined as the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts. US Treasury Department rulings and regulations mandate that valuation take the following factors into account:

- Appraisal of the assets,
- Demonstrated earning capacity,
- Dividend paying capacity,
- Good will,
- Economic outlook,
- Quality of management,
- Degree of control represented by the business interest, and
- The values of similar publicly traded companies.

It is important the appraisal of the business be done by an outside qualified appraiser. If left to the family, obstacles may include lack of communication, lack of transparency, lack of information, an unrealistic view of the value of the entity, and family members who believe that the value is quite different from what a qualified appraiser would determine. If the owners wish to enter into a buy-sell agreement, it is important they do that when there is no conflict.

It is very important that an agreement is set for the valuation method and that any appraiser must be one who is qualified in

accordance with IRS standards. It also is critically important to review and update the agreement annually to determine if the value is still what it should be or if it should be adjusted.

Future of the family business.

Siblings might never agree on everything, but family business owners can prudently plan and minimize serious conflict in the future by establishing these basic policies and procedures.

- **Develop a disaster plan; model out different scenarios.**
- **Maintain open communication, such as a family council, to keep those who are not involved up to date.**
- **Communicate face to face regularly.**
- **Develop a good governance system.**
- **Be open and honest about succession issues.**
- **Develop dividend policies and family employment policies.**
- **Keep all documents up to date (corporate, estate planning, and life insurance).**
- **Meet regularly with your advisory team to keep everyone informed.**

Honest thinking and open communication are critical when addressing both the personal and the professional dynamics inherent in a family business. Working with professional financial service providers on these strategies can help protect the sustainability of the business and preserve family harmony.

About the author.

Patricia M. Annino is a partner in Rimon PC's Trust and Estates Group where her practice focuses on all aspects of private client work including estate planning, will and trust planning, incapacity planning, prenuptial and postnuptial agreements, estate litigation, advising executors, trustees and beneficiaries, and administration of estates and trusts. A nationally recognized authority on estate planning and taxation, prolific author, and frequent public speaker, Ms. Annino has been quoted extensively in a wide variety of national publications including *The Wall Street Journal*, *Barron's*, *MarketWatch*, *Investors.com*, and *Women's Business Journal*.