Family Business

THE GUIDE FOR BUILDING AND MANAGING FAMILY COMPANIES

What's fair in love and the business?

Issues of equity, equality, and need should be resolved now, or there'll be a lot of love lost later.

By Peter Davis

Productivity and fairness are central themes in family business life. Productivity because someone has to produce the goods and compete so the business can stay alive. Fairness because without it the social fabric of the family unit is ripped apart.

Questions of fairness are a pervasive concern at every stage of the family business drama and for each member of the cast. The parent asks: "How can I be fair with all my kids?" The overworked sister laments: "Is it fair for us siblings to be paid the same when we are clearly making different contributions?"

What is fair, of course, depends greatly on point of view, and is often a matter of infinite subtlety. Consider two brothers who have worked together for 40 years and built a successful business. For the longest time they made pretty equal contributions of time and effort. But in recent years, the younger brother has become much more central to the company's success and has been working longer hours. Still, they are paid the same, and each owns half the company. Is this fair?

"No," says the younger brother. "It's time for a change. I am making a much bigger contribution. So I deserve more."

"No you don't," says the older brother. "There have been times when I have carried a bigger load than you. And don't forget all the big deals I have brought in. After 40 years, this isn't a time for change."

A senior manager describes these two brothers as "like Abbott and Costello: One is no good without the other." But the fairness issue is explosive and threatens to derail succession in the business.

The younger brother wants a redistribution of the shares that the partners plan to pass on to their children. For he has two children and his older brother has only one. He wants them to split the shares equally among the three, but the older brother wants to pass on half the company to his son. Who is right? And by what criteria should the distribution of stock be determined? Who is going to be the ultimate arbiter?

Unfortunately, the issue is not dealt with in any prior agreement between the brothers. They had once discussed a possible financial redistribution because of the younger brother's extra effort, and could not agree on the terms. The younger brother, under pressure from his oldest son, is now pressing to let the kids share the stock equally. That issue hadn't even been broached before.

Despite their long history, the brothers have no previously agreed-to standard or rule that will allow them to resolve the issue without putting great stress on the family. Each member can only appeal to some abstract principle such as fair play, or try to remember what their father said about such issues.

Are we clear in our family about what is fair?

The family might try to negotiate an outcome with some give-and-take in it. For example, the younger brother might pay a substantial sum to the older brother for the additional shares. Or he might grant the older brother veto power over certain issues for his branch of the family. In the absence of any prior understanding, the partners must compromise if they want to keep the business together. And as in all such compromises, of course, the negotiated outcome is likely to satisfy no one.

So, before problems arise, it behooves the leadership of a family business to ask a few crucial questions: Are we clear in our family about what is fair? What are the important fairness questions we will face in the years ahead and how can we start to address them now?

Of course, some principles applicable to the business may be found in legal documents that have been written over the years. For example, the corporate bylaws will establish fairness in owner representation and voting rights (although 95 percent of the time, no one has read them). Partnership agreements very likely spell out how the company will be valued and financial rewards distributed if one partner wants to sell. Yet, there are often huge gaps in understanding about how such issues will be resolved.

In his book *Distributive Justice*, the psychologist Morton Deutsch points out that those who formulate values should not do so in terms of abstract conceptions of justice but rather in terms of utility in achieving key objectives. During succession planning, three primary values are usually central to achieving the family's objectives: equity, equality, and need.

To each according to his or her contribution: If the primary goal in the business is to ensure productivity, then the primary value is that of equity. According to this standard, each family member should get out of the business what he puts into it. Each should be given an opportunity, not a handout. If he's successful because of his efforts, he deserves to enjoy the fruits of his success. The most competent should be chosen to lead the business, and everyone in the family has to accept that some members will do better than others because they are brighter, work harder, and are more productive.

To each in equal measure: If the primary goal is family cohesion, then the primary value is that of equality. The basic principle here, of course, is that in opportunity, in pay, and in prestige, the children have to be treated equally. To preserve family relationships, the members have to avoid any hint that one of the children is receiving preferential treatment or being given a dominant role.

To each according to his or her needs: If the primary goal is maintenance of family welfare, then the primary value is need. Under this criterion, children with larger families get larger pay. The company pays a dividend when one family member needs money to buy a house. The family may adhere to the principle that members do not take resources out of the business until they need it. Nevertheless, they can take what they need when they need it, regardless of merit or contribution.

With growing affluence in many companies, need ceases to be a dominant value. But it certainly is a powerful influence among more traditional and paternalistic families. A lot of young people who are underpaid are, in effect, still being paid an allowance. When they need a bigger house for a growing family, however, they request—and usually receive—a pay increase.

In reality, of course, equity, equality, and need are not mutually exclusive values. In fact, the key problem that most parents have is how to combine elements of all three.

One model combines the principles of equity and equality. The business is seen as a legacy, in which the children inherit equal ownership. But if family members work in the business, they have to be competent, and they are paid for what they do. A variation on this model is designed to further encourage entrepreneurial opportunity. The competent children get to run the business and own it. The other children are given equal value in other assets as part of an estate distribution.

When the family has fully discussed, clarified, and agreed-upon standards of fairness, the parents might then codify them in family statements of principle and in legal documents. The family that sticks by a set of consistent standards can avoid much of the confusion and agony of succession. Parents who make it up as they go along are asking for trouble, for themselves and their progeny.

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