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Governance Beats Avoidance for Long-Term Family Business Harmony

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Most successful business-owning families have a common fear: "How do we keep the next generation from fighting over the business?" This fear is well founded, as the survival rate for family businesses from founding generation to second generation and beyond is low. Further, most of us know tragic stories of ruined family relationships and lost fortunes because a group of siblings or cousins - who were to be the beneficiaries of a wonderful blessing - could not get along. "Shirtsleeves to shirtsleeves in three generations" is a common refrain that haunts the dreams of great entrepreneurs around the world.

The Root Cause of Family Conflict in Family Business

While there are many reasons why family members do not get along, the issues that surround conflict over the family business are often predictable. When heirs of a family business feel that they are not being treated fairly or respectfully tensions will mount and frequently explode into conflict. Ultimately, it is important to remember that the experience of "fairness" is more driven by the decision-making process than by the decision itself. People can feel as cheated or second-rate when the shares of a business are distributed equally as well as when they are not. I recently heard a story of a family business heir whose response upon being told the size of his inheritance was "only $60 million? I've been screwed!"

The core issue is almost never "how much" but rather, how the decision was made. The power of engaging stakeholders in the decision-making process cannot be overstated. While finding agreement with many voices is hard and can be divisive at times, engaging all affected stakeholders in a decision is critical to buy-in and ongoing alignment. When leaders in a family business seek to avoid the complexity of engaging all stakeholders in decisions they often bring on the very conflicts they were trying to avoid. The reality is, when family businesses succeed beyond the founding generation into subsequent generations of ownership and leadership, the dynamics of decision-making need to change. While there is a natural acceptance of decisions made unilaterally by the founding generation, when the elder members of the family are no longer able to make such decisions, previously compliant next-generation family members may explode in conflict over even minor decisions if they feel they have no real voice at the table.

Family trust and harmony are keys to preserving patient capital. All shareholders need to have confidence that their interests are being considered in decisions that involve their capital. When one sibling attempts to make unilateral decisions about the future of the company — the way a founder might, without consulting all owners — resentment may result regardless of quality of the decision itself.

The Cure Can Be the Disease

In their efforts to prevent family disharmony many business owners actually exacerbate the problem by taking actions that remove family from the process. Often with the best of intentions, the decision-makers in one generation will set a future course that seeks to avoid complexity but results in negative consequences. For example, some owners will sell a business with a great future so that the proceeds can simply be divided up among heirs equally. While this solution is reasonable because each heir can get an equal share of funds to do with what they want, it may be shortsighted. Immediate access to cash may deprive generations to come of a great family legacy and an economic engine that could continue to generate wealth for many generations. More often than not, when wealth is divided up into smaller portions to be invested in the stock market, it does not last beyond three generations.

In another approach to limit complexity, rather than sell the business, some owners attempt to promote family harmony by having one member of the next generation buy-out the other members of their generation to achieve sole ownership. Entrepreneurs often struggle to imagine how a business can be effectively run if the leader does not have full and total authority of ownership. While this logic is appealing on one level, it comes with serious risks. First, because the business is strapped for cash, either due to leverage or the use of free cash to buy out other family members, it may underperform or ultimately fail. Alternatively, if it does succeed and grow, those who sold at the time of transition (typically at a minority shareholder discount) will feel cheated because their shares would be worth much more had they kept them. Finally, when the business is transferred to only one family branch it may create a perceptual "gulf" between the owners and their cousins in future generations.

Some other measures to head off conflict attempt to legally "tie the hands" of future generations with regard to the business they are supposed to own. This is a near-guaranteed prescription for failure because no business leader or advisors today, no matter how successful and smart, can predict the business needs of the future. Good businesses must remain flexible and adaptive to thrive in the future. Any attempt to construct a trust or use other legal tools to put a business on "auto pilot" is on a likely path to failure.

Any formula to prevent future conflicts among family members by removing them from any say in the enterprise, while making them beneficiaries of the success of the business also mostly fall short. One common approach is to give one or more heirs working in the business control while making those heirs who do not work in the business beneficiaries of dividends or other distributions. This effectively puts different family members into roles of "makers" vs. "takers." Such an approach often opens the next and subsequent generations to bitter disputes over the salaries and benefits of those who run the business. Also, beneficiaries who may have legitimate questions about the dividend policy set by their relatives with voting rights will run the risk of being labeled greedy. Mature adults tend to chafe at the idea that a significant portion of their wealth is entirely outside of their control.

Good Governance Makes Good Owners

While there are businesses that successfully choose to concentrate the ultimate decision-making authority into one or a few hands, in our experience all affected stakeholders want to feel they have a voice (even if they do not have a vote) in the process. In addition, by the time a family business has multiple owners it needs to have policies and processes established for good governance that represents the welfare of all owners and the enterprise as a whole. This is the point when the Board of Directors needs to actually meet, create advance agendas and be structured to represent all owners effectively. This does not need to be an overly bureaucratic process but it should be a time when owners who work in the business and those who do not sit and consider major strategic issues together.

If the ownership group is large enough, or the business requires a professional board that does not include all owners, it is important to develop a process where all shareholders can have their voice heard. Many families will convene an annual shareholders' meeting or may develop a shareholder's council that meets quarterly to discuss ownership issues. Whatever forum you use,

it needs to be a process where all shareholders can be brought up to speed on the business and have their concerns and priorities heard. These meetings are often held in conjunction with family meetings that focus on broader family issues and offer an opportunity for younger next generation owners to learn about the role of being an owner before they take on the mantle of leadership as governing owners or business executives.

In our experience, the progression of governance often follows a pattern of the senior generation forming an advisory board of outside business experts that meets with the fiduciary board representing the owners of the business. Over time, perhaps as the CEO role transitions to the next generation, the senior generation will focus on the role of board chair and integrating next generation owners into functional board roles. As good governance progresses, the board will transition from its advisory board to appointing outside independent directors that are trusted by all owners for their business acumen and decision making.

When the practice of good governance has matured, all owners will have the necessary transparency into their business to trust that those who are running the enterprise are competent, fairly compensated, and accountable for the good of the whole. When this is the prevailing perception, owners are aligned around strategy with management and a family business reaches its true potential for success.

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