Paying Family in a Family Business: Where Good Intentions Create Hidden Risks

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An advantage of private business ownership is the freedom to make your own decisions, innovating and improvising to create success. Family employee compensation is one tool family leaders can use to improvise solutions to challenges unique to family businesses. For example, how to fairly employ your children or how to entice the next generation to leave outside careers to return to the family enterprise.

In some cases, family leaders use employment compensation to "take care of the family" without connecting this to business success. While these approaches can work in the short term or under a particular leader's control, we observe that over time, they prove to be incompatible with growing a successful business and sustaining family ownership.

To support success for the family employee and the business, we frequently encourage clients to adopt "good practice" philosophies widely validated by human resources professionals, such as:

- Ensure the family employee is in a real role that contributes to the business's strategic purpose — not in a "make-work" job; if you wouldn't hire a non-family person for a role, don't offer it to a family member.
- Define clear objectives for the role so that family employee performance, both success and failure, can be objectively evaluated.
- Support family employee development with supervision from a long-standing, trusted non-family leader who will hold them accountable and provide actionable feedback for growth.
- Pay market-based wages.
- Set expectations for family employees by establishing and communicating a family employment philosophy.

At the same time, there are some common approaches to family employment compensation that, although "outside the box" of HR norms, do address pressing challenges in family businesses.

This article will look at three of these approaches and consider the trade-offs and benefits that come with each:

- Equal pay for family employees
- Non-market pay to family members, both above and below market
- "Sweat equity" benefits

While those approaches to family employee compensation might make sense at one point in the life of the family and business, they are typically difficult to sustain through increased complexity in the business or into future generations. Our role as advisors is to bring perspective on the inevitable changes that time brings, help family leaders see the risks of inaction, and guide them in adapting their approach to family employee compensation in a manner that protects their vision of success.

What's the Right Number? When Families Set Pay on Their Own Terms

"What am I worth to you, Mom and Dad?"

When working with families looking to hire their first next-generation family member, we often encourage them to follow the proven HR practices outlined above. While this is objectively good advice, it is not always how things proceed, and sometimes, that's OK.

For example, some families elect to pay above-market wages. The Jones family had a couple of hardworking cousins who received excellent educations and found jobs in major cities, earning salaries that quickly reached six figures. After three years, family leaders wanted the cousins to consider returning to their rural family business to join a management training program, which typically pays 30-40% less than city jobs. In this case, the Jones family highly valued the capabilities and drive the cousins had demonstrated and decided to pay them a "family premium" outside the business's standard market compensation to match their current pay.

When the cousins joined the business, family leaders had to adjust profitability metrics for the managers who took their outsized pay into their department budgets. The Joneses also came to recognize that this approach would not be a fit for all the first cousins and had to decide as a family how to manage the consequences of premium pay for some but not all in the cousin cohort.

Other family businesses pay family members under-market rates because everyone in the family is expected to "pitch in" when the business is going through a rough patch, or because family members are also receiving special benefits like unlimited PTO or use of business vehicles.

This approach has implications when the business's need for talent exceeds the family labor pool, and pay must be adjusted to market rates to attract and retain non-family employees. Family employees can become resentful when non-family employees are paid at market rates, but just out of habit or tradition, they continue to receive lower family rates and are expected to accept this situation because of their status as owners.

> Over time, it becomes important not to conflate the rewards of ownership (returns you should expect because you keep your capital in the business) and those earned as a salary for doing a job. Not differentiating between these leads to distortions and potential resentments. We have seen situations where family members who don't work in the business resent the large salary that a family employee earns, because it feels like that person is somehow getting an unfair benefit, when in fact they may simply be paid the market rate for their work. This can also go the other way, where a family employee resents distributions paid to siblings or cousins who aren't active in the business, feeling they haven't "earned it" because they don't work in the business day-to-day.

Same Pay, Different Jobs: A Model That Works Until It Doesn't

"I love (and pay) my children equally."

We often encounter situations in our work where we must accept that a model that might not be "right" on paper is effective for a particular family and therefore appropriate in that context. Paying siblings the same wage is one such example. Sometimes, this causes friction and doesn't benefit the family (or the business). However, there are times when it works, even with significant differences in the roles and responsibilities of sibling team members.

Siblings of parent founders often grow up working in the business on weekends, in summer jobs, and eventually as a full-time occupation. Early in their careers, siblings may have similar levels of experience, be given the same initial responsibilities, and receive the same starting pay as one another. Even when siblings bring widely varied experiences or hold unequal job responsibilities, they are essentially paid the same because their parents say, "We love our children equally, so we want to pay them the same."

The implication for families who use an equal pay practice is that they must honestly assess whether it continues to work over time or is generating resentment among siblings (especially if some are carrying a much bigger workload than others). If this is not bothering family employees, there is no reason to change it just because the "best practices handbook" insists that compensation be determined by role, responsibility, and performance.

While some siblings who grow up in the same household and all work in the business full-time may feel it is OK to be paid equally, it's unlikely that their children, the cousins, will feel the same way. Cousin cohorts typically have a broader age range and unique interests that come from growing up in different households. Not all of them will likely work in the family business, and the business may have evolved to a point where equal professional opportunities are not available for all cousins. At this stage, it will be important to ensure that compensation paid to family members is closely aligned with pay for a non-family employee in a similar role.

Earning Your Share: The Promise and Risk of Equity-Based Compensation

"Can't we just give them a stake in the business?"

Another tricky situation comes when equity is part of a compensation plan for family employees. When a business is in its earliest stages, it is not uncommon for founders to limit their compensation and put all free cash flow towards launching and growing the enterprise. Many business start-ups offer key employees a "stake" in the business for their labor, because the company cannot afford to pay them a market wage. Replacing a cash salary with equity makes sense because an employee/owner is taking on real risks. The business may not make it, and in some cases, they may also have to sign personal guarantees.

If a family business got its start with this model, or the founder/leader had similar experiences during their professional "coming of age," they may see a lot of logic in providing equity as part of the compensation of next-generation family employees who are contributing and building the business's success. They see this compensation structure as motivating and rewarding the hard work of family employees. Another assumption behind this approach is that if the family employee's economic interests are tied to the business's growth and success, this will also benefit other owners.

While this may all be true, models of family compensation that layer in equity can create distortions that harm the business and the family, especially once you are past the stage where owners are taking on personal risk. For one, some family members may choose to work in the business primarily to access ownership, even when it is not the right professional path for them. This misalignment serves neither the individual nor the business.

Another risk comes if there are limited opportunities for leadership. In that context, are you unintentionally creating a system where older siblings or cousins hold a structural advantage over those in younger cohorts that gives them both greater leadership and ownership opportunities?

A third consideration is that equity "paid" to operating owners in one generation may create unintended consequences for future generations. For example, a high-potential next-gen with interest in leadership may emerge from a family branch with a minority ownership stake because her parent elected a career outside the business and was not eligible to be awarded additional equity.

In a family with a strong operating owner culture, this future family leader may be passed over in favor of a member of the majority ownership branch, who may or may not be the most capable leader for the third generation. We note that when an operating leader holds outsized ownership control, it can be difficult for non-operating minority owners to hold them accountable in cases of underperformance.

When It's Time to Rethink Your Approach

Signals that it's time to revisit your family compensation program often emerge in G3, when cousins come into the picture. Cousins grow up in distinct households, with unique values and experiences, unlike their parents' experiences as siblings in the founders' household. As a result, the cousins hold varied preferences for employment and involvement. At this stage, it is important to ensure that compensation models do not create perverse incentives that may motivate family members to enter the business for the wrong reasons or create a sense of "unfairness" that leads to conflict.

Sometimes, G2 siblings may seek change because they have experienced conflict tied to compensation issues and want to spare their children that pain. In other cases, the enterprise's strategic needs may fall out of sync with the owning family's traditions regarding employment and compensation, creating friction that needs to be addressed. It's important to see these tensions as an opportunity to build momentum for change, like establishing a philosophy of family compensation, updating a family employment policy, and verifying that the approach aligns with the family owners' values, vision, and goals for the future.

How to Begin: Moving Toward Market-Based Family Compensation

Moving toward a new approach to family compensation often begins with intentional conversations among family leaders and business stakeholders to establish a shared understanding of the family's current approach. Those conversations often uncover the family's purpose for its current system and bring insight into how that purpose aligns with the family's values and vision for ownership. Equipped with that information, the family can begin to discern a compensation philosophy for the future, with input from objective stakeholders like a non-family CHRO, compensation consultants, independent board directors, and family business advisors.

When working with families on these matters, we advise them to include family stakeholders in the process as early as possible, particularly rising-generation family members who will be affected by the planned changes. In our experience, when family members have a voice in the development of a family policy, they are much more likely to support the policy.

In their book, *Family Business Compensation,* our colleagues John Ward, Craig Aronoff, and Steve McClure offer a useful framework for making changes to family employee compensation:

Be as transparent as possible about your goals and the process you will use.

Access objective information.

Revisit your compensation philosophy.

- *Does the family understand the "what, how, and why" of employee compensation?*

Does your philosophy/approach to family employee compensation align with your owners' vision and goals? Does it serve the business?

Communicate along the way, share learning.

Take time to make compassionate changes.

Share progress and expected benefits of the changes.

What Comes Next: Aligning Compensation with Your Family's Future

While "outside the box" models, such as equal pay or sweat equity, may serve a purpose in the early stages of a business, the transition toward proven, market-based practices is often a necessary evolution to protect both the enterprise's health and the family's harmony across generations.

As you reflect on your own family's approach, consider:

- Does your current compensation philosophy truly reward the contributions of your employees while honoring the rights of your owners?
- Are you building a system that the next generation will view as fair and transparent, or are you inadvertently planting the seeds of future resentment?

The conversations you start today can set the stage for compensation practices that work for both the business and the family in the generations ahead.

To learn more about our firm and how we serve families like yours, call us at (773) 604-5005, email info@thefbcg.com or visit www.thefbcg.com. There is absolutely no obligation.