Professionalizing your firm helps to ensure continuity

Instituting effective governance and managing family dynamics can help you improve performance and plan for succession.

TODAY'S MOST successful family businesses are focused on professionalization as a means of improving the bottom line and securing their longevity. By professionalizing their companies, family businesses can enhance performance, capitalize on unforeseen opportunities, strengthen their future prospects and provide attractive options for succession planning or an eventual exit strategy.

Professionalizing a business can mean different things, but two critical focus areas are instituting effective corporate governance practices and managing family dynamics by defining roles and planning for succession. Concentrating on these areas can help ensure the evolution from a hands-on, entrepreneurial organization to a thriving family business.

Enhancing corporate governance

Before the enactment of the Sarbanes-Oxley Act of 2002 and the public company accounting scandals that preceded it, many family businesses focused more on operations and less on how their companies should be governed. The changing environment has encouraged many family firms to adopt more stringent governance principles, which can ultimately deliver important benefits. For example, professionalized governance helps ensure the orderly, productive management of a company and facilitates long-range strategic planning. It also increases credibility with financial institutions.

Ideal governance models differ depending on the size of the organization and the makeup of its ownership group, as well as the level of involvement of family members and the generations represented. One key goal is to institute a framework for raising, and dealing fairly with, emotionally charged issues. In an effort to address these issues, more family companies are either appointing non-family members to their boards of directors or forming a board of advisers consisting of non-family members.

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The composition of the board of directors is critical to its success. In many cases, particularly with a larger business, a board including some outside members is appropriate. An alternative option is an independent advisory board, which has no legal authority but can monitor and enhance the management of the company by offering complementary skills and insights.

Outside board members or independent advisers can bring a fresh perspective, experience-based wisdom and objectivity to important company decisions. They can often provide in-depth expertise in critical areas such as operations, finance and technology. They can also assist with evaluating growth opportunities, assessing investments and risks, developing marketing strategies and objectively reviewing the performance of family members.

Furthermore, experienced outsiders can help resolve disagreements among family members, navigate intergenerational relationship problems, facilitate emotionally charged decision making and address situations in which a key executive becomes—or wants to become—less committed to the business.

Fostering accountability

In family businesses, holding certain employees accountable to performance standards and other expectations can be tricky. Emotions, overlapping roles and—in some cases—feelings of entitlement often create complicated scenarios.

One way to foster accountability and professionalism in a family business is to operate according to a "transparent" organizational policy designed to ensure that management, employees and family members not involved with the business are fully aware of what is happening at the company. Issuing regular financial reports and holding periodic meetings to formally update owners and senior managers are activities that form the basis for a sound system of communication and accountability.

Other accountability-focused strategies used in public companies can also apply to family businesses. For example, establishing a code of ethics can help dissuade self-dealing and other conduct that goes against the best interests of the company. It also sets forth the expectation that full-time employees should spend their entire workday on business; helps to ensure full disclosure of business and financial information to all shareholders; and establishes standards of fiduciary behavior for officers, guidelines for family access to company perks and a process for addressing questionable practices.

Family businesses should also consider forming an audit committee and separating audit functions from non-audit services. Other key accountability practices should include formal document retention and record keeping as well as procedures for reviewing executive compensation practices and monitoring company loans to executives.

All of these processes are mandated for public companies by Sarbanes-Oxley. While closely held family businesses are exempt from these regulations, they would be well advised to become voluntarily compliant, especially if they plan to access the capital markets or sell the business to a public company.

Defining roles

Family businesses can benefit significantly from defining family members' roles clearly while creating a sound succession plan. For some companies, the need for a succession plan comes about suddenly and must be addressed immediately. However, a proactive succession planning process, which typically involves either transferring ownership to a subsequent generation or preparing the business for sale, should ideally allow three to five years for the identification and training of a new leader or assessment of a company's value prior to seeking potential buyers.

One of our clients, for example, founded a housewares manufacturing company. The founder created two classes of common stock, one being voting (of which he controlled 100%) and the other being non-voting. He also formed a separate entity to buy the real estate that housed the operations. Two of his children worked for the business and received non-voting stock over time. His other children, who did not become involved in the business, were gifted ownership interests in the entity that owned the real estate, which was leased to the business at a fair market rental.

By embracing this type of structure early in the company's life cycle, the founder was able to achieve two important goals: (1) setting the foundation for the successful transition of control of the company to the next generation; and (2) building wealth—through rental income and the appreciation in the value of the real estate—for the family members who did not work for the business.

Careful succession planning has the added benefit of helping a company's customers adjust to the changeover. A few years ago, another client sought counsel in preparing a three-year succession plan for his logistics business. The plan called for regular vacations for the founder, during which time his sons took on more company responsibilities. The gradual transition helped the family slowly change the management structure according to a well-planned timeline. It also allowed the company's longtime clients to adjust, since they were accustomed to working with the founder personally.

An important component of succession is proper estate planning. Without it, the death of a family member could require the sale or liquidation of a family business to satisfy estate taxes.

Another way to help ensure family control of the business is to carefully consider buy-sell or redemption provisions. For example, when two women formed a home building company, they wanted to be sure that, if either of them died, her family would be provided for and the business would be able to continue operating. To achieve those goals, each partner purchased a life insurance policy in an amount equal to half the company's value (which was reviewed periodically) and named the other as her beneficiary. They also entered into a buy-sell agreement that called for the surviving partner to use the life insurance proceeds to purchase the deceased partner's shares from her heirs. This strategy prevented family members who were not involved in the business from becoming shareholders and ensured that the family members were paid a fair market price for the shares they inherited.

Improving the odds for success

Family businesses that professionalize their companies by instituting state-of-the-art governance practices, carefully defining roles and planning for succession will reap lasting benefits. These steps will help ensure a stronger, more productive business, while also contributing to the long-term continuity of the company. FB

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