A Closer Look

Family Businesses, Family Dynamics, and Governance

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Donna Trammell
Director of Family Wealth Stewardship

In Brief

- **While most family business owners hope to pass their business on to their children and succeeding generations, many do not manage the transition successfully.**
- **The specific reasons for these failures are often unique to each family, but they can typically be traced back to the interaction of family dynamics and business dynamics.**
- **Effective family governance can help improve family dynamics and increase the odds of a successful generational transition.**

Parents devote decades to building a thriving family business and hope that one day their children will take the reins — only to discover that none of their adult children want anything to do with the business.

What's going on here?

By most every measure, family businesses are a powerful engine for the U.S. economy. They account for more than half of U.S. GDP and U.S. employment, and almost 90% of all new job creation.[1] Moreover, they tend to focus more than other companies on employee satisfaction — they hold five spots on Fortune's 2018 top 10 best places to work — and they play important civic and philanthropic roles in their communities.

Yet statistics show us that managing a leadership transition from the owner to subsequent generations is difficult, despite good intentions — less than a third of family businesses survive into a second generation of family ownership.

The reasons for this failure can be as numerous and diverse as the family owners themselves, but often they can be traced back to the conflicts that can arise when family dynamics collide with business dynamics.

Still, if you are a family business owner, or perhaps an owner of a family foundation or a pooled investment vehicle where a board makes investment decisions,[2] a failed transition is by no means a foregone conclusion. Working with experienced professionals, you and your family can identify the tensions and challenges you're likely to face in advance and establish effective governance systems for dealing with them. These endeavors can not only improve family dynamics (a worthwhile outcome in itself); they can also help you to determine if retaining family ownership actually makes the most sense for your family and, if so, improve the chances of a successful transition.

Why Do Transitions Fail?

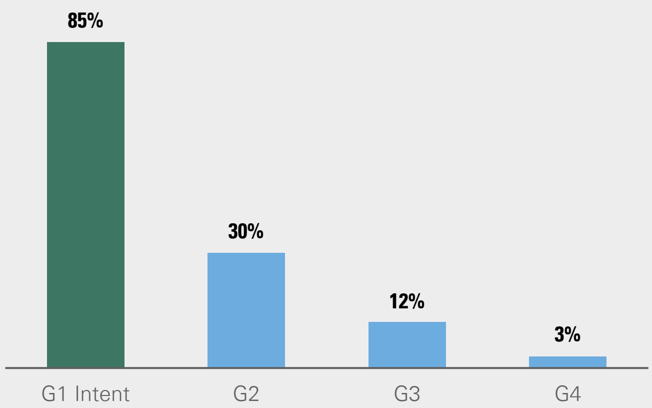
Most founders would like to keep their business in the family as long as possible and employ future family members for many generations.[3]

[1] U.S. Census Bureau's 2012 Survey of Business Owners.

[2] We refer to family businesses in this piece for purposes of simplicity, but the challenges and solutions presented here apply equally to other family-owned entities, such as family offices, foundations, or pooled investment vehicles.

[3] According to a 2003 American family business survey by Raymond Institute/MassMutual, 85% of family-owned firms that have identified a successor say it will be a family member.

Exhibit 1: Beating the Odds — Family Businesses Passing Successfully to the Next Generation



Sources: Raymond Institute/MassMutual, American Family Business Survey, 2003; Joseph Astrachan, Ph.D., editor, Family Business Review, 2003

It rarely happens. In fact, only 30% make it to the second generation, 12% make it to the third, and almost none survive to the fourth.[4]

Why, then, is keeping a business in the family so hard to do? It could be a result of an inability to come up with a leadership succession plan. Or the lack of estate planning (or the right estate planning). Or a failure to invest in the business to keep up with the times.

While these are all legitimate reasons, failure to keep the business in the family is often the result of something more fundamental: family dynamics. As family businesses grow beyond the founder/owner, single-decision-maker stage, complexity grows rapidly, requiring family members to develop more sophisticated skills and processes around decision-making and conflict management.

John Davis, who currently leads family enterprise programs at MIT's Sloan School of Management, and Harvard Professor Renato Tagiuri introduced the Venn Diagram in Exhibit 2 over 40 years ago, and it continues to help families understand the different roles and responsibilities involved in a family business.

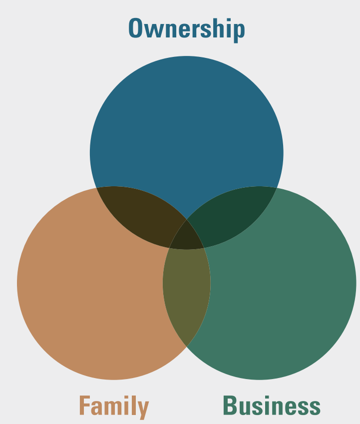
Typically, in the founding stage of the business, many families are close to the center of the diagram — they are family members, business owners, and business managers. At this stage, problems can arise with regard to overlapping roles. Family members are not always clear about what lenses they are using to make decisions. Are they speaking as owners, family members, or as participants in the business?

As a family and its business grows and members of the second and third generation become owners and/or owner/managers and spouses join the family, more people are located in outer parts of the diagram, and there is often less of an overlap. While that can sometimes provide a certain degree of role clarity, it also leads to competing interests. With more family members inevitably less connected to the business, communication lines can become fragile, and back channels can occur.

Unfortunately, busy family members are often slow to recognize this swiftly mounting complexity. As a result, they fail to establish critical decision-making processes and frequently end up feeling "stuck" when it comes to making business decisions and resolving issues. Such a situation can cause serious damage to the business — damage that can happen quickly and then persist for years.

Exhibit 2: Various Constituents in a Family Business

Three-Circle Model of the Family Business System



Source: Tagiuri and Davis, 1982

[4] Joseph Astrachan, Ph.D., editor, Family Business Review

Four Common Challenges

Family businesses face numerous challenges, many specific to each individual family, but several do tend to appear frequently:

- **The sticky baton effect.** While a founder's powerful vision can be a great help — and, arguably, a necessity — when it comes to growing a successful family business, it can work against succession by suppressing other voices. Many founders talk about succession, but when it comes to transferring real authority to the next generation, they just can't bring themselves to do it (they can't pass the baton), either because the business is an essential part of their identity, or because they're concerned that the next generation might not be ready to take on that heavy mantle, or both.

- **Confusion around family and business goals.** As a family expands, family members naturally tend to have different priorities and points of view. A family shareholder may prefer distributions over reinvestment in the business, for instance, while a shareholder working in the business may well prefer the opposite. They both have valid — but opposing — interests. And that's just one example. There can often be a lack of clarity around family ownership, employment, and compensation. Who is considered family with regard to the business? Who is an employee? Who can own shares? Do they pass to a spouse if a lineal owner dies, or do they stay within the bloodline? Do in-laws have a say? Do all family members working in the business receive the same compensation? These confusions and resulting conflicts can often become complex and serious.

- **Family members have stopped listening to each other.** When family members aren't listening to each other, it can trigger all sorts of conflict. They may not be speaking to each other at all, or maybe they are speaking, but they inevitably find themselves tangled up in the same unproductive conversational cul-de-sacs. Maybe they're making broad assumptions based on past roles they've played in the family. Maybe they're responding to a lack of transparency in the business. Whatever the reason, distrust prevails, and constructive engagement disappears.

- **Risk appetite changes.** Often in the second generation, but even more so in the third, the appetite for assuming business risk decreases. After all, it's one thing to build something from nothing; it's another entirely to have a great deal and not want to lose it. When a founder pressures the children to be entrepreneurial — whether they are temperamentally suited to the role or not — they have a tendency to make unwise decisions that they're not really comfortable with, which can damage the business and erode the family's fortune, sometimes very quickly.

All of these situations can wreak havoc with family dynamics, creating an atmosphere of anxiety and frustration. Sometimes this can lead to extreme levels of avoidance (e.g., one sibling going to great lengths to avoid crossing paths with another sibling), opposing factions, and deep levels of disrespect. At these times, it would seem that the best thing for everyone is just to sell the business and hope that family peace can be restored. Sadly, such measures rarely solve the underlying problems; in fact, they can actually make matters worse.

Fortunately, there are ways to improve family dynamics that don't necessarily involve throwing in the towel on a family business.

Some Families Have It Right — What Are They Doing?

In our experience, all family businesses that have survived through the fourth or fifth generation have both good family governance and good business governance. Family governance borrows elements of classic business governance but speaks more directly to the complex dynamics of a family system. Family governance clarifies why the family wants to remain together as owners, what to expect from the business, what not to expect, and what is expected of the family when it comes to the business. When both family and business governance are in place and rules of engagement are clear between the two, sustained success is possible.

A Sample Vision Statement

- Our family mission is to continue to strengthen the family's stewardship mindset with regard to the family and the business, leaving a legacy that the next generation will embrace and support.
- For our family, we hope to give rising generations the most solid base we can — of family harmony, of education, of shared experiences — so they can aspire to contribute in their own unique ways to the growth of the family's human, intellectual, social, and financial capital.
- For our business, we want it to operate in a manner that reflects our values and enhances its reputation and legacy. We embrace meritocracy and accept the risks related to pursuing profitable, long-term growth.
- We pledge to revisit our vision and decision-making process with each generation, making adjustments as necessary.

When it comes to family governance, there really is no single best practice for every family, so we'll call them "good" practices that may be appropriate for your family:

- **Articulate a shared vision.** Having no explicit vision, or a vision that is the founder's alone, can be a recipe for failure. Having families grapple with fundamental questions — What do we stand for? Why do we have a business? — isn't always easy, but it is critical for all family members to explore their dreams and individual interests in the family business to arrive at a vision and plan that everyone can agree upon. Such a vision should be put in writing and reaffirmed with each new generation.
- **Build the family's capacity for communication and conflict management through regular family meetings with a skilled facilitator.**
  - Ensure all voices get heard. Effective communication is impossible when only the founder or another family member dominates the proceedings. An experienced facilitator and a code of conduct can help keep everyone on track.
  - Build out communication skill sets through practice. A facilitator can guide family members through practice sessions on conflict resolution, giving feedback, negotiating, and teamwork. Among other things, participants will learn how to identify and address areas of potential conflict before they have a chance to grow into full-fledged disputes.

Case Study: Governance Can Help When Communication Breaks Down

A family imposed strict transfer restrictions on the shares of its business to keep ownership in the family. This seemed to make good sense, except one sibling desperately needed money and didn't want to be part of the business. Her siblings were unaware of her situation, and she became increasingly estranged and uncommunicative.

Since she couldn't cash out, she was stuck in a business she no longer wanted to be a part of — a lose/lose situation.

But the family's code of conduct required her attendance at a family meeting, and she showed up — in the back of the room with her arms crossed, but she was there. Since they had established effective communication processes, she was finally able to inform the rest of her family about her situation.

At that point, the family was able to find a way to provide her with a loan to ease her financial distress. They also took the opportunity to create a prudent redemption policy.

In short, they were able to find a solution that worked for her and also the family business.

  - Celebrate family: Regular family meetings can help family members enjoy each other's company and feel connected beyond their shared economic interests. Building up a positive memory bank of shared experiences can be called upon when tensions emerge.

- **Establish a framework for decision-making (aka governance).** For many people, the term governance conjures up images of a big company with inflexible rules, but it doesn't have to be — and really shouldn't be — that way. Effective family (and business) governance systems are flexible, and wherever possible, the rules are simple and straightforward. In our experience, complexity in a family business can come on fast; effective governance keeps things as simple as possible.

Family Governance

As important and useful as they are, the formal legal structures and documents related to a family business — articles of incorporation, shareholders agreements, investment and distribution policies, and sometimes trusts — generally aren't flexible enough to effectively address the complex dynamics of family member relationships and the family's relationship with the business.

Family governance can help by providing a framework that allows for the good practices described above. In essence, it serves as a structure that clarifies roles, responsibilities, and processes for family members, and improves communication both within the family and also between the family and the family business.

The principal governance tool is the family constitution (sometimes referred to as the family charter or simply the family agreement). This document, tailored to the specific needs of each family and then amended as needed, typically serves as a roadmap for accomplishing the following:

- **Preserving the family's history and values and documenting a shared vision.** The first step in developing a family constitution is articulating the family's values and goals in the form of a mission (or vision) statement. What were the founder's motivations for building the family business? Do they continue to make sense for the family now? Have they changed? Why have a family business? What do you want to accomplish?

- **Establishing basic family governance structures.** The constitution typically includes a variety of detailed policies and procedures regarding employment of family members, compensation, distributions, ownership transfers, redemptions, loans from the business, and the succession process, among others. There might, for instance, be policies regarding prenuptial agreements, how and how often shareholders are informed about the business, or policies regarding confidentiality and public relations (this is particularly important in the event of divorce). Agreed-to procedures around when policies are reviewed and how recommended updates are handled are important parts of the governance process.

- **Allowing the family to speak with a single voice to the business's board of directors.** Without that unified family voice, messages can quickly become muddled and disruptive to the business. Establishing a family assembly (typically open to all family members above a certain age) and a family council (a smaller representative body), and subcommittees — perhaps focusing on next-gen education for future leaders and owners, family meeting planning, and other issues — can increase family unity and help to provide a unified family voice and point of view.

- **Providing a forum and process for conflict management.** Disagreements among family members are inevitable; the key is to address them before they grow into full-blown conflicts that damage family relationships and threaten the well-being of the family business. A clear process and venue for addressing any issues that arise is critical. Formal family meetings or family councils can often be helpful in this regard; in addition to protocols that ensure safe and open communication, the services of an outside facilitator can be worth considering in certain situations.

- **Preparing the next generation for a possible role in management/leadership of the family business.** The next-generation education process can and should begin as early as possible with age-appropriate programs and activities — workshops, seminars, mentoring programs, peer groups, and others. A junior council, even if it doesn't include any actual voting rights, can be an important and direct way for younger family members to learn about the family's history, values, and the family business.

Business Governance

The goal of business governance is to protect and balance the interests of owners and the business in terms of financial goals; to oversee management (appoint the CEO) and monitor performance, compliance, risks, and compensation; and to advise on the "big picture," the company's direction, leadership, and organization.

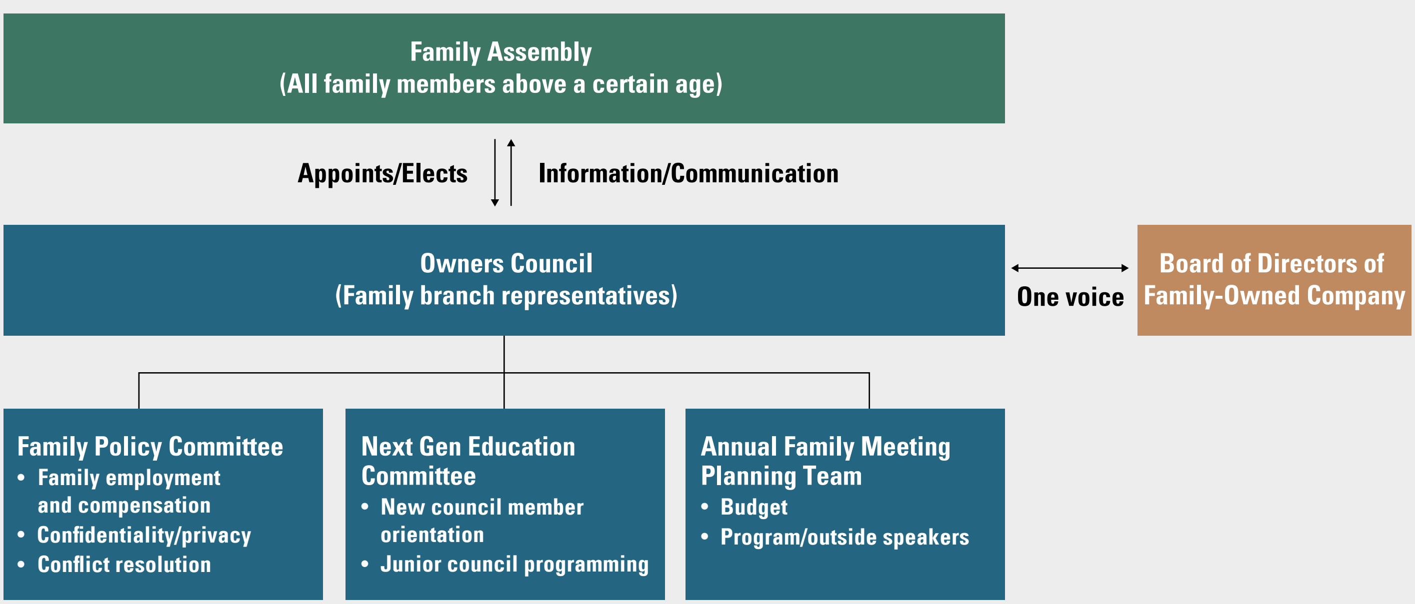
In many ways, business governance is similar to the corporate governance you'd find with a large public company, but because the family business usually starts smaller with a founder/owner and evolves over time, so too does the governance.

In fact, business governance usually progresses through a number of predictable phases.

In the beginning, there's usually a board that is often advisory in name only — a paper board with named family members (it's required when a business incorporates) but no actual board meetings.

Eventually, though, the board does begin to meet, and at some point, it begins to include some trusted advisors at these meetings, but they have no fiduciary obligations, and family members aren't required to take their advice. Nevertheless, this is an important intermediary step; it's the family beginning to open up the books to a slightly broader group that might have more relevant experience; it's like a test drive for the important next step, an actual fiduciary board, ideally with more independent directors than family directors.

Exhibit 3: Family Governance Structure



Source: Bessemer Trust

Case Study: A Junior Council Reminds Family of the "Why"

A junior council can be a great way to engage the next generation in the family business and begin preparing them for their future roles. They can also teach senior family members some valuable lessons.

In one example, a family in its fourth generation of business ownership was experiencing great anxiety about selling its legacy business, which was quickly being disrupted by competition. But family members, particularly the elders, had significant emotional attachment to it. Some wanted to sell, some didn't, and the disagreement was creating turmoil. Before a recent family meeting, an electronic survey of all adult family members conducted by Bessemer revealed many assumptions and myths related to the legacy business and the family.

Meanwhile, in a separate meeting, the family's junior council had just finished creating a poster board that depicted the family's mission statement and several financial concepts they had just learned about with Bessemer's family wealth stewardship professionals.

The junior council was delighted to present this to the rest of the family, reiterating the concept of stewardship that was so prevalent among its members, and reassuring the adults that the future of the family business was in good hands.

The climate of the room changed dramatically; it brought the family together, refocused them on their shared goals, and allowed them to move past their deadlock.

Consider a Family Business Consultant

Building governance systems requires ongoing attention and effort from the entire family, but the process can be much easier with the guidance of family business consultants. These highly skilled and experienced professionals can work closely with your family for an extended period — up to two years in many cases — to develop all aspects of governance, from the formation of a family council to drafting and ratifying a family constitution that makes sense for your family, assisting with succession planning, and steering your family through a host of other important issues. Bessemer has had the privilege of working with some of the finest family business consultants around the country and can help identify candidates based on your family's culture and situation.

Start Small, but Start Now

Establishing an effective governance system is not easy. The learning curve can be steep, and it's not always successful. But you don't have to go it alone. Bessemer Trust is itself a family-owned business that has transitioned successfully through six generations of family ownership — with a seventh in the wings.

Moreover, since our founding more than a century ago, we have helped guide many family businesses through multiple generations of family ownership, providing advice every step of the way.

While no one can guarantee that your family business will beat the succession odds, taking the time to establish good family governance can increase your chances for a smooth generational transition.

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