IV. Special Compensation Issues in Family Firms

Compensation planning touches so many aspects of the family business that it often raises a variety of other issues. Here is a summary of a few of them.

Compensation as a Catalyst for Other Crucial Planning

One reason compensation planning can be difficult is that it often unearths major unresolved issues.

Developing a compensation philosophy that ties pay to the goals and mission of the business requires the business owner to articulate those goals. That demands a foundation of sound strategic planning, an effort that may have to be completed before compensation plans can be laid.

Compensation planning also can raise questions about whether the CEO's pay and savings are sufficient to assure a financially secure, independent retirement. This can lead to a personal financial planning effort for the CEO and spouse which in turn often raises estate-planning questions.

Compensation planning also can raise questions about family members' role in the business and their collective mission as shareholders. As compensation is shifted to a more rational foundation, many families find it necessary to reunite as shareholders behind a newly articulated statement of mission or values. The result is what is often called a family mission statement or creed, or simply a family plan, as discussed in, *Family Meetings: How to Build a Stronger Family and a Stronger Business.*

These four plans—the personal financial plan, the estate plan, the strategic plan and family plan—form the cornerstones of sound family-business leadership and continuity through generations. Compensation planning frequently stimulates these planning efforts, and in fact can seldom be completed without them.

Retiring Family Executives

Ideally, a retiring CEO has planned and accumulated enough resources to sustain an independent retirement. As he or she hands over responsibility and authority to the next generation, pay can decreased down accordingly. In this ideal model, the business owner is paid appropriate to his or her contribution right up to the last minute of employment. He or she should not take more than needed, because estate taxes will be levied against assets remaining in the estate at death.

But the ideal is far too rarely achieved. Most retirees have not developed enough financial independence to sever their financial ties with the business. Many make the mistake of simply staying on the payroll. This not only compromises the compensation system, but it can raise awkward questions about

annual reviews and pay increases in a company trying to take a systematic approach to compensation.

A better solution may be to develop a consulting agreement for the departing CEO. A retiree may feel proud of such an arrangement. It allows him or her to sustain dignity and a sense of importance while achieving independence and control over personal time. It also allows the next generation to set a time limit on the cash outlay, while giving the retiring CEO adequate time to achieve financial security. A consulting contract might contain a provision that would continue benefits and partial payment under the contract to a surviving spouse, in case the retired CEO dies.

Ideally, the consulting arrangement should be as much like an arm's-length agreement as possible, priced at the market and evaluated by the executive committee or the board. In one case, a retiring CEO's long-term consulting agreement, entitling him to annual revenue equal to his salary at retirement, to be reviewed by the board every five years. The agreement, the board's compensation committee noted in its minutes, "reflects the value of (the retiring CEO's) role to the company." This honored the CEO while preserving people's respect for the compensation system.

Unfortunately, many retiring CEOs object to the idea of a consulting arrangement. Many find almost intolerable the idea that a successor is making more money than they are. This can force a family business into the costly situation of keeping a retired CEO on a salary that is continually rising to stay ahead of a successor's. In the worst cases, the retired CEO also continues to work part-time, interfering with successors' autonomy, and holds onto all the stock in the business as well. Such an arrangement can jeopardize the financial and strategic health of the business.

Again, shaping expectations can be helpful in avoiding such problems. Many family businesses beginning a systematic effort to plan for succession find that personal financial planning for the retiring CEO is an essential component. At that point, an active outside board or other trusted outside advisor can be of enormous help in identifying various financial options for retirement.

An active board can help smooth the retirement process. The departing CEO might be given a board fee or honorarium for acting as chairman emeritus. Though the retiree would not vote or even necessarily attend meetings, the board fee provides a way of channeling funds to him or her. The drawback is that this method risks people's respect for director compensation.

One of the most effective ways to provide necessary funds to a retiring CEO is to redeem some or all of the departing executive's stock. Repurchases must be carefully planned to coordinate with estate plans and be done with the advice of appropriate counsel.

Equal Pay in the Sibling Generation

Many family-owned companies pay brothers and sisters who work in the business equally. In fact, in our experience, equal pay policies exists in the

second or sibling generation. The rationale of these policies is that brothers and sisters should be paid equally if they are equal stockholders. After all, these owners reason, aren't their stakes in the business worth more than any differences in job salary? The shared risks and rewards of ownership may dwarf any concern about pay differences among brothers and sisters. For instance, if four siblings each own 25 percent of a business valued at $10 million, a 10 percent increase in shareholder value means that each partner experiences a gain of $250,000. Under this philosophy, compensation is treated as a tool to reinforce family members as a team of equal business partners focused on growing shareholder value.

Under one equal pay model, siblings might all become members of an executive committee as the older generation begins transferring management authority. Each sibling might be paid, say, $75,000 a year for serving on the executive committee or team, regardless of his or her base pay. This equal reimbursement for sharing the policymaking role sends a strong message that leadership is shared. It also conveys the view that each sibling is a "fraction of a president" in addition to his or her day-to-day responsibilities.

Another second generation equal pay approach is to establish a team with a designated leader. This sets apart one member of the team as a CEO or president. Under this model, siblings are paid equally, but one person takes final responsibility for decisionmaking and tie-breaking if necessary. The CEO would receive additional compensation, perhaps $80,000 a year. The amount of extra pay should not be enormous, but it should be enough to reflect a meaningful responsibility rather than a token title.

Sibling pay at equal levels can also be understood from a family perspective. There is tremendous external and self-imposed pressure on parents to treat children equally. It is a commonly applied rule in planning distributions of one's estate, in decisions to pursue co-leaders in the second generation, and all too frequent when parents make judgments about sibling pay levels.

A Case Of Equal Pay In A Manufacturing Company

In a manufacturing business the oldest of four brothers joins the business while his younger brothers are still in school. He does well in his sales role and is soon earning $80,000 assuming he hits his sales targets which he consistently does.

Two years later his younger brother approaches dad about a job in the business. His request represents a challenge to dad who expects his sons in the business will be equal partners, and thus wants to pay both his sons equally. The challenge is that his oldest, in his sales role, has variable pay, based on hitting sales targets, which is the same method used for all other sales positions. After consulting mom, his solution is to fix his oldest son's pay at $80,000 and pay the younger one $80,000 in his position as a shift supervisor in the assembly department of the plant.

Even though he feels it unfair, the oldest son decides not to make an issue of it. Yet, he does make the point of telling his spouse that he now feels underpaid,

as his inexperienced brother is earning the same as he. Yet, after a while he adjusts to equal pay with his brother as raises come regularly for both. His brother helps the situation by being a dedicated and hard worker and quickly establishing himself as an innovator in his department.

Comments On the Case

What if the younger son did not excel in his position? We know of several family firms where deep resentments owe their beginning to equal pay for unequal contributions. In the worst cases, the best performing sibling leaves the business feeling underappreciated, or severe conflicts between the siblings emerge just as the parent begins to scale back or retires.

That said we also know of many sibling teams who pay themselves equally and could not imagine doing otherwise. These sibling teams justify equal pay because they share leadership decisions, demonstrated by weekly owner meetings and well-understood, clear rules about the kinds of decisions which require the owner group and on what company functions each owner unilaterally directs.

Other businesses may base family members' paychecks on the market value of the jobs they perform, but they also want all to enjoy a certain minimum income to sustain comparable lifestyles. So they guarantee a "minimum family income" to all. For example, in one business with two brothers and two sisters, a guaranteed minimum family member income of $200,000 was established. A salary based on the market value of each sibling's position in the business was added to that, and an opportunity for additional merit bonuses was afforded family members in key positions. An advantage of such an approach is that money received by employees because of their roles as family members is clearly identified as such, and doesn't send mixed messages about the value of the job they perform in the business.

Compensating Family Members in Unique Roles

Family Governance Positions

Some business owners extend compensation practices to unique family roles. For example, the chairperson of a family council may receive compensation, and in some cases all members of the family council are paid for their services. Others have justified compensation for a committee of next generation family members formed to begin the process of working together as a team with tasks like creating their own new shareholder education program, creating codes of conduct and drafting family employment policies. These business owners argue that family council work and succession preparation work is vital to long-term success of the family business and is deserving of a salary or special fee, similar to board fees. A further benefit, they argue, is that the participants will take their responsibilities more seriously if there is compensation involved, as will others' whose respect matters, such as other family members, board members and members of management.

In our experience, paying for roles outside the formal business is not a trend. Most family businesses will not choose to pay family members for their family governance roles. The most common argument against the practice is that family members are owners or spouses or children of owners, and their efforts will add to the value and long-term stability of their investment. They will receive their rewards as owners and investors in their family company. Paying an individual to add value to their own investment seems redundant to these business owners.

For family firms paying for family governance roles there is little guidance as to what might be fair pay. Few external benchmarks exist. Salary surveys for non-traditional roles in family firms are not available. Some use directors' fees as a comparison, yet most are more arbitrary.

Unique Roles Inside the Business

Another common compensation challenge for family firms is a non-traditional family role inside the business. Such positions are only filled by family members, and thus have few guidelines for appropriate compensation. For example, family businesses will create jobs for younger family members who will become future shareholders in the business, i.e., internships. Other roles might be designed around the skills of an individual, with the rationale that a family member in the business will be a better employee, that a family member could benefit from this opportunity to be involved in the family enterprise, or that it is a way to entice a move home by a young couple with a new family now residing far from grandparents. Examples of such family roles include:

- a "special projects" job involving a series of business-enhancing assignments;
- a management development program that includes a tour of many of the departments in the business;
- a part-time CFO who conducts analyses and monthly reviews of the financials in addition to her regular job as a financial analyst in a large regional bank;
- an "assistant to…" position putting a family member in a spot where he or she gains direct exposure to issues critical to the business; or
- As a liaison with the family shareholder group, seen in family firms with many outside shareholders.

Family firms should approach employing family members in non-traditional roles with great care, as it is harder to demonstrate equitable compensation for these roles to other family members and employees, notwithstanding the challenge of them being seen as making a valued contribution. Characteristics of the business and the family that have the most success with non-traditional family roles include:

1. Objective procedures for establishing goals, measuring performance and providing feedback, and thus accountability;

2. Good family communication about the procedures used to appoint an individual to a non-traditional role, indicating how accountability will work;
3. Above-average understanding of compensation practices, particularly internal and external equity (see Chapter III).

To arrive at fair compensation we recommend a job evaluation process like the one described in the previous chapter guided by an experienced professional.

Compensating Experienced Family Members to Join the Family Business

A best practice for family firms is for younger family members to work elsewhere before joining the family firm. Doing so may result in the individual pursuing a career outside the business for several years before expressing an interest in working for the family. Sometimes after a certain age (often after reaching 30), a younger family member who originally intended to stay with a career in another field, finds a new appreciation for working for the family firm. And there are some family firms that, because of their small size, cannot support a successor to the business' leader until the late stages of transition. When it is the right decision to recruit and hire a family member, how can it be done when there are large compensation differences between the family business pay scale and the compensation of the family recruit?

The challenge is to bridge the compensation gap and stay consistent with the company's internal pay system (internal equity) and the family's philosophy of fair pay. Some young family members might have the capacity to take a pay cut to join the family business and rationalize it as a fair tradeoff for the value of the future opportunities. However, we more frequently see the opposite. The very capable individual that the family firm wants to attract and hire has been successful elsewhere, perhaps in a high cost of living region of the country, and the individual's lifestyle is in keeping with his or her income, i.e., private schools, home, a spouse who may not have to work, etc. The result is a gap in the pay and benefits for the role that makes sense in the family firm and what the recruit is now earning, and there is a strong desire on the part of the family recruit to make an equivalent transfer. It may be that the decision makers in the family who are attempting to recruit feel the same way—we should not ask our cousin, son/daughter, or brother/sister to take a pay cut, or at least not a big one.

We are strong advocates of trying everything possible to make the recruit regret-free about taking a role in the family firm. Here are ways in which creative and persistent family firms have dealt with the gap in pay:

1. Up-date the external pay comparison—If the external pay level has not been checked recently, doing so may result in an upward adjustment to the fair market pay range for the position. Ask, what would

we have to pay if we were attracting a non-family candidate to fill the target position, and we were competing for high potential talent?

2. Maximize the use of variable compensation—By taping into bonus programs currently in place or by initiating an incentive bonus based upon achieving clear goals, salary can be kept within a market range, while total compensation at the end of the year can more closely match pay in a previous position.
3. Subsidize differences until increased responsibilities and associated pay come back into balance with previous pay level. Families, especially parents, using assets available to them outside of the business, make up some or all of the differences with financial gifts that close the gap between what the family business can pay and a previous salary. This can also be accomplished with the gift of a residence, funding of children's educations, or some other means of off-setting the difference. This approach allows equitable pay, yet reduces the income gap felt by the recruit.
4. Take advantage of cost of living differences—Some family firms approach negotiating a pay package when there are big gaps in pay as, not to make pay equal, but to make the lifestyle equal before and after the move. If the recruit and his/her family are moving from San Francisco to Grand Rapids, Michigan, the significant reduction in cost of living can be a factor when settling on compensation while preserving lifestyle options in the new environment.
5. Special projects allow a rationale for increased compensation—Special projects in family firms may include upgrading the information technology system, establishing innovative sales tracking and customer information systems, or measuring actual costs across multiple products. Projects may be added to a standard role, for which compensation is at market rates, with appropriate added compensation fitting with the project. Many projects can be priced by comparing the cost to the company if a consultant were to perform the project.
6. Signing bonuses and other add-ons—It is a common practice on the part of businesses seeking to recruit highly qualified employees to use significant signing bonuses, and employment contracts with special variations from the standard pay and benefits of other positions in the company. This is especially the case when the supply of good candidates is limited. The same case can be made for a family member recruit, but only if they are exceptionally qualified.

Finally, it may be the case that the chance to someday qualify for a top position in one's own family company represents such a significantly better opportunity than a recruit's current position, that a reduction in pay and benefits is justified. Or, it may be that there is just no way to make an individual whole in

the transition, and pay cannot be matched. If the gap has been significantly reduced but there is still a difference, everyone may have to find a way to live with it. Yet, there are many very capable family members working for their families at half what they could make in another business, but they would not hear of leaving.

Beyond Compensation: Other Forms of Cash Flow to Family

Dividends and Distributions

Although dividends or distributions are fundamentally different than compensation, the two are often confused. Owners and family employees should clearly understand the distinction between the two. Such confusion recently was exemplified by a college professor who does not work in the business, but whose sister does and with whom he shares ownership. When asked if he approved of his sister working in the business their parents founded, he said, "I do not approve of my sister working in the company as she now takes more out of the business than I do, even though we are equal shareholders."

Compensation in the form of hourly wages, salary, bonus or sales commission, is for employees who have a job in the business, whether family members or not. Dividends are paid to owners of the business, whether they work in the business or not. Dividends are a form of return on investment and are paid as a portion of annual profitability of the business. Therefore, a dividend amount should never be related to the compensation of a family member who works in the business. The dividend amount paid to a family shareholder is based upon how many shares they own, and how much of the company's profit the board determines is prudent to distribute to its shareholders.

In family companies, dividends are rarely paid during the first generation when the business is being built and growth is fueled by retaining earnings. In the second generation, a business may have all owners working in the business, and the sibling owners may still forgo dividends opting instead to use the earnings to fund expansion. Dividends or distributions paid out often emerges for the first time when there are shareholders who do not work in the business, although we know many family companies whose external shareholders view their stock as an heirloom or stewardship responsibility and do not expect a return on their inherited portion of "Dad's business." Dividends are most often initiated when family members begin to view their ownership as taking on investment characteristics, often by the time the third generation acquires control of a successful company. Still, many may feel conflicted about their ownership; seeing it as a combination of an heirloom and an investment.

Dividends are typically structured in three ways:

1. Constant dollar—a fixed amount that is paid to shareholders each year, e.g., $2 million. This structure allows predictability on the part of shareholders and the company alike, yet may be difficult for the

company when profits are low as there could be little left over for business reinvestment with retained earnings after dividends are paid.

2. Constant payout ratio—a variable amount that is often based upon a percentage of after tax profitability (e.g., 10 percent of net after tax profits) or a percentage return on the stock price, (e.g., a two percent yield - $1.00 per share valued at $50). This structure pays greater dividends as profitability or value increases, thus sharing growing profits with shareholders while preserving earnings for reinvestment in the company.
3. Combination fixed and variable—an expected amount paid annually to shareholders, combined with a variable amount, perhaps with a maximum limit, or cap. In some years the variable amount may not be paid or be quite minimal, yet the fixed portion is always paid, unless suspended by the board of directors. This is often accomplished by establishing a certain dividend per share paid each year combined with special dividends paid in years of exceptional performance.

Dividend Practices In Family Firms—A Case

A third generation manufacturing business is a C corporation and has annual sales of $50.6 million, and after tax profitability of $6.072 million; or 12 percent. There are 600,000 shares outstanding owned in equal amounts by six cousins.

Several years ago the six (three sisters from one second generation member and three cousins; one each from three other second generation members) developed a dividend policy when their uncle, the second generation leader of the business, passed away. In a meeting one year after the uncle's estate was settled, they confirmed to each other that they were fully responsible as a team of owners for the business' success. They agreed that they would consider their ownership a stewardship responsibility first and an investment second. This was reflected in their shareholder agreement which placed a conservative value on shares of the business should someone want to or need to sell their stock, and in their family employment policy which specified market compensation as the basis for employed family members' pay. In the past, their parents had paid dividends in a discretionary way, deciding as a group each year how much they needed and what the business could afford. The cousins concluded that they needed something more formal and predictable for themselves and the next generation so they proceeded to develop the family's first dividend policy, which they later formally approved in a board meeting. The core of the policy document included the following:

1. We will pay dividends because we believe it is a healthy discipline for our management to generate a return on the shareholders' capital investment. We want our shareholders to be able to predict minimum dividend income, thus a conservative minimum will be paid out.

Upon Board approval, a fixed dividend of $500,000 will be paid out annually, in quarterly installments.

2. We wish to protect the low capital cost advantage of our business and, after the fixed return to shareholders, we will consider the capital needs defined by our business strategy and corresponding annual reinvestment before making additional dividend distributions. After board review and approval of the annual reinvestment budget, a variable dividend may be awarded when there are excess earnings. Thus, after year-end financial results are finalized, after consideration of the reinvestment needs of the business, subtracting the previously distributed fixed dividend portion, an amount over and above 10 percent of the net profits, may be paid out as dividends.

Utilizing this policy, for the current year a fixed amount of $500,000, or $83,333 was paid to each shareholder in quarterly amounts of $20,833. In February, after the financials were confirmed for the previous calendar year, an additional $512,000 was paid out, or $85,333 to each shareholder. In all, the business paid $1,012,000 as dividends; 16% of earnings.

Of the six, two cousins are employed as the CEO and COO in the business. In addition to their annual salaries of $210,000 and $160,000 respectively, they participate with the rest of the senior management team in a bonus program that awarded them 30% and 22% of their respective base salaries. Thus, for the CEO total direct compensation was $273,000; plus he received the same total dividend of $168,667 as did the other five shareholders. The four cousins outside the business used some of their dividends to buy champaign for their cousins in the business in recognition of the exceptional profits.

Comments On the Case

This family clearly understands the distinction between shareholder returns and compensation, illustrated by the fact that they do not mention compensation in their dividend policy, and there was no consideration of base pay when dividends were paid out. The use of a collaboratively developed dividend policy is a recommended practice often accomplished in a family council. One particularly good feature is that their philosophy is defined in the policy. Like a good family employment policy, philosophical statements allow for the family to return to the policy in later years and remind themselves of the basis behind the method, and even while there may be changes to practices, they can remain true to their values.

Some family firms pay dividends like public companies, based upon a return on the value of a share. This requires an accurate assessment of share price or market capitalization; an unknown in many family businesses. Yet if a value for market capitalization is established (often through an outside valuation), some family firms' dividend practice is to pay a fixed rate, for example a two percent yield, and a variable rate, such as 15 percent of after-tax profits. The rationale may be that it is a generous distribution, yet less than the New York Stock Exchange average, thus preserving their cost of capital advantage.

For smaller family firms wishing to formalize their dividend practices, simpler methods are common, such as the following two examples:

Policy Example One

Subject to board approval a Sub S business family calculates the maximum taxes for the sibling with the greatest tax liability, and sets the distribution at $20,000 over the tax amount owed. Even with equal distribution amounts, because of lower tax liabilities, some may have available as much as $75,000 after taxes, while the sibling with the greatest taxes will only realize $20,000 in cash. They have been doing things this way for years and it remains acceptable to everyone. They all are assured that they will have enough to pay their taxes each year and they count themselves lucky to have cash available after tax.

Policy Example Two

An even simpler approach is one based on cash flow. The policy states that "the dividend shall be 20 percent of free cash flow, determined after finalization of year-end financial statements." As an informal component of this family's practice, occasional special dividends are paid out. Annually, management and the board determine appropriate cash and debt levels for the company and when cash target levels are exceeded, special dividends may be considered.

Shareholder Liquidity

Another way that family members benefit from their ownership, independent of compensation, is through the sale of their shares. Like a dividend, liquidity is not a form of compensation. Shareholders can redeem or sell some of their shares facilitated in some family firms by an internal market. The ability to do so may decrease inappropriate pressure for cash from other means such as compensation, or selling the entire company to meet a substantial shareholder's individual goals or needs for cash (e.g., divorce settlement).

A recommended practice is that families define in their shareholder agreements how transactions may be conducted between shareholders (cross purchases) or between shareholders and the company (redemptions). The agreements define in advance how share value will be determined, when shares can be offered for redemption, the terms of payments, and when shareholders might trade their shares for cash. Some families, such as the third generation of a successful manufacturer in California, organize cross purchases annually at a meeting of the five majority shareholders. Those interested in selling shares are matched with family shareholders who want to buy in a process that gives a fair hearing to all parties. The advance understanding gives family members who might want or need cash an opportunity, to get their short-term needs met without pressures on others who do not need liquidity. One result for many is that the company is freer to remain consistent with fair market compensation practices for the family members who work in the business.

Benefits and Perks—Differences from Non-Family Employees

As a best practice, given enough business success and continuity, family businesses should as a rule provide only the pay and benefits warranted by the position held by family employees. This equitable, merit rule means linking compensation to organizational structure, tenure, and pay grade or general group of similarly important jobs.

For example, all supervisory positions are eligible for a profit sharing program based upon hitting productivity goals. Or, "four weeks of vacation are awarded after two years full time employment in salaried positions." Real challenges to family business owners are when:

- A new deferred compensation program is implemented for all at the VP level and two of the parents' children are in the VP ranks and two are not; or
- A son or daughter with young children gets divorced or loses a job and health insurance with it motivating a parent to add them to the company's group health plan.

In practice, particularly in first and second generation family firms, family members inside and outside the company are beneficiaries of the company's access to group benefits. Health insurance benefits are most common. One company we know with ten brothers and sisters in the second generation provide all employed family members with company cars which are replaced every three years. The "used vehicles" are then given to members of the extended family of cousins based upon a clear decision making rule.

Other examples of benefits provided based on family membership include education funds, vehicle fuel, use of corporate aircraft, and use of company owned condos in resort communities or vacation trips and sporting event tickets awarded to the company by vendors.

The trend with family firms is that what starts in the first generation may continue in the second generation. Many other groups of family owners make tough changes as part of generational transitions. By the third generation, we typically see family employees receiving market-rate compensation and benefits consistent with all other employees. The occasional exception we see in the third generation is extra time off or more vacation for family members employed in the business, justified in part by additional family governance obligations; e.g., attendance at day-long family council meetings or university-based family business center functions.

As with equal pay, qualifying for benefits because you are a family member is difficult to justify when challenged. One of the reasons family benefits disappear in the third generation is that third generation firms often come with shareholders not employed in the business who may object to additional vacation for their cousins employed in the business. "It costs the company money to provide cars to every family member working in the business which comes

right off the bottom line and reduces distributions to shareholders," said one family shareholder in arguing that such benefits should cease. A simple benefit like fuel for family vehicles can cause family conflict when some family members perceive others as taking advantage of the privilege. And as some successful family firms that have invested in aircraft for business travel, natural second generation competitive sensitivities can easily lead to perceptions of unfairness and resentment when a brother or sister takes advantage of the perk. The privilege may disappear right after the first time the non-family CEO must travel commercial because a family member is using the corporate jet to attend a concert in Las Vegas. (Use of aircraft leads to some of the most debilitating family shareholder conflicts in our experience.)

In the end, most family firms ultimately see the practice of providing company benefits to all family as a quagmire increasing proportionally with their growth in numbers, through the addition of spouses and children to the family. At some point family leaders realize that the practice cannot be sustained indefinitely and they must find a way to stop it. Chapter V covers ways family firms have extracted themselves from benefit difficulties as well as inequitable compensation practices.

Compensating Non-family Executives

Rewarding and retaining key non-family executives can be a continuing challenge for family businesses.

Using stock to compensate key managers is a tempting idea. It is an obvious way to tie compensation to the long-term value of the business—an idea many family businesses find appealing because of their long-term orientation. Also, handing out stock can seem a cheap way of rewarding key people. The idea is increasingly topical as more public companies use stock and derivative products in executive-pay packages.

But stock ownership should never be discussed casually with non-family employees. Offhand remarks can come back to haunt you. A business owner trying hard to lure a top recruit may drop a reference to the possibility that he or she "might own stock someday." Most business owners don't really want to grant stock ownership when "someday" comes. But many find that their casual hint has been transformed in the mind of the recruit into a promise, raising expectations—and major problems. Family businesses that are considering offering stock to non-family employees should formulate a policy before even raising the issue.

Because they usually want to restrict ownership to family members, most family businesses ultimately decide not to grant stock to non-family members. Moreover, by the use of so-called "phantom stock," incentives can be offered without conferring rights of ownership.

Phantom or Shadow Stock

Other business owners try to get non-family executives to "think like owners" without actually owning stock by using an equity substitute called

“phantom” stock or stock appreciation rights (SARs). The value of phantom stock is tied to changes in the value of the business. The formula might be based on changes in book value, an industry-based multiple of earnings formula or on some other measure of shareholder value.

For many family businesses, book value is the simplest and easiest-to-explain indicator. While book value is often understated, it still works fine as a “weather vane” for changes in the company’s value without reflecting the wild and often irrelevant swings of the financial markets. Larger family businesses may hire an independent valuation specialist to value the company based on such factors as: book value adjusted for changes in the price of assets like real estate; multiples of earnings before interest depreciation, taxes and amortization (EBITDA); and other factors.

Phantom stock allows the non-family executive to participate in any rise in the value of the business without actually owning a stake. In the family business, this approach can lessen the “us-versus-them” attitude that can develop among employees who may feel cut off from ownership. It also can encourage employees to think about long-term goals. When phantom stock matures, however, substantial cash is required to reward executives who benefit from increases in stock value.

Other Tools

Family businesses use a variety of other ways to reward non-family executives.

Some family firms give non-family key executives unusually high pay, perks or incentives, in an effort to make up for their inability to acquire stock or rise to the CEO position in a family-run business. This technique can go awry, however, if it results in increased secrecy or perceived inequities. In its most negative variation, the business owner might also make a point of frequently reminding the non-family executive of his or her high pay, in an implied threat or implicit demand for loyalty.

Deferred compensation is a potentially more constructive technique. To encourage the non-family executive to remain with the company, some business owners put income into a deferred compensation plan that may take five, ten or more years to vest. Even after vesting, some businesses make the money available only after the manager quits or retires.

While deferred compensation, often called golden handcuffs, can provide an incentive to stay with a business, it can backfire by driving executives to quit in order to get the cash. Some businesses make at least some of the money available earlier as a morale booster. Other firms always defer the compensation by three to five years. Asking for help from a compensation consultant or other professional advisor is usually wise when constructing complex compensation packages.

Participation in family investments is another option. Business-owning families may join in investment opportunities such as non-business start-ups, warehouse or equipment leasing, or real estate. Non-family executives may be

allowed to participate as well, usually in one of two ways. They may be allowed to invest at a discount, or they can participate in any investment gains for free. The problem with the first way is that it requires the non-family executive to risk personal funds based on the family's investment decisions. He or she may be reluctant to do so, and equally reluctant to tell the family why. The latter alternative gives the non-family manager the upside potential of the family investment, without exposing him or her to the downside risk.

Other family businesses allow non-family executives to own franchises or shares in related business units, suppliers or retail outlets for the company. This affords them an opportunity to participate in the benefits of ownership without diluting the family's equity stake in the parent.

Table 6 summarizes the pros and cons of a variety of ways of rewarding non-family executives.

Compensating Family and Non-family Directors

The same principles that guide compensation should rule directors' fees. Though abuses are common—with directors' fees being used to save on taxes or channel compensation to needy family members, for instance—directors' compensation should reflect "market values." The fee paid family directors should convey the significance of their role. If the board is inactive and a rubber stamp for the CEO, then membership should pay little or nothing. Otherwise, over time, family members will lose respect for the business and all its pay policies.

Role confusion is common, again because family directors sometimes play multiple roles—as owners, employees and board members. Briefly, family members who manage the company and also serve on the board should receive no board fees. Customary business practice dictates that board service is part of top managers' jobs. Their interaction with other directors is valuable partly because of their knowledge and understanding as managers of the business. If family members who do not work in the business are also on the board, they usually should be paid the same as outside directors.

Other questions may arise. A family member who is a shipping room clerk, but is also a director for family reasons, obviously isn't present on the board because he or she is a top manager. If the clerk is seen as representing family interests on the board, rather than simply attending as an inside director, he or she might be compensated for serving. (To maintain the integrity of the pay system and the board, the clerk should probably take unpaid time off for attending board meetings.) Similarly, a family member elected or chosen by other family members to represent family interests on the board may deserve to be compensated as an outside director. Having family owners on the board simply because they are family or because they work in the business, however, may not be a good idea.

TABLE 6

Incentives for Key Non-Family Executives

Concept	Advantages	Disadvantages
Discretionary Bonus	• Encourages clear goal-setting and comprehensive review.	• Rarely done well; usually uncomfortable for both parties.
Discretionary Perquisites	• Strengthens personal-family ties.	• Others may be offended; can create paternalism.
Annual Profit Bonus	• Related to ability to pay and to company performance.	• Not long-term oriented; profits can be affected by uncontrollable events.
Long-Range or Multi-Year Profit Bonus	• Ties employee to company longer; encourages more long-term view.	• Profits don't necessarily measure most important criteria (i.e., return on equity, market share, etc.).
Phantom Stock	• Long-term orientation and related to shareholder benefit.	• Difficult to value for private company.
Real Common Stock	• Long-term orientation and related to shareholder benefit. Confers greater emotional meaning or status.	• Complicated legal administration and difficult to value.
Non-Company Investment Opportunities	• Strengthens personal-family ties. Doesn't affect company's stock ownership.	• Not readily available. Any failure brings major disappointment.

TABLE 7

Some Common Reasons for Hiring a Compensation Consultant

- You want to set up an organization-wide incentive program.
- You want to overhaul compensation in favor of a rational system.
- Family shareholders not employed in the business start asking questions about pay.
- You find yourself giving all employees almost the same raises every year.
- You begin losing key non-family executives.
- Your outside board says you need one.

Objectivity in Compensating Family Employees—Board Compensation and Employment Committee

In Chapter VI on Building Trust, we refer to the value of an outside board of directors. One great return on the investment a family firm makes with independent directors on its board is when objectivity is needed for family employment decisions, particularly decisions involving compensation. It is of huge value if family members can be insulated from one another when decisions are needed such as:

- Annual raises based on performance against goals;
- A need to decide that the company should not pay directors fees to the COO (and CEO's daughter) just elected to the board; or
- The decision to include or not, the CEO and CFO (brother and sister), and other top tier non-family managers, but not the plant manager (the brother of the CEO and CFO) in a new senior management deferred compensation program.

That the family does not have to participate in such decisions because the independent directors are objectively evaluating the situation is invaluable because they look at the situation purely from the perspective of the guidelines the family continuity and the integrity of the business's merit system. Family members, confident of the fair process followed by the independent directors, can remain comfortably removed whether they agree or not with the ultimate decision. (See the Appendix for an example Board of Directors Compensation and Development Committee Charter.)

Objectivity in Compensating Family Employees—Using a Compensation Consultant

Many family businesses, particularly smaller firms, tap an accountant or outside directors for objective advice and counsel. Other, larger firms may use a compensation consultant. Some common reasons are listed in Table 7.

Compensation consultants are especially valuable for providing recommendations about pay for nontraditional family roles or when there is a dispute about family members' compensation. To achieve the greatest potential for acceptance of a consultant's recommendations, design the consulting process first. Family members agreeing on a document that contains the following items, and then faithfully following the steps will enhance trust:

- Qualifications of the consultant—favorable toward family business, meaning an appreciation of the complex nature of family and business together, general experience with the jobs to be assessed, confidence-inspiring to the decision makers;
- Decision among consultant candidates—clarity about who will decide on which consulting proposals;
- Scope of services and consulting fees—what decisions will be made and specific recommendations required from the work of the consultant, without over-specifying the consultant's methods (interaction during the proposal stage will help specify the methods, such as who will have access to the consultant and the consultant's access to company information);
- Access to the consultant's report—with whom and how the results will be shared?
- Final decision maker(s)—this individual or group may be seen as the consultant's client and should be carefully appointed to provide maximum trust from the extended family as well as those whose compensation will be directly affected. Among the options of those who might engage the consultant include a board committee of independent directors, the company CEO, or the company's human resource manager. The chances of success are greater when you avoid placing family members in roles that make decisions about other family members' pay.

If you turn to a compensation consultant, trying to negotiate prices is always advisable. As part of your total package, here are some additional services you might request:

- A procedure manual;
- An evaluation of perks;
- A presentation to directors, executives or shareholders on the findings and recommendations;

- Training or orientation sessions for employees or family members;
- A review of special issues such as director or sales-force compensation; and
- In larger companies, an annual review for one or more years to evaluate and fine-tune the system—for no extra charge. (Smaller firms probably won't need a consultant's advice more often than every two to three years.)