

FAMILY TIES

Planning for continuity

Family Ties is now established as a newsletter to help improve and preserve business family life. It complements the existing body of knowledge in the marketplace and I hope it will capture your interest differently from others as we explore the day-to-day phenomenon of the business family's relationship to one another and to the business as individuals, as shareholders, as family members and as employees. We will investigate the many proven systems and structures that help shape the values of a dignified accidental partner interaction.

In my company's 1998 Trends in the Family Business Environment survey, I observed, "accidental partnerships are becoming more complex" and "distinct decision making and accountability are gaining in popularity". This newsletter introduces and explains the terms "accidental partner" and "governance". In my consulting practice and research, I meet more and more business family members who are involved in complex stakeholding situations – ones that they never would choose. But, as these accidental partnerships evolve, the participants have to find a way to make sense of their relationship. They might be in business together, or inactive shareholders, or they might share in the management of the family foundation, but, whatever the case, good governance underpins the partner relationship and gives everyone the framework to listen, keep the peace, make decisions and enjoy a shared future.

At the annual Family Firm Institute (FFI) conference (www.ffi.org) recently held in Washington, DC my colleagues and I shared a lot of these thoughts. It appears that all over the world the opportunities facing family businesses have never been more spectacular (for example see www.fbn-i.org). To deal with these issues of business growth, leadership and more complex shareholder situations, business families are beginning to embrace more sophisticated leadership selection criteria, and governance systems than ever before. More advisory boards, owners forums and family councils are being established to foster accountability, improve communication, and to satisfy the increasing need for more sharing of information and

decision-making. Naturally, this has also strongly influenced the methodology for choosing competent family leaders who can straddle both the family and the business – a tall order for many next generation accidental partners.

For more complex situations where there are shareholders who are business employees and those who are not, the owner's forum is the key decision-making body. Depending on the number of shareholders, everyone with stock might participate or there might be a method of representation that makes sense. But, the importance here is the need for rules and guidelines to allow for smooth decisions that will affect how you enjoy a healthy relationship and a thriving business.



Aron Pervin, CMC

The family council is the family voice in the governance structure. Typically, this is the forum that represents everyone in the family, spouses and other non-shareholders, whether in the business or not. This is where the relationships, traditions, values, myths and rules are discussed and a creed or constitution developed, especially for family participation in the business.

It seems clear to me that the success of the family firm requires choice – the choice to develop relationships that work and rules that

provide the context for a healthy interaction. If we view family business problems as relationships with faulty communication patterns, we can focus on the here and now – not the past – and build interactions that work for the future. Establishing governance systems and structures is just the beginning of the journey – making the relationships work requires a strong commitment. This newsletter will try to help in these areas.

In the world of governance, we typically know that the shareholders choose the Board and the Board monitors the business, and that more shares or voting shares are important controlling mechanisms. Of note is the difference in the way shares are transferred in Brazil, where the laws specify equality to the next generation while in other countries, their laws allow for unequal share transfers. This has led to an interest by Brazilian business families in having fewer owners over time, but it is difficult to accomplish and gender differences exacerbate situations. North American and European cultures might share in this strategy, but, perhaps for different reasons. In India, families seem more interested in larger shareholder groups. At times, I have also observed some family leaders, especially those with a particular controlling nature use differing share ownership as a weapon rather than as a business decision or a legacy.

It appears that the hermetic seal of secrecy crosses all borders and remains a family business theme. Internationally, there appears to be a strong cultural resistance to outsider participation in private family affairs, unless forced by a financial lender. In Brazil and India, for example, an outsider on a family board is extremely rare, and, typically these independent directors would only serve on the "public" not the family board, or be part of the shareholder appointed audit committee. In North America, and in the UK, anywhere from 15% to 30% of family firms have a board, but the 85% insider rule reigns. The good news is that the use of outside independent directors is slowly gaining in popularity, as owners become more open to the value of good, objective advice.

Accidents will occur in the best regulated families.

Charles Dickens, David Copperfield (1850), Chapter 28, Mr Micawber

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What is Governance?

Pervin defines governance as the integration of systems, structures and processes that help balance the management of relationships and interactions between the accidental partnership, family business and business family.

As we know, governance in the family firm typically takes on an expansive role, as there are two constituents at a minimum to satisfy, the family and the firm. Indeed, personal goals and interests become increasingly disparate as the size of the family, ownership group and the firm continues to grow. These forces of separation are very natural and predictable, but destructive if left unattended.

Therefore, governance in the family firm is about the management of ownership relationships, and has two aspects: ground

rules and governing aspects. Ground rules and policies help families in business together address accountability, trust, commitment, roles and communication patterns in order to exercise fair and consistent power or authority in modelling acceptable behaviour. Governing implies a foundation of mutual interests that keep the family and the firm in a straight course or smooth operation for the good of the individual and the whole.

Finally, in order to be interested in governance, the business family must perceive that they are a family business rather than a closely held or privately owned enterprise. They must also be committed to a shared future, where everyone has an appropriate voice that is heard and acknowledged.

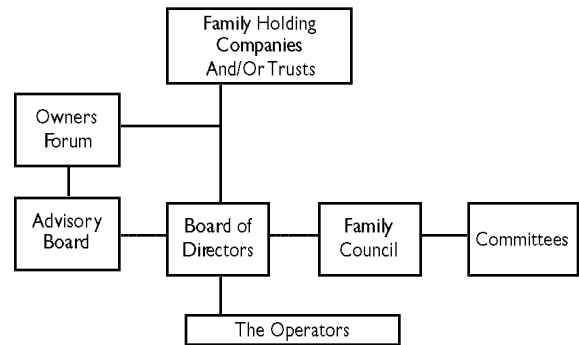
The key question to start the governance process:

What are my intentions and what do I want to do?

First consider:
Some Personal and Business Goals

It often helps to start the process by better understanding your personal and business goals. The next step is to explore how these can be achieved through the institution of an appropriate governance system.

Family Enterprise Organization Chart



Shareholder agreements

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As a tax and corporate lawyer with a practice involving family-owned businesses in Canada, I am constantly surprised by how many companies which are owned by various family members, are not governed by a legally binding shareholder agreement. In my experience, there are normally two reasons for this. The first is that the family believes that all business issues can be resolved amicably 'in the family' and legal agreements are not required. Alternatively, when the business started, it may have been very small and the shareholders believed that it was not worth the time or effort to enter into a shareholder agreement. As the business grew, a shareholder agreement was still not a priority. Sadly, I have seen many family businesses ruined because of management or ownership disputes between shareholders which could have been resolved without arguments or litigation if there had been a properly drafted shareholder agreement.

A shareholder agreement is a legally binding document which sets out the rights and obligations of the shareholders of a company. The agreement would normally cover the management of the company, including details relating to the board of directors (number, ability to name nominees and a description of the duties of the directors), how officers will be appointed

along with banking arrangements including signing officers. The agreement should also set out how major business decisions will be made, including the sale of a substantial portion of the assets, issuance of further shares, changes in the nature of the business carried on by the company and the entering into of major contracts. As well, there should be a method to determine the hiring and remuneration of employees, including shareholder employees and family members.

Frequently the shareholder agreement will also set out a policy regarding the distribution of company profits as well as how financing will be arranged for the company, including whether shareholders can be required to make compulsory loans to the company or to personally guarantee company loans. In addition, the agreement could deal with future marital disputes of shareholders, possibly requiring each shareholder to enter into a marriage contract which prohibits the shareholder's spouse from making a claim on the shares of the company. If appropriate, reference can also be made to an Advisory Board and/or a Family Council.

One of the most difficult issues to resolve in a shareholder agreement is whether shareholders have a right to transfer their shares to others (e.g., children) and when will shareholders be required to sell or buy from another shareholder. For example, what happens if a shareholder is incapacitated, dies or otherwise ceases to be an employee of the company? Who decides whether such shareholder retains his or her shares or is required to sell to active participants in the business? In addition, a properly drafted shareholder agreement will provide when shares can be transferred to outside third parties. The agreement may contain a right of first refusal which provides existing shareholders with a first

option to acquire shares if a shareholder wishes to sell to an outside party and 'carry along' rights which permit a majority shareholder to force minority shareholders to sell their shares if the majority shareholder wishes to sell all of the company.

The shareholder agreement should also set out a mechanism to deal with disputes between shareholders. For example, if there is a major dispute, can one shareholder force the other to sell or acquire shares? Perhaps a 'shotgun' provision would be included in the agreement. This would permit one shareholder to set a price for his or her shares and provide the other shareholder with a right to either buy such shares or sell his or her own shares at such price. The agreement could also provide for mediation and/or binding arbitration in the event of a dispute.

It is also usual for the shareholder agreement to include insurance provisions which provide funding in the event of death and/or disability so that the sale and purchase of shares between family members can be funded on a tax effective basis.

Provisions dealing with non-competition and confidentiality should be considered. For example, if a family member decides to leave the family business or is forced out of the family business, can he or she immediately compete with the family business and use confidential information, such as client lists? As can be seen from a review of these issues, a shareholder agreement involves numerous decisions and can be quite complex and time consuming. However, a properly drafted agreement should help a family business continue for many generations and eliminate disruptive family disputes.

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The accidental partnership is a powerful and bizarre family ownership phenomenon that arises due to circumstance – not choice. You do not choose these partners as fellow contributors to the business. Rather, you inherit them from the "lucky gene club" along with the family history of rules and relationships.

Do not create any illusions about the structure of the accidental partnership. It is pre-ordained, often tax driven, given to you with little or no choice and then expected to function as if it were a working group of peers who sought out, trusted and respected each other. No wonder it is a difficult relationship.

..Aron Pervin

How to make the best of an accidental partnership



by Aron R. Pervin, CMC

Edward turned down a chance to work for his family's thriving firm, and prospered with another company after graduation from university. Eventually, however, he relented to his mother's repeated requests and rejoined the family enterprise as president. Despite their problems - certain family members' alcoholism and ownership questions, for instance - he believed that he could help them.

Before long, Edward fell into the grip of old family grievances. His three siblings told him he had abandoned them, only to return believing he was better than them. His calculating older sister was making end-runs around others in her department. All the siblings wanted dividends, whether the business could afford it or not.

This is the world of the accidental partnership, the bizarre phenomenon of the family business, where partners are thrown together by circumstance and a common gene pool - not by choice.

Along with the reluctant partners come the unspoken rules and subliminal messages that characterize society's most basic social unit, the family. Dominance, acquiescence, resentment, pride, anger and dozens of other human emotions seem to be transmitted and received almost telepathically.

But in the accidental partnership, their intensity is multiplied. One cannot leave without breaking the partnership and the business and, perhaps, betraying the family.

Many accidental partnerships learn ways to co-exist, value differences and flourish into the next generation. The key is not to create any illusions about the

structure. It's preordained, often tax-driven, passed on with little or no choice and then expected to function as if it were a working group of peers who sought out, trusted and respected each other.

Making the partnership a happy accident and not a tragic one is really a matter of recognizing it for what it is. Your family connection got you in, and you now must find ways to develop a different relationship, a relationship that is accepting, trusting and dignified.

How do you do things differently? Step one is to develop a partnership creed. Set up monthly confidential meetings that focus on the family relationships.

These meetings are not about how business is going lately - they're about what people do, and what they want to do. Most family partners say, "We meet all the time," but, when probed, admit they deal with business issues and seldom address the relationship.

Try to break down barriers. Don't go to one partner's house - find private and neutral ground, perhaps renting a room at a private club or hotel. And don't share the discussions with others - even a spouse - until agreement is reached. Set the dates ahead of time and make them sacrosanct.

children in one family firm realized they were barely tolerating one another. The business was lucrative and they didn't want to kill the golden goose, but there was little hope of resolving their poisonous feelings for one another.

They decided to set down rules that they would follow in the interests of preserving the business for their own children to one day run it in harmony. Their first move was to challenge the family rule of participation.

After almost two years of discussion about what would be best for the family, the business and the partnership, they agreed to value competency first, instead of lineage. Working in the firm is now a privilege, not a birthright. They set clear rules for entry, staying in and exiting the firm.

Today, discussions are open to such an extent that some children - members of the third generation - have introduced the idea that they may not participate in the business. Now, the debate revolves around how they might sell their interests and to whom - a far easier discussion than one with overtones of betrayal of the family heritage.

While the partnership creed can be a lifesaver, it's important to treat it as a living organism. Don't believe that just because

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What's up for discussion? Everything, that affects power and progress for the people in the partnership. It's not just about decision making. Within families, there are plenty of buttons waiting to be pushed. Are there dynastic intentions or do the partners want to sell? Who can be a partner and own stock? Does the family head want to work until death? Does birth order matter? What are the dividend and compensation policies?

Sometimes, even the most combative families can make peace and limit conflict. With their father still active in the firm, five

you have made a decision, that's the way everything will work. Stick with it for a while and see how it works. Arrangements may change and evolve, and navigating the relationships could take years.

The accidental partnership is an arranged marriage, and therefore takes a special effort to understand and make it operate smoothly. Almost any relationship can be changed by those willing to put real energy into making it better. Most people know this, but few choose to act on the knowledge.