

# Changing Lanes

Transition planning for entrepreneurs and family businesses

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with compliments from



Edward Rosenfeld



Guiding Families and Business. Now to Next.

## Why have a compensation policy?

Cathy Penmaen is the VP of Sales and Marketing for Penmaenship Tool and Die, a company founded by her father, Thom. At age 40 Cathy is the eldest child and the only one of three siblings directly involved in the business.

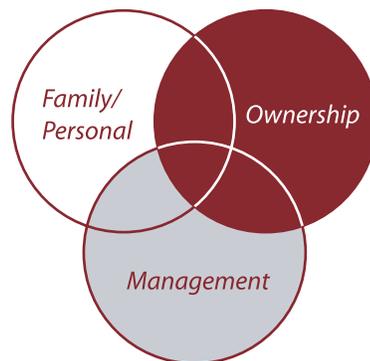
As the only son, albeit the youngest child, Derek is the favourite to eventually take over the company from Thom. However, Derek doesn't seem interested in his father's pride and joy. Much to Thom's dismay, he has aspirations of a music career and wants to take his share of the business to fund his venture.

Thom struggles with how best to support Derek while Cathy is upset at what she perceives as inequality among the siblings. "I feel I'm working for my money while Derek isn't. Yet he reaps the benefits," complains Cathy. Does Cathy have a legitimate concern? Is Derek even entitled to a share of the business?

**I feel I'm working for my money while Derek isn't. Yet he reaps the benefits.**

While compensation is an emotional topic for all of us, it is definitely something that can trigger issues within a family business. It is an area where many business families find it difficult to set aside their personal and family values to focus on the principles of running a good business.

About 25 years ago, the pioneers of family business consulting developed the 3-circle model to illustrate the importance of separating family issues from business issues. **This principle certainly applies when determining how family members will be compensated for their role in the business, or how shareholders are rewarded for their investment in the company.**



Tagiuri & Davis, 1982

The Penmaens need a compensation policy. They need to separate this issue into the appropriate circles or the confusion will lead to even greater conflict among family members.

Determining compensation is also a key component of a comprehensive transition plan. This issue of Changing Lanes includes a look at how entrepreneurs can ensure compensation issues don't negatively impact the transition process.

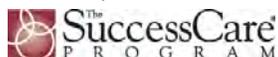
### Inside....

Separate the Compensation 2

Compensation is Key to a Transition 3

Entrance / Exit Compensation 4

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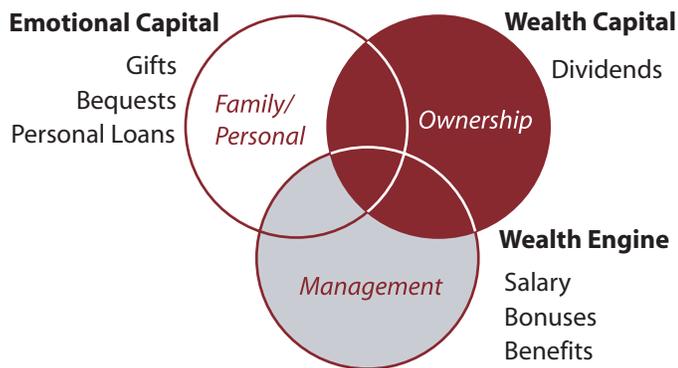
## Separate the Compensation

To understand why separating family from business is critical in determining fair compensation for those entering and exiting ownership of the business, and for those who will be involved in the day-to-day operations, we must first understand the key objectives of each circle.

### The Family /Personal Circle

We call this area of the family business the *Emotional Capital* as the key principle here is to support the individual family members and help meet their needs. Understandably, these needs include the ability for family members to have a level of financial independence so they can meet their financial responsibilities.

Families need to be clear that it is not the responsibility of the business to ensure those needs are met. In other words, family members should not be compensated for their role in the business based on the fact that they happen to be members of the family. Instead, financial support within the family circle might take the form of a gift or a personal loan between individuals.



### The Ownership Circle

The focus of the ownership circle is to protect and manage the asset that is the family business - thus the title of Wealth Capital. In terms of compensation, the objective of the ownership circle is to ensure that shareholders are compensated fairly based on their investment in the business.

## What about the Penmaens?

Thom has made it clear that all three children can choose to work in the business. However, it is important that Thom also makes it clear that each would be paid for the job that they do rather than an arbitrary amount because they are part of the family.

Compensation for a job well done belongs in the management circle. Therefore Cathy is entitled to fair compensation for her direct contribution to the operation of the business. If Derek chooses not to work in the business, he is certainly not eligible for a salary.

On the other hand, if Derek worked in the company, he would be paid market value for the role he played. Thom needs to be cautioned against paying both children the same amount in an effort to treat family members equally. Equality is a family principle and therefore must be addressed in the family circle. Paying market value for the job also ensures that non-family members are given the same level of respect. Thom values the contribution his employees bring to the business and would want to show respect in return.

If Thom wants to support Derek financially, there are other ways to achieve that goal. Financial support for family members might take the form of a gift or a personal loan between individuals. Even then, Thom still has to address Cathy's concern about preferential treatment for Derek!

A number of years ago, on the advice of his accountant, Thom assigned some shares to each of his three children. As shareholders, each child could receive compensation in the form of a dividend based on the return on their investment or ownership in the company. This is one way Thom could ensure financial support for Cathy, Diane and Derek while being fair to each and separating business from ownership from family.

Continued on Page 3

# Changing Lanes

Transition planning for entrepreneurs and family businesses

## Separate the Compensation *continued*

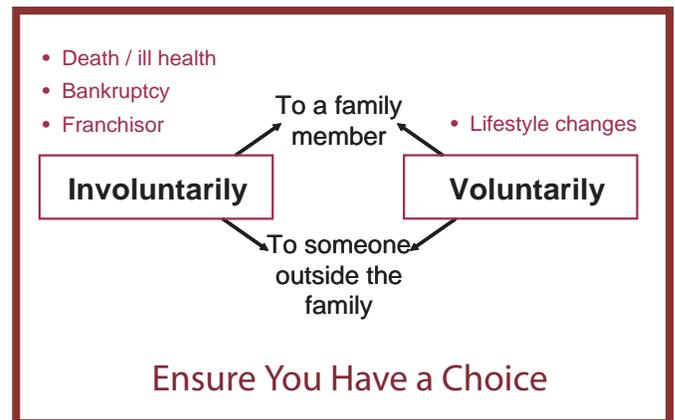
This compensation should be independent of the fact that a shareholder is a family member or working in the business. For example, shareholders can receive rewards for their financial or intellectual investment in the form of dividends or ownership bonuses.

### The Management Circle

The objective of the management circle is to build wealth by running a profitable business. To this end, compensation should be determined by assigning the market value for each role, regardless of whether that position is held by a family member or a non-family employee. Contribution in this area can be in the form of salary, bonuses or benefits such as health or dental plans. In some cases it may also be appropriate to include perks such as company cars or club memberships.

There are many factors to be considered in developing a structured compensation plan. We can help develop a plan that meets your needs. 

customers, suppliers and the franchisor, and build a strong management team. In addition, it is critical that you create processes and systems that will enable the business to function under alternative leadership – in other words, the business is not dependent on you!



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## Compensation is Key to a Transition

Determining compensation is an important component of every comprehensive transition plan.

While it is not a thought that many relish, the reality is that one day every entrepreneur will exit his or her business.

As a business owner, you will likely want to have maximum control over how and when to sell. When planning for that exit, your goals should be to ensure a voluntary sale and a choice around whether to sell internally to a family member or key employee, or externally to someone outside the business.

### Step 1

You have two choices. You can sell voluntarily – under your terms – or involuntarily as a result of a decision by your franchisor, poor profitability, or even death or disability. As a business owner, you can plan for a voluntary sale by ensuring that you keep the business competitive, maintain profitability, keep a positive cash flow, manage relationships with

### Step 2

Your next choice is to decide whether the sale will be an *internal* or *external* sale.

In the case of an *external* sale, determining the compensation for both the exiting owner and incoming owner is relatively straightforward. The ideal situation is to obtain what we call a 'fantasy' price for the business.

Arriving at an appropriate level of compensation for an *internal* sale can be more difficult. In this case, an affordability factor is added to the equation.

For more information on determining compensation for either an external or internal sale, turn to page 4.

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## Entrance / Exit Compensation

In the case of an external sale, the sale/purchase price will be based on a combination of the valuation of assets and the current or expected return on investment. The key is to clearly show a buyer how his or her investment relates to the profitability or expected return, how he or she can be compensated separately for the job they do, and how they can receive compensation for their investment when they eventually exit the business again.

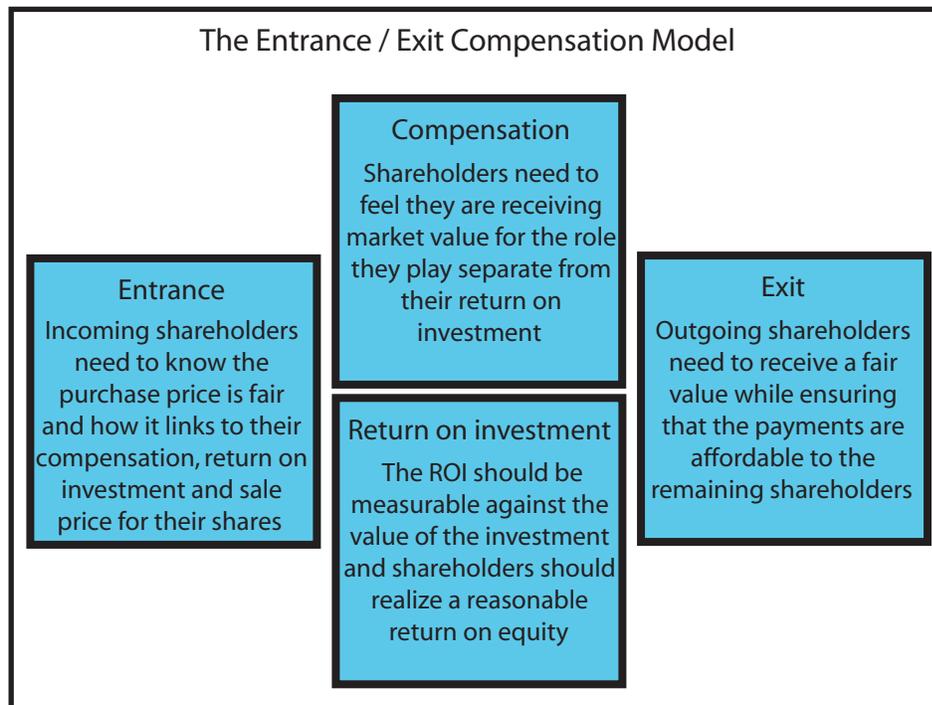
Occasionally, the expected return on investment can be substantial due to estimated restructuring or cost reductions on the part of the purchaser, resulting in a fantasy price for the business. So the ideal buyer is one who would enjoy a higher level of profitability as a result of the acquisition!

If the preferred option is to transition to a family member or someone already involved in the business, a balance must be found between the realization of value for the exiting shareholder and the affordability of the purchase on the part of the incoming shareholder. As most entrepreneurs have the majority of their wealth tied up in the business, a high level of certainty around how they will be paid for their shares is key. On the other hand, an affordable and manageable payment schedule for the purchaser is critical to ensuring that the transition is operative. Again, separating compensation for the shareholder's role in the day-to-day operation of the business from the return on investment as an owner is vital.

Making the distinction between compensation for ownership versus compensation for a job allows family members the

freedom to be owners in the company without working in the business. As a result, the family can pursue their value of allowing individuals to follow their own passion while still being connected to the family business.

Compensation is a big factor in creating the choice to keep or sell your business. If you follow the principle of separating it into appropriate circles, you will be able to manage the conflict that forces many transitions off track. We encourage you to contact us for guidance in this area. 



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