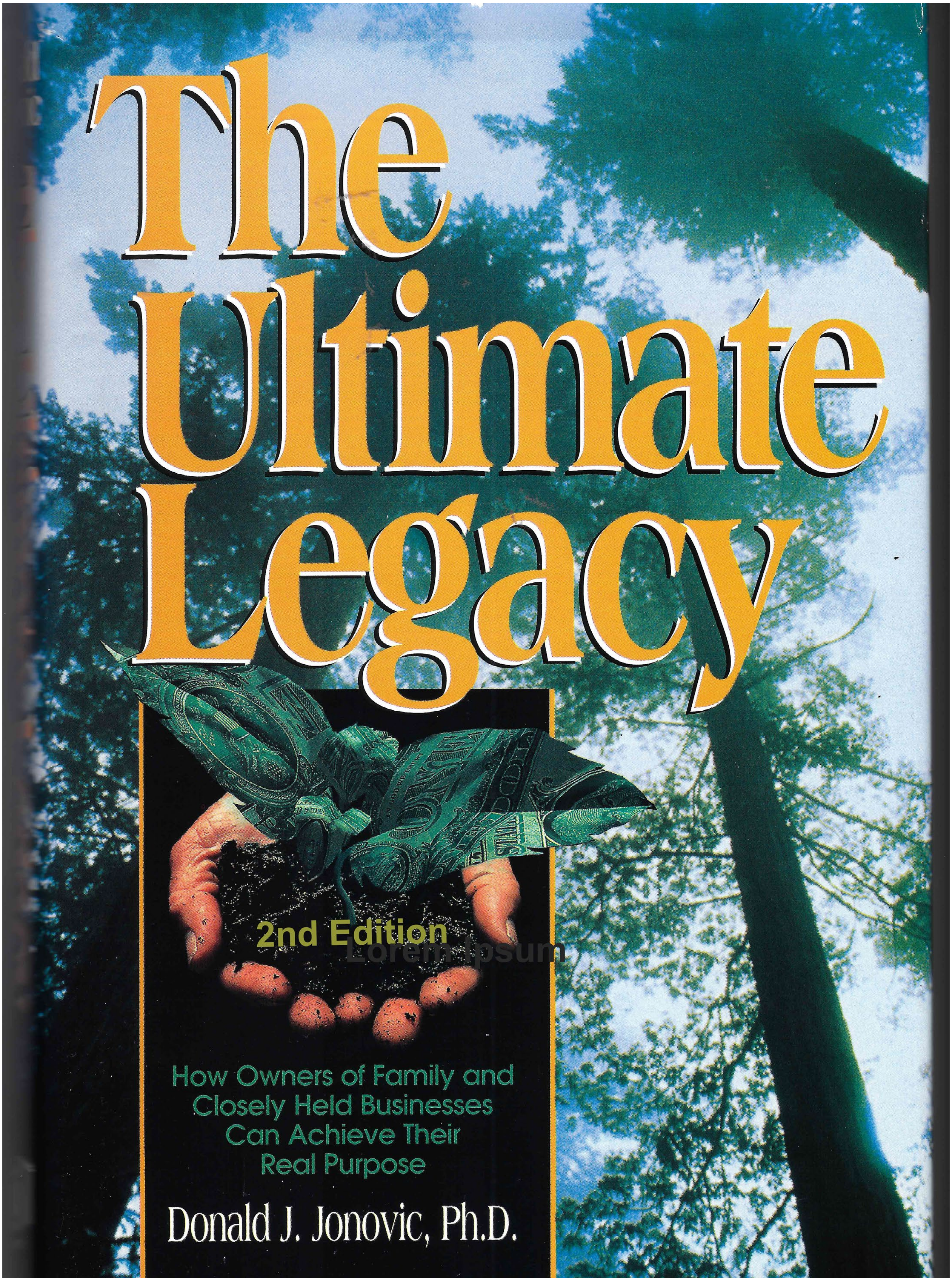
The Ultimate Legacy
2nd Edition
Lorem Ipsum
How Owners of Family and Closely Held Businesses Can Achieve Their Real Purpose
Donald J. Jonovic, Ph.D.

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DEDICATION

This edition is dedicated to everyone who has transformed from colleague to friend over my more than four decades as a family business advisor, and particularly to the many impressive men and women who served with me on boards of directors on which I have had the honor to join. The shareholders and senior managers of each of these companies have my enduring gratitude for the confidence and trust they placed in me and my fellow board members as we navigated the wonders and terrors of preserving and growing a family company.

Also, you all have my gratitude your generous sharing of wisdom and lessons of experience as my teachers.,,

,,,and, above all, to Pamela—my editor, friend, spouse, guide, defender, muse, counsellor and partner for a half century for our life together,

An advisor to business owners since 1978, ***Donald J. Jonovic, Ph.D.,*** *is a specialist in the management development, growth and ownership transition in the successful owner-managed/family business. In his consulting practice, he has worked with a wide range of family companies throughout North America, He has served on 20 family business boards.*

EDUCATION/ACADEMIC AFFILIATIONS. Dr. Jonovic holds a B.S. in Mathematics from Marquette University. He earned his M.A. and Ph.D. in Communication at the University of Wisconsin at Madison. Don conducted seminars in persuasion at Cleveland State University, and is former Director of the Ashland Institute of Private Enterprise at Ashland University, Ashland, Ohio. He served as adjunct assistant professor with the Communication Science Department of Case Western Reserve University.

PUBLICATIONS/BOOKS. Dr. Jonovic is author of 8 books on family business governance, planning and succession. He is co-author of one of the first books written specifically about independent directors on family business boards: *Outside Directors in the Family-Owned Business: Why, When, Who, and How (with Léon A. Danco, Ph.D., 1981*). His other published titles include:

- **Ag-planner/IV: An Agreement Builder for Family Agribusinesses**
- **Passing Down the Farm: The OTHER Farm Crisis**
- **Planmaker: A Growth & Succession Planning Workbook for Family Companies**
- **Someday It'll All Be Yours ... Or Will It? How to Survive-and Enjoy-Succession in a Family Business**
- **The Second-Generation Boss: A Successor's Guide to Becoming the NEXT Owner-Manager of a Family Business**

MANAGEMENT EDITOR & COLUMNIST. Dr. Jonovic was for 5 years a group publisher/editor of a family-owned trade magazine published for family-owned HVAC contractors. He later became one of the first nationally syndicated columnists on family business issues. His long-running monthly management column, **Can Their Problem Be Solved?"** in the Meredith Publications magazine, *Successful Farming,* reached more than 1 million readers. It was consistently rated one of the most popular features in that magazine since its inception in 1984. The column was recognized by the Magazine Industry Association as America's "Best Personal Advice Column of 2014.

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PREFACE TO THE FIRST EDITION

This book was in the "formative" stages for more than 10 years. Since *Someday It'll All Be Yours…Or Will It?* was published in 1982, I've been fortunate in developing challenging and productive long-term working relationships with a wide range of client companies. Together, we have built successful techniques and approaches and collected an expanding body of experience and, one could even say, wisdom.

Desire and accomplishment, as most business owners know, are two different things, however. It took the encouragement of Roger J. Warrum, and a series of meetings with executives at The Union Central Life Insurance Company's Family Enterprise Institute, particularly Charles W. Grover, to give me both the impetus and the support needed to dedicate the time necessary to writing this book.

Few, if any, useful ideas spring solely from one individual. Credit for whatever practicality and effectiveness is found on these pages must be shared with my clients, many of whom have become respected friends over the years, and, with whom, most of these ideas were developed and "field tested."

Among them (and it is impossible to recognize everyone) are William H. Darr of American Dehydrated Foods, Springfield, Missouri; Ernest D. Key, Jnr., of the Atlanta Belting Co.; Webb and Scott Cooper and Joseph Abramczyk of Belting Industries, Kenilworth, New Jersey; Clyde and Paul Snodgrass, of Clark-Snodgrass Co., Toledo, Ohio; Jack Day of Graphic World Printing Co., Cleveland, Ohio; James D. Olson, Brownlee Cote and all the members of the extended Cote family of Etoc Corp., Minneapolis; Ray Zukowski, Michele Canty, Ken Wakeen, and Robert Garon of Euclid Industries, Cleveland, Ohio; Jack Shaffer, John Gill and Rita Williams of Gill Industries, Grand Rapids, Michigan; Joel Marx and John Geller of Medical Services Co., Cleveland, Ohio; Carolyn Martin, Jan Sidley, Robert Sidley, and John Monroe of R.W. Sidley

Inc., Painesville, Ohio; and William E. Spengler, Sr., of Tolco Corp., Toledo, Ohio.

Ideas have intellectual parents, also. My early mentor, Léon A. Danco, planted many of the seeds. Other colleagues added greatly to my understanding of these issues, particularly Malvin E. Bank, James E. Barrett, Theodore H. Cohn, and Ernesto J. Poza.

In boardrooms, where the bullets fly and theory becomes practice having real effects on real lives, I have benefited from the experience and wisdom of fellow directors, particularly Frank S. Doyle, Jeff Grover, James Hooker, Walter W. Faster, Kenneth Kensington, Dale Lytkowski, John Warfel, Ed Waters, and James Weaver.

Special thanks are owed to George, Donald, Norman, and John Santa, to Ronald Case Sharp, and my fellow directors on the Santa Holding Co. Board, Paul R. Ruby and Dean M. Hottle, II, for their contribution to developing the concepts behind the retirement planning model in *Appendix A-11*. Also, particular credit is owed to Bob Purcell, Nick Schomacker, D.J. McVicar, and Randy Green of Atlanta Belting Co., for helping to develop the profit-based incentive compensation system summarized in *Appendix A-3*.

Most central and fundamental of all has been the unwavering support, insightful advice, penetrating critique and persistent focus on quality I’ve enjoyed from my business partner, best friend, and spouse, Pamela McNeil Jonovic.

DJJ
Shaker Heights, Ohio
September 1996

PREFACE TO THE SECOND EDITION

As a young destroyer gunnery officer in the late 60s, I once came across this statement in a safety manual:

"Every safety regulation or procedure herein was originally written in blood."

Now, a full half century later, as I finish the revisions to this book, I find that I keep coming back to that stark sentence.

Revisions to the first edition of this book are necessary to bring "The Ultimate Legacy" into "true," as a skilled carpenter would describe that elusive characteristic called "rightness." Absolute truth is not possible, of course, but this edition brings this book at least as close to *true* as I see it today—taking advantage of the more powerful lens provided by the intervening quarter century.

We have come a long way since my mentor, Leon Danco wrote his seminal book: "Beyond Survival," a work that launched a paradigm shift and an entire consulting industry.

There is no Theory of Family Business, not in the same sense of a physicist's theory of the universe. Instead, what we have is an expanding body of wisdom built, ring-by-ring like a growing tree, on the ancient core of the first human decision to join family and work toward generational legacy. From sacred texts, through Shakespeare, to books by experienced family business specialists, basic fibers and patterns and cycles have been experienced and reformed and reborn. Like the experience of standing before an ancient oak, revising this book in the light of a long career, inspires awe, respect, some amazement, and a powerful dose of humility.

This revision contains few *fundamental* changes from the 1996 edition. Foundational explorations of family enterprise were begun long ago by the likes of Virgil and Shakespeare. Humans remain *homo sapiens*, families continue to be clans, and individuals will ever be themselves. But we always learn. This book was, from the beginning, intended as an evolving "safety manual." It emerges from the lifeblood of many business-owning families, from the pulse of their drive to build something together.

The first edition was based on 25 years of experience. This revision draws on nearly a half century. Where fundamentals have changed, I have tried to point them out clearly, with justifications for the revised perspectives. My focus has been more on tuning and timbre than creation or original composition. In that, this essay is part of a continuing evolution of an ancient evolution toward full understanding, toward a more founded wisdom that will, I believe, come to even more full flower long after our "succession."

But isn't that what generational transition is all about?

DJJ
Shaker Heights, Ohio
August 2020

FORWARD:

A MOM'S LETTER TO HER FEUDING SUCCESSORS:

A letter sent by a frustrated client/mom to her heirs:

To My Dear Children,

For the past 5 years, as you each finished your education, married, and decided to join your Dad and me in our business, my hope and joy at your decision have been damaged by changes in the way you behave toward each other. Your natural sibling rivalries are evolving into a fierce competition among you and your spouses. You are each putting increasing pressure on Dad and me to give you individual advantages, benefits, and authority which your siblings (and their spouses) naturally resent.

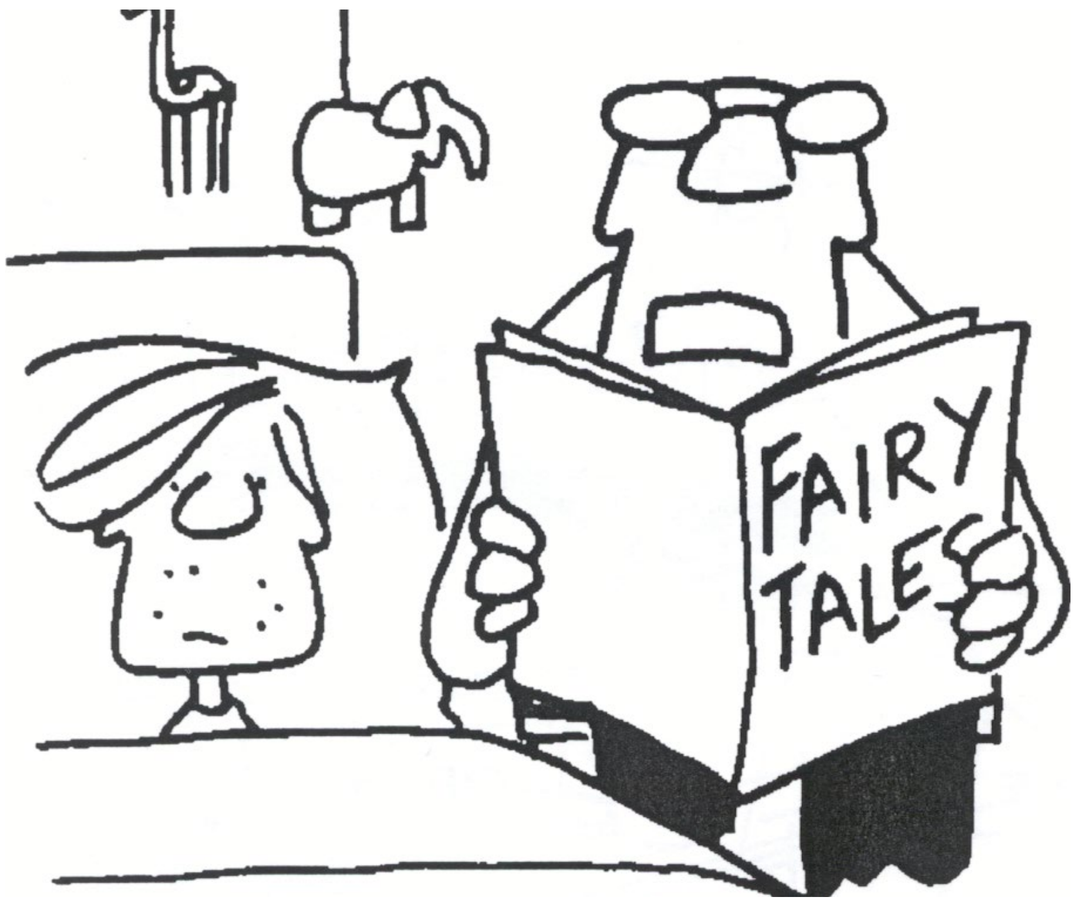
It is past time to administer a dose of reality. To that end, the following principles will be observed and followed in our family and business lives from this point forward:

1) *Equality of love does not imply equality of either our distribution of ownership or authority.*
2) *"Gift" and "compensation" are different concepts. Gift is expression of love; pay is reward for contribution.*
3) *Age difference almost always makes a difference.*
4) *Those who will not cooperate and/or work positively to settle business disagreements will always have our love and always be welcome as members of the family—but will ultimately be asked to leave the business.*

Your Loving Mom…and Your Boss

INTRODUCTION:

THE FUNDAMENTAL STRATEGIC QUESTION: "WHY?"



"Then the young lad respected his father, learned from him, took over running the company without asking for control…and cheerfully supported the old guy through his dotage."

With all the frustrations, stresses, demands, and risks involved in owning a business, it is a mystery why so many entrepreneurs (and their advisors) choose to continue the investment.

There are lots of competing answers:

- Because it is a source of ever-increasing cash flow…
- Because we—and our heirs and descendants—can have something their own to operate and manage…
- Because it brings influence and power in our community…
- Because it can be a launching platform for further growth and acquisition…
- Because we can eventually translate it into liquid wealth…
- Because…well, just *because*!

The reasons are as varied as the population of business owners, and the more owners there are *within* a specific business *partnership* over time, the more objectives and needs that business is expected to fill. The variety of individual "whys" increases with time, as, therefore, does the potential for misunderstanding.

Sorting through this ever-expanding fugue of dreams and expectations can leaving all the owners feeling like Disney's Sorcerer's Apprentice, his dreams overshadowed by both outside reality and the expanding group of other "dreamers."

In the end, the goal seems obvious. Beneath all the logos, product lines, price lists, and organization charts, beyond all the daily challenges from personnel issues to government regulations, *a business is an investment of precious capital* (not only financial, but also valuable time, energy, ideas, concern, and commitment), ***for the purpose of achieving an acceptable financial—and emotional—return on that investment***

Without reaching these goals, it will be difficult, if not impossible, to maintain any business partnership in the face of the daily challenge, stress, frustration that accompanies, always, success.

Obvious? Well, maybe, but we seem always to forget what Shakespeare tried to tell us. The reality is that we are not always guided by these simple economic principles.

There is an old saw still circulating in the ag world about the farmer who won millions in a state lottery. When he was asked by a reporter what he planned to do with the money, he replied, smiling broadly at the oversized check on the stage next to him: "That's easy. I'll just use it to farm…and I'll keep farming 'til it's gone..."

Should ring a bell of recognition, eh? Even if we're not farmers. His reasons for farming—the independent lifestyle, the love of the land, etc.—were so powerful that he put his love of the occupation ahead of abstract ideas like ROI and positive cash flow.

Well, who is to say a business can't be used as a self-supporting hobby or harvestable cash cow? These are, after all, forms of return on investment. My point here is that the chosen definition of purpose (or collection of purposes) isn't as critical to survival of a partnership as the need to know and agree on why the investors/stakeholders are doing what they're doing, and why *together*.

Where business partners run into serious trouble is in situations where conflicting definitions of "return" either vie for attention in the mind of a sole owner or fertilize disagreement among multiple owners, each of whom (remember Shakespeare) have differing definitions of "acceptable return" and (too often) don't even agree on their "investment." The existence of these conflicting goals and definition, whether within a sole owner or a group of partners almost always ends in failure to achieve a reasonable return of any kind.

The bad news is that defining and agreeing on "investment" and "acceptable return" (which, together, I refer to in this book as "owner value") is not simple. The better news is that, when defined carefully and managed well, the owner value of a closely held/family business can significantly exceed financial value alone.

Owner value can be defined many ways, but *it must be defined.* It can be defined as ever-increasing cash flow, large distributions, continued owner-management. It can take the form of economic and social influence, acquisition and growth. It can even be ultimate sale of the business at an obscene multiple and investment in tax-free municipals.

Up to us.

But therein lay the rub: the US.

Financial investment/growth goal definitions typically are inadequate as partnership goals. There is always a mostly ignored spectrum of other value components. goals held close to the hearts of individuals, but never discussed constructively in the planning process. Little wonder one investor can have a great year while his partner can be seriously disappointed.

This leads us to Rule 1 of our "written in blood" safety manual: ***The failure to agree upon and to manage to the full spectrum of purpose for sharing ownership of a business will become a serious crack in the foundation of that partnership.***

Without agreement about what owner value is—which, given our topic here, ultimately means reaching agreement about the purpose of the family business itself—the investors will inevitably disagree on results and direction, boards will remain fictional or paralyzed, managers will conflict and dissipate essential energies, and the business will increasingly fail to respond to challenges both from within and in the business environment.

A major focus of this book is on exploring the components of and achieving this defined goal. I will list the typical sources of difference among owners, various effective approaches to getting the right help to resolve those differences; structuring and managing the process of reaching and maintaining agreement…and exploring various forms that agreement can take.

Building understanding and agreement as to exactly what this jointly desired owner value, vision, dream and return are, *not just the successful management and transition of that business,* represents the most important way to assure achievement of the ultimate legacy, that dream that lay in the heart of any successful family business—and, in truth, every healthy business-owning family,

CONSIDER, FOR A MOMENT, MIKE JENKINS…

> Mike looked up at the frayed Christmas banner above his office door. An edge curled where the tape had lost its hold, dried out from the old building's hyper-heated air.
>
> The headache still sat on his shoulder, probing his knotted muscles.
>
> *Thirty years of work. For this…*
>
> His son, Jenks, had just stormed out, ranting at Mike's insensitivity to his righteous complaint, whatever that was.
>
> Mike couldn't remember, not really. There were so many.
>
> The real issue this night, the source of his headache, was a major customer, ABL Industries, who accounted for 20% of Mike's sales volume.
>
> "We got a quote from one of your competitors," ABL's VP/Purchasing had called that morning to tell him. He was sincere. Even regretful (*right!).* "You guys were Supplier of the Year, excellent quality, good service. We've had a great relationship. Goes back 20 years.
>
> "But," he added (Mike could hear the bomb fuse ticking), "Universal's offered a 15% lower price, Mike."
>
> Then: silence….
>
> Mike knew he'd keep the business. No question of that. But now the groveling began. Service. Quality. JIT. All those great fantasies airbrushed in *Wall Street Journal* profiles usually ended up as margin shavings on the CFO's office floor.
>
> Mike looked around his office. The picture of him with Bush—maybe the guy *was* a little vague, but Mike could never avoid smiling in his presence. Next to W, the family pictures.

> The grandkids. All eight of them. He couldn't stop *that* smile, either.
>
> He looked at the old, framed certificates, AMA "Strategic Management," that sort of thing, and an empty sense of loss washed over him.
>
> Only yesterday, the colors behind the glass were sharp and fresh. He and his two brothers had left the GM plant full of enthusiasm, naiveté, guts and a touch of stupidity, certain beyond anything that they could stamp parts better and cheaper than anybody.
>
> *We did more than any of us ever expected with this thing...*
> *But what did we really gain…?*

Mike has "owner value" problems. His business is successful. He is more powerful and wealthier than he ever thought he would be. Yet, he's sitting alone at his desk, questioning all of it.

What did we really gain?

If you are a business owner, you know Mike is not really alone. He has his family; works day to day with his brothers. Kids stayed home. That's the good stuff, but for most business owners, no matter which generation of ownership they represent, success comes as a mixed blessing, all the good things combined with a surprising amount of baggage.

Sure, we're not naive—we learn early there's no free lunch—but when success comes, it's always bigger and brassier and more costly than we figured. One minute we're putting out brush fires all over the landscape, and, suddenly, the next minute we're standing in a mature orchard with leaf rust and a hurricane predicted by morning.

There's often time to see it coming, but we get blind-sided because of our natural tends always to be focused elsewhere. By experience, inclination, necessity, and just plain personality, business owners live in the short-term business reality. Immediate issues like cash flow needs, a downed press, sudden opportunities, and competition, absorb most available waking hours—and a large portion of our dreams, as well.

Fortunately, it is possible to build a successful business this way. It happens all the time. Unfortunately, relentless focus on immediate business results is not the best way to build and maintain a partnership or the owner value of that business over the long term.

Think about the impact of this “brush fire” outlook on just one key component of business value: management succession. Who would disagree that smooth ownership and management transition in a family business can enhance the value of that business, value both to current owners and potential buyers? Yet, for companies mired in the immediate and the urgent, management transition is considered an “event” in some distant future and forever postponed:

“We’ll get to that when the time comes.”

Sure, this is about as sensible as storing the company’s cash under a mattress, but businesses do not suddenly *decide* to have a transition any more than a woman suddenly *decides* to give birth.

Still, we all know if transition is not planned or managed, life’s surprising accidents have a high probability of turning into disasters. Like the worth of a house on a flood plain, the value of a business without a clear path to management transition—or successful completion of one—is, by definition, merely theoretical.

We can say the same thing about other value-enhancing steps like building a strong management team, for example, or developing a unified investment strategy for the business, or creating and maintaining a sound buy/sell agreement (bet that last made you sweat). We know each is essential to the long-term value of the business—to the owners and to others. Yet…

My assumption throughout this book that the *business model* of the family or closely held company is strategically appropriate and viable. Without that, of course there is no reason to worry about successful transition or growing wealth. But once given a reasonably effective business model, priority must be given to the management of future resilience and flexibility…in ownership, management, levels of authority, strategic objectives and individual goals.

Building long-term owner value for stakeholders of a successful business (which is our the ultimate legacy, remember), requires significant attention to the four key components of that value:

1. Independent, top-quality professional advice and assistance
1. A strong and dynamic governance structure (i.e. an independent board)
2. Dynamic (meaning *regularly revisited*) agreement among the owners on fundamental business values and what they *collectively* mean by "owner value" and "return on investment"
3. Competent, creative management talent
4. A management compensation system that's designed both to define and to reward achievement of owner value targets and the strategy that supports them.

Let's look at each of these more closely.

INDEPENDENT ADVICE AND ASSISTANCE

Convincing business-owner clients to install a key component—outside review—necessary to drive the management of owner value has probably been the toughest challenge I have faced as an advisor.

Back in 1981, Léon Danco and I wrote one of the first books[*] on the concept of installing independent directors on family held business boards. Good book. Great idea. The only problem was, most business owners had a hard time buying the concept.

---

[*] Danco, Léon A. and Donald J. Jonovic, *Outside Directors in the Family-Owned Business: Why, When, Who, and How.* Cleveland: University Press, 1981.

Their reasons were pretty much the same:

- To preserve independence: *Why should I let someone tell me what to do?*
- To keep control: *Isn't that part of the attraction of being The Owner(s)?*
- To avoid ill-informed or biased advice: *It's tough trusting someone you don't know with your main asset.*
- To maintain confidentiality: *Why should I trus outsiders with sensitive and valuable competitive information?*

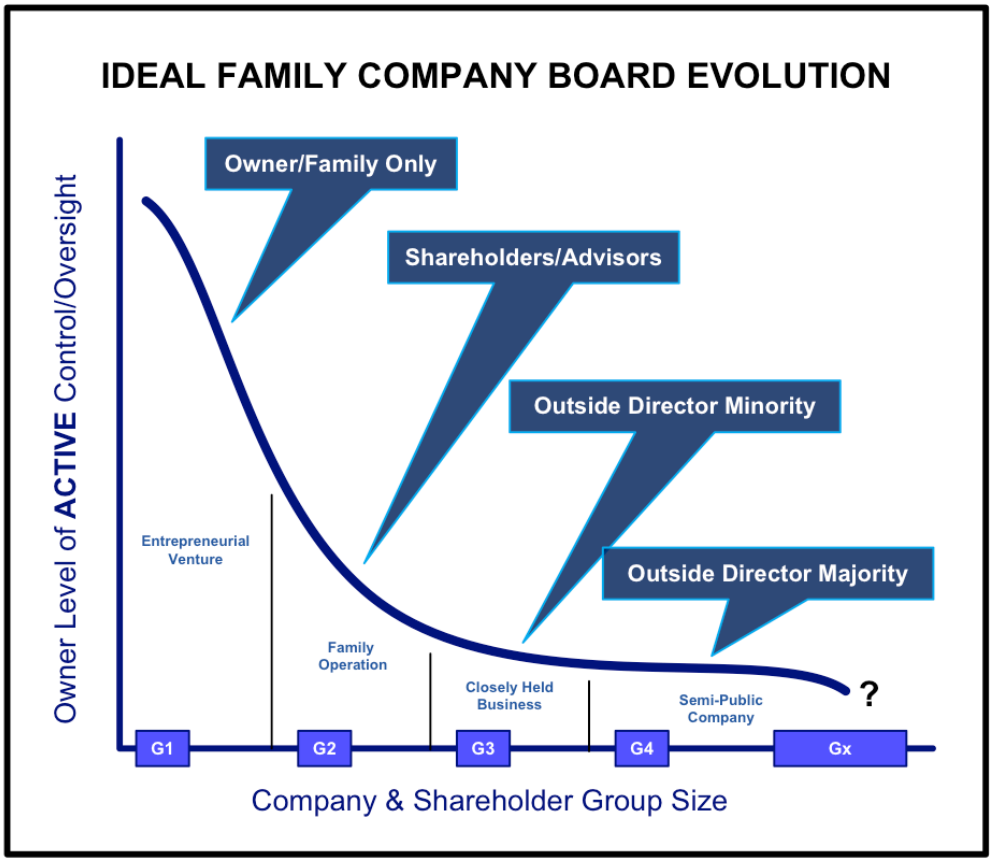
There are valid reasons to keep things close to the chest. Problem is, the resulting hermetic seal can eventually become asphyxiating. Instead of protecting a business, secrecy can become a stranglehold leading to atrophy. It can deprive a business of the very creativity and dynamic flexibility that made it a successful entrepreneurial venture in the first place.

Many, if not most owners of closely held companies aren't ready for a fiduciary board of independent directors. In many cases, it's for good reason—some of the reasoning in our book was flawed (or, more charitably: a bit naïve). Instead of heading right to the altar, we (now more experienced) are really looking at a courtship-engagement-matrimony situation

This does not mean, however, that "director" *dating* is a waste of time. Since "Outside Directors" was published, I have served on more than 30 family company boards, fiduciary and advisory. I have served as an independent director on 12 boards (four of which I chaired), and as chairman of board committees for most of them. To my earlier point, I've also served on 30+ advisory boards and have significant experience as a governance "date." This experience, as independent board member or as advisor to the board, demonstrated in every case that a body of strategic, independent reviewers can have profound, positive impact on the success of the family businesses they serve,

Figure 1: Family companies become successful, they grow, and they change and elaborate. This diagram illustrates the sort of evolution the board structure can undergo and business and the stakeholder group grow. Note that a fiduciary board only becomes truly essential once Generation 3 arrives as full stakeholders.

True, we've learned over those years to respect more



flexible and appropriate "board" structures and processes, that boards should be designed to fit the stage of evolution of the companies they serve. In all cases, though, the objective is bringing broadened skill, knowledge and wisdom to the business.

We have, however, found that the use of advisory boards an effective and practical interim step on the evolution to true independent boards.

EFFECTIVE GOVERNANCE STRUCTURES

Entrepreneur-driven businesses generally operate on a feudal governance structure. The King and the Heirs hold all the power and appointment authority. Everybody else is either part of beholden nobility, a serf, or a mistrusted outlander.

So I exaggerate—but the basics are true. Mankind operated on this model for millennia (some nations still do). Family businesses (some at least) still do also.

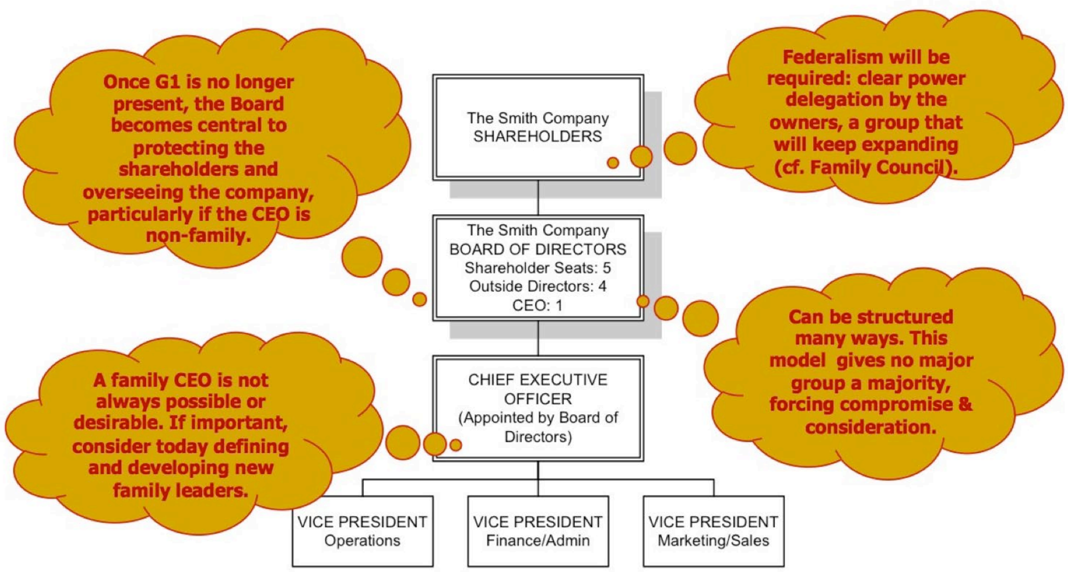


Figure 2: A simple illustration of family business governance "federalism," where the owners (the source of all power) delegate the power to appoint and oversee the effective management of the company and assure shareholder goals are both defined and met.

The natural reaction to these ideas when they are first suggested to business owners is that they are little more than “consultant speak.” Before you leave me, however, just take a minute to remind yourself of the range of challenges you face as a business owner/member of a family in business:

HOW DO WE FOCUS OUR PEOPLE ON BUILDING VALUE?

In this age of acquisitions, it’s obvious even to a casual observer that quality and depth of management is the second asset potential buyers look to when considering business value..

A functioning management team with a positive and identifiable impact on bottom line, market share, and competitive advantage can neutralize one of the most troubling negatives in the value of a closely held company—lack of (objectively measured) management depth. Acquirors (and, by the way, future owners) will find the existence of such a team a critical asset when deciding whether to buy (or keep) the business.

What’s this to do with installing a board?

Consider that mysterious thing called executive compensation. We can debate how effective pay is as a motivator, but there should be little argument as to whether it is an effective *pointer*. A well-planned and carefully structured compensation system, one that firmly connects pay and results that build owner value, focuses management on increasing business health, which, like physical health, is essential to life (*see Chapter 6 for detailed discussion of “strategic” approaches to compensation)*.

Assuring addition of strategic compensation systms is where “outside review” can be priceless. Advisors and directors can help explore options for broadening the reward tool kit to include some form of equity-like participation. It can certainly tie management effort more strategically to the bottom line and cash flow.

These are complex issues, but they *are* manageable—with the right help from the right people.

HOW DO THE OWNERS DEFINE VALUE?

Building "owner value," which should be the Holy Grail of a family business, begins logically with agreeing on the target value and its components. How's that determined? Single owner? Agreement by definition (assuming no schizophrenia). Partners? Depends on whom you ask? Multiple generations…?

Shareholder and their families have lives and their differences multiply logarithmically with each birth and marriage. There is nothing genetically determined about the way family business shareholders analyze, plan, communicate, and make decisions. They are only slightly more likely to agree with their parents and siblings (and not likely with their children).

This isn't to imply we should send all our partners to leadership school or raise them as accountants. What it does mean is managing their roles, communication and relationships such that they can work together productively and make decisions *effectively*.

Communication isn't an end in itself, however. We want our business communication to lead somewhere, to have a purpose. The flow diagram in *Figure I-1*, below, puts communication and decision making in the context of managing owner value. It's because this can be such a complex process—in the beginning, for sure, but also throughout the life of the business partnership—the role of a board begins to stand out in sharp relief:

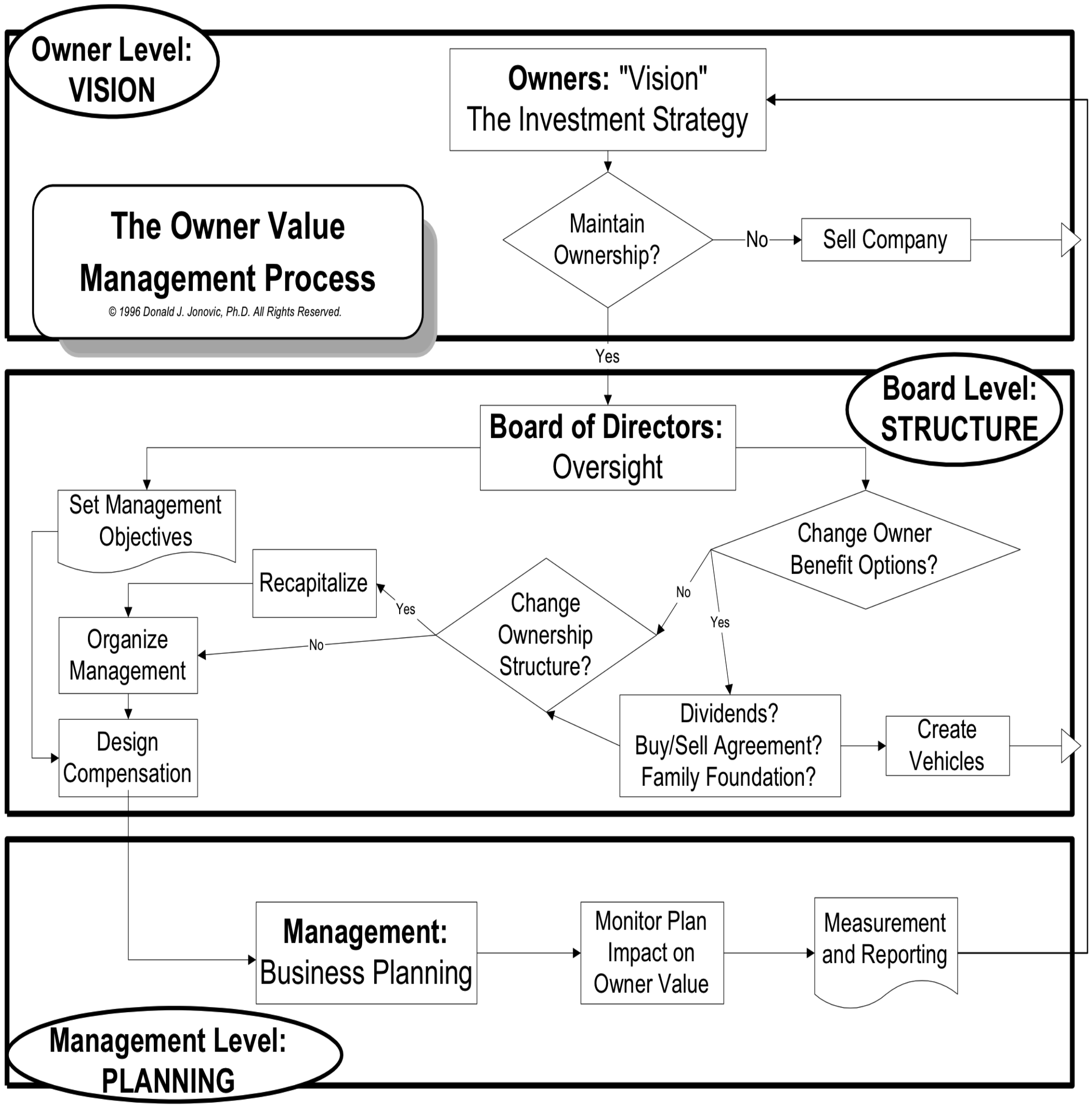


Figure I-1: Managing owner value begins with the definition of an investment strategy by the owners and "ends" with the evaluation of how well the business plan fulfills the investment goals the owners set. The process never really ends. Instead, it becomes a way of business life, a cycle that repeats itself at least annually.

Let's lay it out in a typical board governance process:

1. The *owners* define an investment strategy (return on investment, growth rates, risk parameters, management philosophy—see *Chapter 5)*;
2. **The *board* assures that the capital structure of the business makes sense, given the investment strategy (e.g., Should we be a holding company? Sub S?) and that the assets are managed through appropriate estate planning (see *Chapter 7*);**
3. **The *board* also makes sure the investment strategy is translated into operating targets, and that management is appropriately organized and compensated to meet those targets (see Chapter 6);**
4. The *management team* creates and goes to work on a plan to meet their operational targets;
5. The *owners*, **the *board***, and *management* measure and monitor operational results (see, particularly, the discussion on advisors and boards in *Chapter 4)*
6. The *owners* revisit and readjust the investment strategy (see *Chapter 3* on owner communication).

Owner value, through the investment strategy, is the driver throughout this process, and underlies decisions at all levels. The real purpose of the business is regularly defined, all activities are pointed at achieving that purpose, and the whole process is reviewed regularly for effectiveness.

We are talking here, not about revolution, but *evolution*—about developing an overall professionalization around the concept of owner value. It is NOT an event. It must be an ongoing process which requires a lot of time and effort—and that demands a driver with responsibility for guiding the journey: **a functioning board** .

Remember *The Ultimate Legacy*: building of value and opportunity for all the stakeholders in our business.

FOCUSING ON THAT ULTIMATE LEGACY

Successful entrepreneurs and founders, by definition, initially do a good job building business (and, thus, owner) value for themselves and their partners by combining talent and energy with the leverage of a short-term, reactive, insightful and driven focus.

The more successful a business becomes, however, the less connected this operational drive is to owner value. Threats loom ever greater, but farther in the future and harder to see. Solutions take more time to implement, and more time to show results. Internal skills and knowledge become engulfed by a rising tide of complexity. Internal confusion and conflict escalate. Value stagnates or drops, and our essential purpose, the reason for staying in business, declines along with it.

This fundamental objective of business ownership is the preservation and building of owner value. True, different owners might define that value in different ways: using different combinations of career opportunity, cash flow, profits, equity, or market value. Equally true, this value can be harvested in many ways: through patient observation of growth, expanding career opportunity, frequent dividends, or even sale to a strategic buyer with investment of the proceeds in tax-free bonds.

However value is defined and distributed, and as expectations for it grow in a growing number of minds, the questions of return on investment, share value, dividend standards, even (as I've noted) management compensaton become far too complicated and variable to remain "assumed". What was once defined and administered by a single owner or very few partners, becomes a democratic value (and we all know how that works out left to itselft).

Reaching dynamic agreement on the components of owner value—how the goas concerning them are set, how they are measured, and how the value growth is to be shared—is a process. Actually, it can only be a process in any democracy (read: shareholder group).

It's a process of regularly defining and reviewing owner objectives. It's a process of developing the ability to see and respond to distant threats. It's a means of ensuring that problem solving begins early and is relentlessly pursued. *It's a commitment to widening the base of knowledge and expertise available to the organization.*

Ultimately, value management is a commitment to linking the owners, the organization, and the board/advisors together into a powerful "meta-management" that automatically scans in ever-widening circles for ways to protect and build owner value in the long term.

Are you still harboring doubts about the need for a board in the business/partnership/management structure? If so, bear with me. We're moving next to a deeper dive into the worlds and experiences of the key players in this family business drama. I suspect you'll recognize many of them.

Take your time. They are special people and very important to you.

1: FOUNDERS & THE "SAPLING" DAY

"So, that's it, Frank. Our coverage ratio's gone to hell, and unless we take some action, we'll be out of cash and at the end of our credit line by June."

Frank sat still for a couple of minutes, studying the spreadsheets on the desk in front of him. He was stunned, yet somehow not really surprised by the CFO's bleak forecast.

When he accepted the VP-Marketing job at Halstead Industries, Mark and Marvin Halstead, the owners, told him there were problems in some of the other divisions and subsidiaries. But, now, almost a year after taking the job, he was getting his first look at overall corporate finances, behind the barn, so to speak, from a guilty and hesitant CFO.

"You're sticking your neck out showing me all this, aren't you, Vince?"

"I suppose," the CFO replied, shrugging with resignation. "But I had to do something to get some action. The Halsteads are always strictly need-to-know when it comes to sharing informaiton. I have no problem with that, except they don't understand how much their people actually need to know."

Frank stood and walked to the window. He watched a huge crane lower another beam through the ceiling of the new warehouse.

"So," he said, finally turning to face Vince, "You need me to help you convince Marv and Mark we have to sell off the vacuum forming business, and base that recommendation on information I'm not supposed to have."

"That's about the size of it," Vince agreed.

"Well," Frank said, taking his chair and pulling the papers toward him, "let's see how the uninformed go about performing the unlikely on the clueless.

"What a hell of a way to run a railroad…"

If there is one characteristic that best describes a business owner, it is secrecy. Sensitive (and many times not so sensitive, but important) information is kept from suppliers, competitors, regulators, friends, relatives, and, as Vince, the CFO knew, even from the insiders. We will leave the IRS out of this discussion for now.

Closely held businesses are not properly named. To be correctly described, they should be called *hermetically sealed* *businesses*. This trait, more than most other cultural characteristics common in private companies, can be root cause of diminished owner value and shareholder/family dysfunctions

To understand, however, we need to review some history.

THE "HERMETIC SEAL:" HOW SECRECY EVOLVES…

Business ownership can mean waking up unemployed every morning, lying in bed in the middle of the night, wide awake, in one of those perennial 3:00 a.m. "blink" sessions, staring at the crack in the bedroom ceiling and wondering how you'll survive the current crisis, whatever it happens to be.

Competing interests are the primary driver. Competition carries added dimensions of opposition: life and death struggles with major suppliers, with the government, with partners, fellow shareholders, even family.

Founders face opposition from nattering critics and all-knowing second-guessers. "How can you do that?" "It'll never work." "What you really need is a business plan." Well-intentioned suggestions? Perhaps. It is bad enough starting a business against the clear (sometimes less-than-clear) competition in the marketplace. What is worse is climbing that slippery mountain with a crowd of nay-saying onion-breathers trying to convince you "it can't be done."

The entrepreneur knows it *can* be done! The best strategy in the face of all that carping is obviously, keep quiet and tough it out alone.

Doubts? Sure, but when they come up, *crush 'em.* Mistakes? Lots. Best to learn, bury them and move along. Disasters? Far too many, but, whatever happens, don't let any of them know. Don't give them the satisfaction. Don't fan their flames of doubt (or your own.

Eventually, there are triumphs. When it works, it's like standing at the Matterhorn's summit, surveying all the world below.

Usually, though, it's a solitary high. Few others really helped. Most muttered doubts and some even shoved roadblocks in the path.

So the founder's tough in defeat. Stalwart in victory. Because of how it all happened, successful founders wind up very much the lone cats in the jungle.

Tigers roam their jungles, with stealth, secretly sizing up prey. When they roar, it's more to intimidate than to communicate.

Secrecy is armor. Entrepreneurs learn to wear it like turtles have shells. They justify it in many ways, but few of their explanations and protestations come close to the *real* reasons for our secrecy.

Hiding Trouble in the Bad Times

In the beginning, founders need to hide how bad things are. Those are the times when there's no money in the till. No cash in petty cash. No balance in the balance sheet. No income in the income statement. No "P" in the P&L.

Not a good idea to let the bank know. First thing they'll do is call the loan. If the suppliers find out, they'll demand prepayment. The employees might panic and quit if they heard. The in-laws smile pityingly, or worse, talk about him or her pityingly when their backs are turned.

Nobody needs to know the trouble we see. We can handle it, all of it. Male or female, we lie in our beds, tense and wide awake in our "blink" sessions, bathed in sweat, worrying about how to survive the most recent crisis. There is no loneliness like lying in that pool of damp perspiration, desperately clinging to the remains of enthusiasm and summoning enough strength to get through the night and enough guts to face the next day.

These are the beginnings of that "hermetic seal," those nights when only stubborn tunnel vision gets him or her through. Here, the seeds are planted for distrust of outsiders. Here, also, begin the fierce loyalties toward those who remained steadfast in adversity—that early key employee, the banker who ignored the facts and loaned us money anyway.

In the tough times (which can occur at any time in the business life cycle) secrecy makes some real sense. It may even be essential to continued survival. But why does this secrecy endure in family businesses long *after* the start up becomes a real company?

Because, with success, a whole different class of excuses for secrecy emerges.

Hiding Success in the Good Times

As business, revenues, cash flow and profits grow, new reasons emerge for keeping things close to the chest. There are many realities about the private company's fiscal policies and results that most people just wouldn't understand.

Friends, in some cases even good ones, tend to become uncomfortable with us if our income levels grow out of synch with theirs. What we take for granted as a lifestyle suddenly outstrips what used to be shared tastes and preferences. Because we value the people we love and respect, the obvious answer is to keep quiet about our success. *Play it as no big thing and maybe nobody'll notice.*

But keeping friends and some stability in their social life isn't the only reason owners stay secretive. There's the matter of employees They seem always to have a mistaken notion about how much money a business generates, and they have little knowledge of the level of risk (no information, remember). If they saw the sales revenue, it would lead, ultimately, to unreasonable demands for increased compensation.

The solution? It's simple. Don't show them the top-level numbers—the same conclusion, notice, that Mark and Marv Halstead came to in the epigram that opened this chapter.

Finally, we must consider the fact of business ownership that "profit" can be a bad thing. Think about it. Pprofit can be expensive!

Often all sorts of contortions are required, anything possible (and legal) to avoid it. What we *do* want, really, is to *break even*, at a higher level every fiscal year.

The cost of tax compliance (more accurately for a for-profit business, tax *avoidance*) in the US is probably between $.5 and $1 trillion annually in the United States. Do not even think about manhours invested. Given that private businesses account for much of the growth of western economies, we would not be far off concluding they pay a large share of that compliance cost. That's a lot of energy and time spent trying to "break even."

We all hate paying taxes, but is it appropriate that tax avoidance (and the secrecy it requires) becomes a primary focus of our management, accounting, and planning?

MAZES OF LOVE AND AUTHORITY: HOW HISTORY "DESIGNS" THE PROBLEM

Every business has a founder. It can be a single entrepreneur, a few siblings, some non-related partners, even other partnerships or corporations. Whoever or whatever is behind the original conception of the family business, a predictable evolution usually follows the birth.

The consequence of the long series of middle-of-the night worries is secrecy, as I've said, as well as an institutionalized Horatio-at-the-Bridge mentality that it's us against the tax man, the competition, the suppliers, the employees, sometimes even the customers. The result, often, is an increasingly distant relationship between the owner-manager(s)/shareholders and most others who relate to the business, particularly the employees.

Nobody Cares for It Like Us

The "distance" is not caused by exploitation. Business owners generally take very seriously their responsibility to treat employees fairly. Rather, it is lack of correlation, best demonstrated by statements like: "Why can't our employees care about this business the way we do?"

The finance department can be at the core of the problem. No matter what stage in its evolution (entrepreneurial accounting typically starts as a checkbook, eventually evolving into bookkeeping, through controller's office, ultimately to take up final residence in the person of a Chief Financial Officer), Through it all, the finance function quickly acquires and maintains forever, at the behest of the business owner(s), one principal and overriding function: that of a financial ***dragon***, like the fierce, scaled beasts of mythology, perched ever vigilant over the family jewels, ever ready to belch foul gases on any of the non-initiated (read: non-owners) who dare to venture near or ask probing questions.

This combination of an anemic confidence in employees with a secrecy-driven, lack of objective financial measurement hobbles any attempt to delegate. As the business grows, more people are added to handle the exploding amount of data, but they are kept on a relatively short rein. The focus is always more on routine posting and tactical forensics than on strategic analysis.

Tell-tale symptom for diagnosis of this malady: an owner-manager becoming more and more burdened with (read: *buried in*) detail.

If we draw an organization chart of the typical successful closely held business, we end up either with the sanitized "public relations" version (the one that shows up in the local business weekly and has no correlation with the reality of the situation), or we have a convoluted web of interweaving lines of authority that, seen from any distance, looks more like an explosion in a spaghetti factory than a workable business operation.

Nepotism: When Employment Is Relative

Add to this what is perhaps the most important "wrinkle" unique to the closely held company: nepotism. Unlike, say, Amazon, where children of shareholders have no special claim as potential employees, closely held companies face the challenge of managing that embarrassment of wealth called the owners' offspring and relatives. They can be real assets to the business. They can be dangerous hindrances. Most often, they represent a raw material with high potential impact and little formal development.

Relatives, offspring, and in-laws tend to adhere to the organization at all sorts of odd angles and configurations. In first and second-generation businesses, the company is almost like another room in the house. People grow up in it. They play around it, hide in the corners, fight in the hallways.

Working in the family business is often "something we've always done." Early employment is the result more of puberty than any defined needs of the organization. Later careers, in those businesses which survive into future generations, politics, family logrolling, peacekeeping, and loyalty replace the endocrine system as drivers of career development. This has ever been the substance of the nepotism process.

Please don't misunderstand. I am not saying that nepotism is inherently evil, or that the beneficiaries of the preference are necessarily incompetent, corrupt, or inept. Often, in fact, those who survive such a misguided and destructive process prove to have needed mettle and talent far beyond the ordinary.

No, the key danger of nepotism (and why it has such a bad name in history) is that it seldom takes the needs of the *organization* into account when the organization *chart* is being developed. Instead, individual and/or family needs come first.

One principal reason business owner fight so hard to keep a business private is the potential of career opportunity for the next generation. While this certainly increases the value of the business to the owning families, it can have the entirely opposite effect on owner value in the future. Nepotism is essentially a concern with the "immediate legacy," which can sharply distract ownership, board, and management from the *ultimate* legacy: building long-term owner value and career opportunity.

Nepotism's benefits can be reaped without these associated evils if effective processes for qualifying successor management and slotting the *right* person in the *right* job for the *right* reason are in place (see *Chapters 6* and *9)*.

People, therefore, are the next issue we must consider.

2: THE CAUSES OF—AND CURES FOR— ANARCHY

I take it, then, that opinions are divided along family lines…

> The petroleum marketer needed someone, as he put it, "to help straighten out my kid."
>
> "What's wrong with your son?" was my natural question.
>
> "Nothing…everything. He wants to add eight more service trucks to the fleet. That's almost a quarter of a million bucks, and he'll do that over my dead body, let me tell you!"
>
> They argued about it all the time, he said. Neither father nor son would budge from the blistered howitzers in both camps. The bad blood between them was heating up fast, with the business sinking into confusion. Dad saw it as "this asinine disagreement over some stupid trucks, proposed by a cocky kid with no experience in the real world."
>
> His son saw it as a dead hand on the controls: "Dad was great, in his time. Hell, he's *still* smarter than 99% of the people out there…even than me.
>
> "But how do I convince him that the *world* has changed?
>
> "We're fighting battles on battlefields that didn't even exist 10 years ago!"

This "case of the $250,000 trucks" sounds very familiar to anyone who has been part of family business management meetings…or even casual conversations. Irresolvable disagreements and conflicts over tactical decisions dot the entire owner-management landscape. Over time, these disputes can dominate and paralyze decision making—as this particular dispute already had.

At this owner's request, I met with him and his son a few weeks later at their offices. We were seated less than 30 seconds when Dad turned to me, pointed to his son, and said: *"All right, Jonovic. Tell him!"*

I ignored his unique view of persuasive argument. Instead of proceeding as he expected, I asked the two men to write on slips of paper exactly how large a financial bet their company could make on a new venture, see that venture fail, and still be around as a viable business.

What, I was asking, was their financial "robustness"?

They each wrote out a number, folded their papers at my request, and handed them to me. I shuffled them to add a sense of suspense, then opened the first one. On it, in two-inch lettering, was written “ZERO!!!” (No need to guess who that was from.) I opened the second slip.

You guessed it. It read “$250,000.”

I was not looking for a “right” answer to my question. The exercise was not meant to test their knowledge of balance-sheet ratios. They both saw that right away. They also understood immediately that what I intended was a demonstration of a key point : they were *not* arguing about trucks. Their disagreement was, in fact, about something much more fundamental than equipment.

They were disagreeing about *risk*, about the long-range objectives and potential of the business. Because they did not understand the roots of their dispute, they had trapped themselves in a small jail cell of miscommunication and frustration.

They did not need to launch a strategic planning process, at least not at that point. That common conclusion, looking to strategic planning as a specific cure for “vision” disputes is seldom the right answer, because **strategy can’t be set in any sensible way without first establishing some form of ownership agreement, an “owner vision,” that defines what the owners want *from*—and are willing to give *to*—the investment.**

This owner and his son had two separate visions, and this schizophrenia was paralyzing the entire company…and they were far from unique in making this mistake. **The lack of a *shared investment strategy* destroys more companies than taxes, competition, recessions and the, uh, benighted politicians combined.**

WHY “VISION” GETS CONFUSED

Consider an example business owned by four major shareholders.

Two of the shareholders are owner-*managers*. They have senior management roles in the business. The other two are not involved in management at all, but are members of the board.

The two owner-managers are working hard to make the business grow. They do try to keep their non-manager partners informed, but you know how it is. The pressure is intense. There is not enough time…and when they do take the time, Pandora's box tends to open: endless discussions about who is paid too much, or why it takes the receptionist so long to answer the phone, or why is depreciation so high, all of which devour even more time.

Obviously, whether we are dealing with shareholders, directors, key managers or potential heirs (and their spouses), each key player has an unique perspective and, if they have one, a different "plan." Worse, those perspectives and plans are unwritten, un-discussed, and probably incompatible, and likely uninformed.

It has been uttered many times in history: **the most common cause of communication failure is the assumption that it occurred**.

Consider, first, the different roles these folks play *(see Figure 3-1).* First, everybody in the owner group can see himself or herself *as an investor* (or a *virtual* investor, which includes the spouses of owners and potential owners). Investors are interested in sufficient cash flow, growth, return, liquidity, all those wealth issues.

Strategically, owners also want adequate increase in the value of their investment, preferably at "appropriate" levels of risk.

Common sense? Of course. *What makes little sense is the common failure to discuss and agree on the exact meaning of adjectives like "sufficient," "adequate," and "appropriate."*

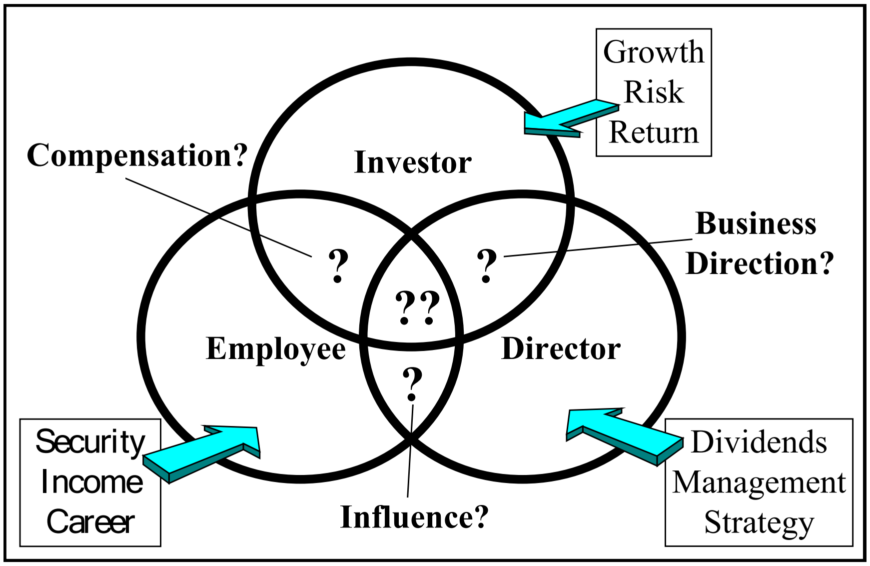


Figure 3-1: *Representing the private business "theory of relativity," this diagram shows how the overlapping of key roles owners play in a business can lead to conflict and discord. This overlap happens regularly in businesses where discussions are not separated and focused on questions appropriate to only one of the key roles.*

Let's return to my opening case.

The petroleum marketer who wanted me to straighten out his son was 72 years old. He had founded the business and functioned as president from its beginning. For most of the 40-plus years since he bought his first delivery truck, he filled every one of the roles in the above diagram, by himself.

Filled them very well, too. Just ask *him*.

As the exercise with the slips of paper showed, however, his focus *as a shareholder* had progressively shifted toward the return on his investment, and away from the concept of growth. Nothing wrong with this. After all, a "long-term" investment of $250,000 means something entirely different to a 72-year-old than it does to a 40-year-old (his "cocky kid's" age at the time).

Dad was still majority owner, so of course he played a significant role on the "board" as well. Since he was semi-retired, the career and cash flow (income) issues so important to an employee had become a lot less important to him than they were in his 50s. As a "board" member, his management attitudes concerning future directions of the business, how shareholders should be paid, even who should be running the show, were all valid, given his point in life and long experience.

Headline: If they lost the business, it would be too late for him to start over.

Now consider his son. He had a few shares and, therefore, was also an owner, but his "investor" focus was on future growth. Return on investment, given the fact that he was relatively young and a very active employee, was defined in terms of salary, bonus, various perks, increased responsibility and a healthy, growing business. His view of "return" was that of a manager. True, risk was a critical issue with him also, but the greater risk to him was the risk of doing *nothing* rather than doing the *wrong thing*.

He was not stupid. He knew that the business could fail if they did too many wrong things? But he also could always start over, with experience and youth as assets.

Could any of us declare either gentleman "wrong"?

These meetings—and the points of most intensity in their conflict—usually took place in the "boardroom," which in their case happened to be Dad's office.

For them a "board meeting" was defined by a routine conversation suddenly getting heated and out of hand. They each brought their *valid* perspectives to the conversation, but they failed to recognize not only how different those perspectives were, but more importantly that the source of those differences. Their personal goals as investors and as employees overwhelmed any discussion they thought they were having about business "strategy."

People unfamiliar with this common reality in partnerships and family businesses find it difficult to understand their strong institutional resistance to board-level oversight. I determined many years ago that *oversight is resisted because current owner/managers have learned from experience that opening major decisions to discussion most commonly leads to conflict rather than consensus*.

SEPARATING PERSPECTIVES IN BUSINESS DISCUSSIONS

Unfortunately, even the greatest generals lose their edge. They eventually, appropriately, must relinquish command and focus on mentoring the new leaders. The best of them KNOW this.

Trouble arises because some of those wizened geniuses fail to carry out the two major responsibilities of an effective leader: (1) to institute a rational planning process and (2) to turn their staff into potential leaders experienced at implementing those plans smoothly.

The first step, since any decision-making process requires effective communication, is to eliminate confused perspectives, the principal cause of decision paralysis in the closely held company (*Figure 3-2*).

The most important early lesson for a potential leader is to understand from whence their followers are coming. The specific "whences" are as different as are organizations, but a leader must learn the specific perspectives held by the people he or she is asked to lead, and use that understanding to better visualize the challenges and to lead decisions how to meet them effectively.

In a family business, separation of perspectives is essential.

Consider what happens when discussions of family business issues are informal and participants are free to take, as partners, any point of view at whatever level of involvement they want:

Where *investors confuse themselves with directors*, we find disagreements about business direction issues. The greater this overlap, the more paralyzed strategic decision-making becomes.

Where *investors confuse themselves with employees,* we run into all sorts of “avid discussions” (to use the polite term for what really happens). For example, a favorite discussions topic is compensation. The concepts of dividend and salary get hopelessly confused, “fair” and “equal” replace common sense and money becomes the root of all evil.

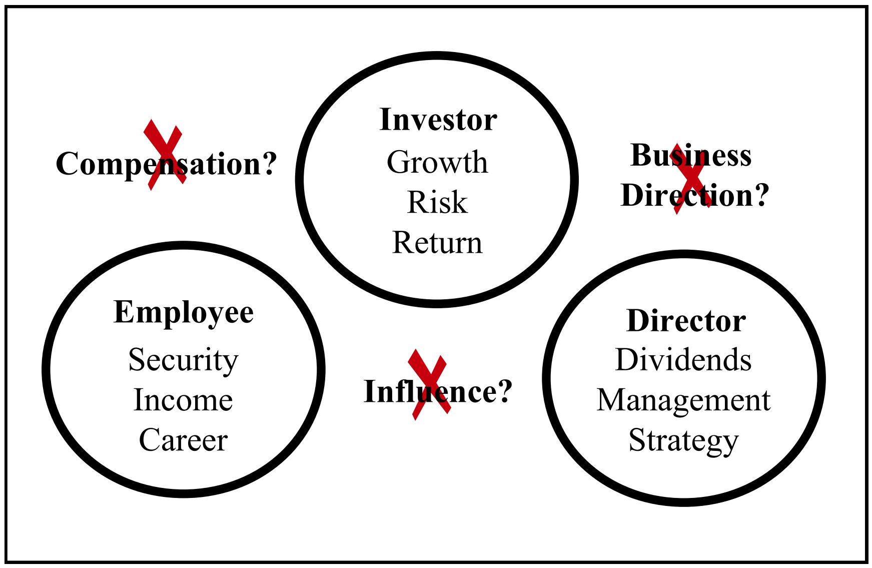


Figure 3-2: *Separation of the key roles in formal discussion allows each person to freely express his or her opinion and makes it much more likely decisions will be made, and made objectively, rather than blocked by emotion. Where this discipline exists in a company,* recurring *disputes about compensation, relative influence, and business direction tend to fade into “manageability.”.*

Where *employees* confuse themselves with *board members,* we have blurred lines of authority and power conflicts: “Sure, I’m just the purchasing manager, but I damn well have some say in who’s going to be my boss,” or “I don’t care if he is my boss, it’s my company, too, and I’m going to do what I darn well please.”

Where *shareholders* confuse themselves with board members, risk management gets conflicted with visionary strategy or maximizing return on investment competes with capital investment.

Where *board members* confuse themselves with managers, office visits become *sotto voce* suggestions intended to be taken as formal orders and commands, not to mention all the wonderful implications of two or three “shadow” governments.

When these perspectives overlap simultaneously in one meeting or discussion, we have an excellent preview of World War III.

Real agreement, it there’s ever to be a chance of its being reached, must emerge out of a careful separation of these roles *(see Figure 3-3)*. It grows naturally out of formal meetings and discussions, with each level setting directions and objectives for the one below. The same individuals can, and frequently (but not always) do play all roles. To navigate that high wire safely they must understand how to and actually do “change hats.”

Unfortunately, this requires, a some bureaucracy—primarily the establishment of a formal schedule of meetings, each concentrating on a different strategic level and carefully structured agendas.

Use the meeting levels as a touchstone for determining the quality/appropriateness of the proposed agenda for that meeting:

The Investor (Shareholder/Partner) Meeting

Investors (they come in many sizes) set standards of financial return, growth rate expected, and liquidity levels: our purposes for fighting this war in the first place. Their discussion of these important issues is logically prior to all other long-range decisions made in the business. Without clear agreement on these basics, all the other discussions are reduced to nothing more than rootless driftwood.

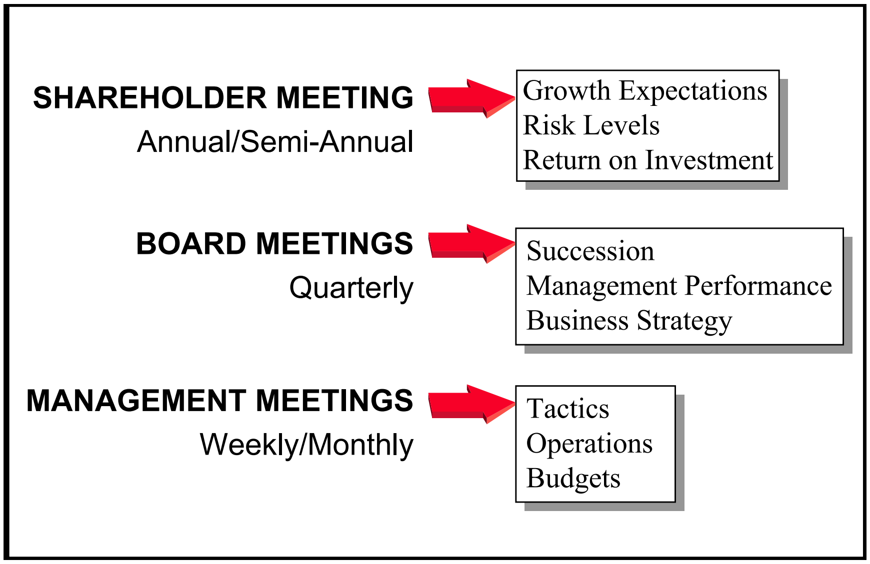


Figure 3-3: *Not all bureaucracy is pointless and dysfunctional. Some is essential to the smooth functioning of an organization. Founding entrepreneurs can afford to discuss issues with themselves, on the fly or in the shower. Multi-owner businesses must be a lot more formal than that, at least by regularly holding the meetings shown above.*

The Board Meeting

Owners should not have to develop their goals alone, won't be able to, in fact, if they have an effective board in place. Directors can and should spend time with their owner group exploring purpose, expectations, risk tolerance, all to provide a foundation for building the business vision and investment strategy. Once that point is reached, the board can turn their focus on connecting with management on leadership needs, performance goals and overall business strategy (questions like: where do we concentrate our forces, who will lead them, what are their broad objectives?).

Fiduciary board meetings proceed on much the same basis as advisory board meetings (, but they are naturally more formal and more strategic in outlook. Much of the input expected from a board arises naturally from the board's function, but to help with understanding these functions an example board policy can be found in *Appendix A-10.*

The Management Meeting

Managers deploy to the front lines, assess situations in the field and implement tactics to achieve the operational and strategic goals as defined by the board and chief executive. Out in the "field," they follow day-to-day operating procedures (how can we accomplish the broad objectives set by the board, and who's best able to carry them out?).

The central purpose for this bureaucratization is to separate the "hats" under which people think, discuss, and operate. Using the specific meeting format appropriate for the level of discussion at hand, we vastly increase the chances that we will objectively come to intelligent, effective decisions.

Obviously, simply holding more meetings is not going to be the panacea for all business problems. A reasonable amount of formalization merely provides a framework in which the right questions can be asked, effective discussion is possible, and sound operating decisions are more likely.

To make sure these meetings work, to make sure, in fact, that they are even *held*, one more important piece of infrastructure is necessary: the right *expertise.*

Which brings us to professional advisors…

3: THE RIGHT ADVICE

"How could you possibly spend $35,000 on a shareholder meeting?"

Sally flinched. Her father's outburst was totally unexpected. Worse, she was not sure what he was talking about.

"I don't understand," she said.

"Here, look at this," he said, tossing a sheaf of papers across his desk. Sally could see it was an invoice from the accounting firm. When she picked it up, the bottom figure jumped out like an accusing finger. $22,000! She was stunned!.

"And that's only from the accountants," her father growled. "The law firm adds another $13,000 to that!

Sally's shock was slowly turning into understanding and, with understanding, came acute embarrassment. She had been given the responsibility for putting together the first real shareholder meeting they'd ever had, and decided to make it a real meeting with real substance. She brought in the advisors and told them she wanted overview presentations of the existing estate plan and a discussion of business value.

"I'm glad you're finally doing this," the accountant had told her. "There's too much confusion among the family, and this is stuff they need to know."

"Absolutely," the attorney said, looking at her above his glasses.

So they put together their presentations. The shareholder meeting was right on target, got right to the important issues; the shareholders, Sally's siblings, and cousins, congratulated her afterward on an informative meeting.

That was three weeks ago. Now this! More than $30,000 to present an existing set of facts…her stomach turned.

"…and from now on," her father was saying, "I want to approve any work you do with any of these guys. You understand?"

Sally looked up at him, her eyes glistening.

"Oh, I understand perfectly," she replied, embarrassment now turning to anger as she mentally shelved the independent board suggestion. "Don't you worry. They'll never give us a problem again."

Sally learned a lesson, all right. Call in outsider, use the advisors, you're likely to get burned.. Unfortunately, Sally is likely to be a good student…maybe too good.

As I noted in *Chapter 1*, closely held companies are misnamed. More appropriately, although regrettably, they could be called "hermetically sealed." Privacy is primary…and it is not all about cost.

At some critical point in the history of every successful, family-owned company, the level of knowledge and skill inside the business is overtaken and overwhelmed by the rising tide of demands and challenges imposed by the outside environment. Unfortunately, just when outside understanding and knowledge is needed the most, it is usually the most inaccessible (or, even worse, inadequate). That is what is about to become the norm in Sally's company. Who wants to pay for words and talk?

The private company's fundamental need for objective outside review has finally become well-accepted and widely known, but filling that need has never been—and still is not—an easy task.

I have been among those who early urged the creation of formal, outside boards of directors as a potential reinforcement to the foundations of family companies. Theoretically, that was correct. Practically, such a leap is neither the most attractive nor effective way to begin adding competent and objective outside advice and review to a closely held company.

The reaction of one of my clients to the suggestion of forming an outside board is a good example. His words were simple and direct:

"No [*expletive*] way!"

We and his two partner/brothers were working on a range of leadership transition issues. It was going along smoothly until I suggested instituting a real board. The chairman dug in his heels, firmly opposed to the formation of a real board.

This was early in my career, and this owner was someone for whom I held the highest respect. As we talked, I started to agree with him. Although he and his brothers had a large distributorship employing more than 200, I could see that neither they nor the business were ready for independent directors or a fiduciary board.

I suggested an alternative: creation of *advisory* board, a hybrid of professional advisors (law, accounting, etc.) and two successful business owners in a related industry. No fiduciary. No formality. NO VOTE. The idea sold.

This advisory board operated successfully for two years, focusing on obvious structural problems involving stock transfer and retirement funding, strategic issues of product and territory, and the quality of the leadership team. We left for later on questions of investment strategy and long-term growth.

It was only five years later that I became the first independent chairman of this company's fiduciary board, consisting of a majority of independent directors. Prudent "courtship" can be very helpful. I'll be retiring from that board in a few months, just as the company is moving to its first non-family CEO.

My years of consulting and board experience convinced me that most family businesses require significant evolution before they can fully benefit from an independent board (see *Appendix A-9* for a discussion of reasons prematurely established boards can fail).

An independent board does not become truly relevant or potentially effective until the company is well through the "threshold" transition from entrepreneurial chaos to professional management. During this transitional phase (what I refer to as the "threshold" period—when business is thriving but still heavily dependent upon the strong leadership of entrepreneurial owners), an advisory board, or advisory council, is much more useful for responding to both business and family needs.

Much more comfortable, too, for the founder/owners.

WHAT HELP DO WE REALLY NEED?

This concept of *threshold* transition requires a closer look (see *Figure 4-1*).

Family and closely held businesses usually go through a difficult period as they grow beyond the founder's direct influence but have not yet fully professionalized management. This is the "threshold" period. Some companies take longer—perhaps even generations—to cross the threshold than others. Size seems to have relatively little to do with how quickly the transition can or must occur. Even very large organizations, for example, can continue functioning for a long time, even with relatively weak middle management.

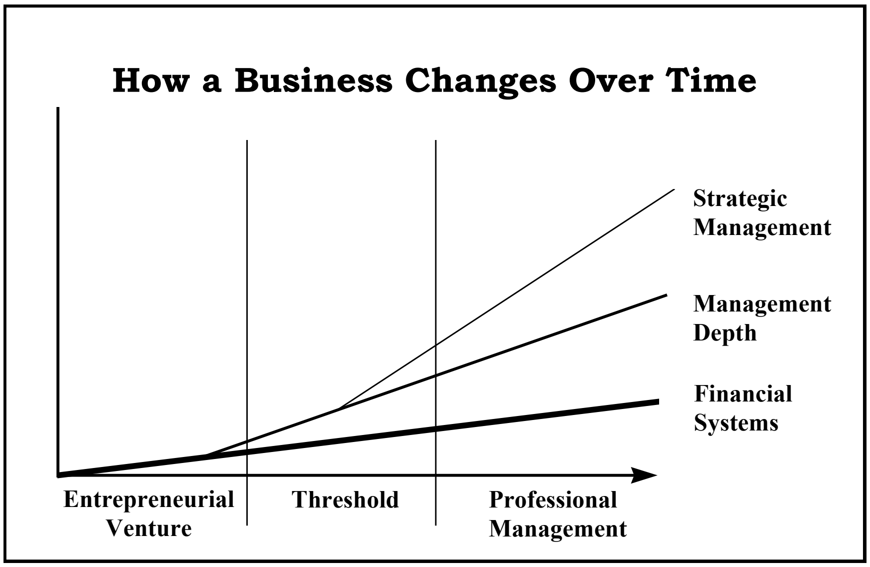


Figure 4-1: *Businesses go through three developmental periods as they become successful. It's only later, on the road to professional management that the concept "strategy" even begins to take on importance.*

Prior to reaching the threshold, most entrepreneurial ventures are primarily self-sufficient. For the most part, the typical entrepreneur—and his/her successor managers, if they retain the founder's style—rely on drive, adrenaline, and persistence to survive, punch through barriers and reach goals. True outside review, by contrast, would be analytical, critical, questioning—in obvious and direct conflict with the entrepreneur's style. Therefore, the hermetic seal (*I do it alone, I do it my way, and nobody but me needs to know about it*) is usually a functional structure in the early years.

In a perfect world, criticism and healthy questioning can be intellectually stimulating, not to mention helpful. In the real world of the entrepreneurial venture, however, survival is a white-knuckle thing, like barnstorming. To the entrepreneur's way of thinking, the fine points of "flying" can be studied later. He has no need for back seat instructors right now. Just give him a good mechanic or two, gas, and a seat belt.

As *Figure 4-1* illustrates, there is little in the way of financial systems, no management depth to speak of, and "strategic" boils down to "next Saturday." Growing value in the new business is the job of the entrepreneur, probably best accomplished in his solitary determination, focused on his dream and fueled by his sweat. Outsiders could tend distract him, drain precious time and energy, and even clutter up his decision making.

In the *threshold* stage, the business owner's afterburners typically begin to sputter just when he needs extra thrust to handle the dangerous turbulence being thrown at him by accelerating growth. It is at this point that he starts looking for technical solutions to technical problems, as well as the people to fly shotgun for him and sweep for strategic land mines like significant competitor moves or changes in commodity markets.

"Loneliness at the top" during this threshold period between entrepreneurial venture and a professionalized company takes on an entirely new dimension for the now-successful entrepreneur. Not only does the buck still stop in his lap, but now flak is whizzing by on all sides and the dials on the control panel are starting to spin. Lacking a well-developed management team, the harried entrepreneur has nobody to watch his back or help fly the plane—help he now seriously needs.

As growth continues—growth which almost always requires an evolving management team—The Boss and his/her managers find themselves increasingly looking farther ahead of the aircraft. Quick responses are becoming more and more difficult to achieve as the asset base grows and problems become more complex. Now, both The Boss and the management team develop an increasing need for some sort of "ground control," somebody to help with the bigger picture, with strategy. Clearly, the operation has changed fundamentally, and because of that change, the need for help also has changed significantly (see *Figure 4-2*).

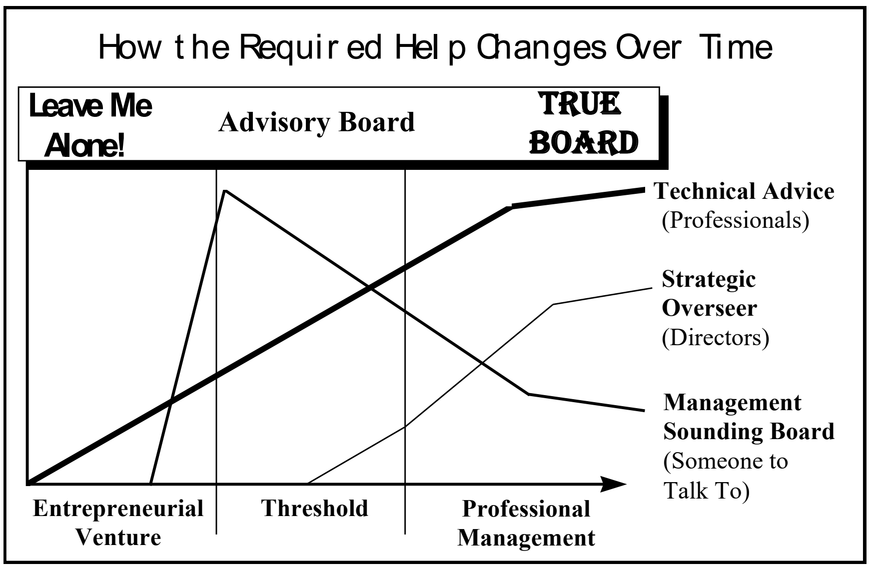


Figure 4-2: *When family and closely held companies are either in the entrepreneurial or threshold phases of development, an independent board is not the best source of help. In the early years, except for a few professional advisors, the founders are best left alone. During the threshold period, an evolving group of professional advisors, successful business owners, even informed friends can work very well in the context of an advisory board. Only once the business is truly professionalized, is it truly ready for a real board.*

In start-up ventue, the new entrepreneur mostly needs room to run. As success and growth comes, however, the need for professionals like accountants, attorneys, and industry consultants, also begins to grow.

Near the end of that early phase, another form of help—that "somebody to talk to"—stays relatively strong through the threshold. Professional advisors are not the best source of help with operating problems of the threshold. For growth companies in changing industries, the appropriate sounding boards are generally individuals who have in-depth knowledge of the workings of the markets served by the business and specific characteristics of the owner's industry.

Thus, through the threshold phase, most owner-managers can get more benefit from technical professionals or industry peers than independent directors. (In some industries, for example, groups of CEOs who get to know each other at association meetings but aren't in direct competition serve this function; they form review groups that periodically descend upon one of their members en masse to evaluate his or her business.)

Beyond industry, product, and market issues, other important issues arise during the threshold period that require specific professional expertise of advisors (see *Figure 4-3*, which shows where advisors can have input to the value management process). For example, a company will almost always need help in bringing the shareholders together in agreement on goals and objectives. As we've already seen, shareholders must separate their overlapping roles as owners, directors, employees, and family members before they can discuss and agree on common strategic goals. Frequently, they need to develop formal agreements defining their expectations of each other and outlining procedures, such as buy/sell agreements, in the event of disruption or disagreement.

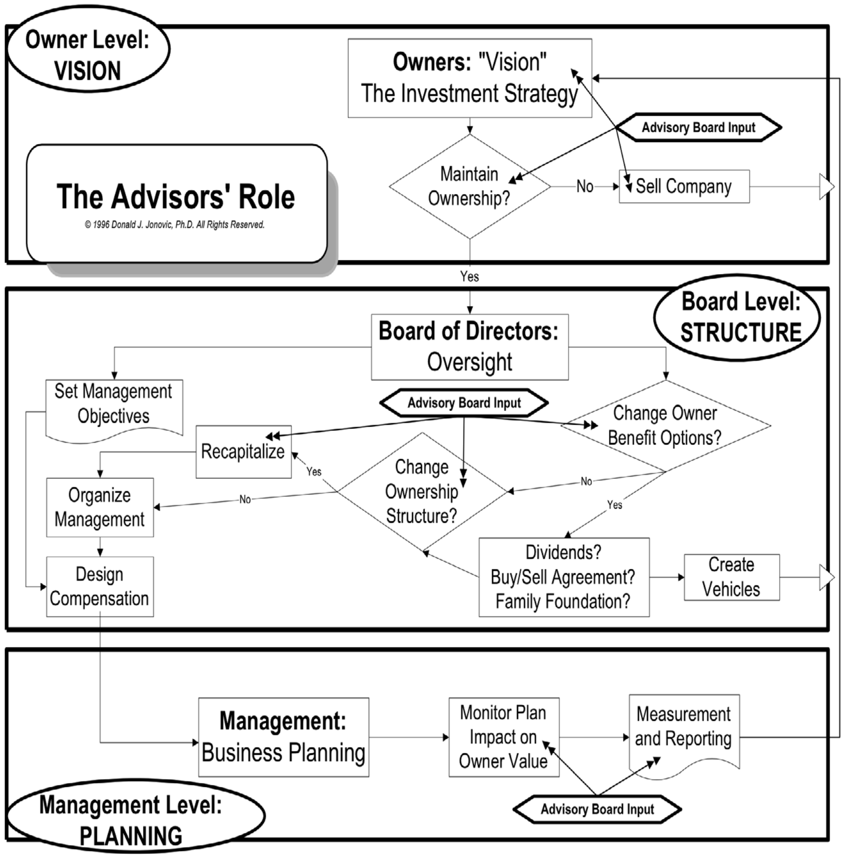


Figure 4-3: *This flow diagram, first discussed in the Introduction, shows where advisors are properly involved in the key decision areas impacting the management of owner value (see Chapter 5 for a discussion of managing shareholder vision, Chapter 6 for approaches to management goals and compensation, and Chapter 7 for a discussion of ownership benefit and transfer planning priorities). The input of advisors and/or directors (exactly which they are depends on the stage of evolution of the company), is needed throughout this process, helping the owners and management with issues they may not be qualified to address on their own.*

Family companies in transition also usually need intensive help in planning management succession. Growth brings with it an urgent requirement to begin separating the concerns of ownership from the concerns of management before they become hopelessly and disastrously confounded with each other. The separation is not natural, but in most cases possible if decision-making is structured the right way. The process requires thinking beyond the present quarter, defining responsibilities, setting up viable measures of performance, instituting a reasonable and understandable compensation system, and establishing a workable management structure.

The help of formal directors is a capstone need that arrives with success. Proper use of competent professional advisors throughout the threshold period can help business owners in transition to become the professional organization that can truly benefit from outside directors.

Avoiding Dysfunctional Owner/Advisor Relationships

In most closely held companies, however, there are major barriers to using professional advisors effectively. Business owners, in general, consider their professionals to be little more than a necessary evil—necessary because (in the business owner's mind) the lawyers and accountants have succeeded in constructing a world too complicated for a normal person to navigate safely.

To the business owner's way of thinking, advisors are an "evil" because:

1. They are far, far too expensive,
2. They are reactive rather than proactive, and
3. They do not understand the real world of the business owner,

When working together, professional advisors—principally accountants, attorneys, and insurance underwriters—and their business-owner clients remind me often of awkward boys and girls at the high school sock hops of my teens. The clients line one side of the gymnasium, the advisors stand along the wall on the other, and they giggle at each other across the empty dance floor. The future depends on their getting together successfully, even enthusiastically, yet they never have the nerve to cross the floor and really *dance*.

Instead, I am often approached by business owners asking if there are any good books on estate planning. With a picture in my mind of all the heavy books in the tax specialist's library, my response is usually something like, *"You might as well tell me you have a tumor on your cerebellum and want a good book on self-administered brain surgery."*

It is easy to understand why business owners and their advisors get together and dance? Principally, for the three reasons listed above, but in reverse order of importance. This is not only my personal judgment. I am simly restating what my clients and other business owners and professional advisors have told me over the years.

It is essential for all of us to understand this "syndrome" in order to resolve and get beyond it, because effective advisory relationships are so critical to the future of the family and closely held business. In fact, building successful advisory relationships is certainly a master key to managing owner value, long term.

Problems with Fee Structure

They're too d…ned expensive!

First in importance is that issue of cost. Business owners, consciously or unconsciously, tend to see hourly fees and insurance commissions as a cousin of conflict of interest. Why, the business owner asks, should I have to pay someone for how long it takes him to get something done? That is like buying a car by the pound.

The insurance agent may try to skate free of the hourly fee complaint by saying he does most of his work at risk. He may try, but it will not save him from the client's displeasure and distrust as he looks at the premium levels. *You want to know why I have a problem with you?* the business owner asks. It is because I have to pay a high premium to cover all that "at risk" work you do for others who don't buy from you in the end. How is that fair? Why is that good business?

Accountants and lawyers, on the other hand, are trapped in their own accounting systems and compensation structures. Many of them agree with the business owners' complaints but are having a hard time changing a hidebound practice.

Change they must (and are), because clients (read: customers) are beginning to insist on a one-to-one correlation between *value received* and *fees paid* for services. In the coming years, I am convinced, we will think of retainer arrangements, quoted project fees, and flat commission structures as commonplace, and hourly fees will be an arcane curiosity. Until, then, however, we need effective, interim solutions, one of which I will discuss below in the context of advisory boards.

The Advisor's "Reactive" Nature

Accountants are bean counters, historians. Lawyers are always looking for ways to cover their butts. The only original ideas I ever get from them are the ones that I bring up in the first place.

These complaints begin to sound like commercial jingles, they are repeated so often. Like commercial jingles, they contain some components of truth, but only some.

I have had the good fortune to work closely with many fine attorneys, accountants, and life underwriters over the years. I agree that they tend to be conservative, more reactive than proactive, but often for good reason.

To be a proactive advisor, one first must be in the position to understand the problem—to know what it is you are actually talking about. In the case of the business-owner client, that means knowing all there is to know about the situation, or at least all that is important to know. Sounds sensible and reasonable, right? But is it simple? Hardly ever. It is not unusual, for example, for an attorney to be asked to design an estate plan, but not be given all the facts (things like *all* of the client's asset holdings, their value, and even insurance in force) that he needs to do the job. It is not unusual for an accountant to be asked to review management accounting needs, never having met many of the managers. It is tough under those circumstances to come forward, confidently and aggressively, with a full-blown recommendation.

If advisors and their clients are ever going to dance, let alone get into step with each other, we will have to find a way to educate the advisors on the nature of the client business. An advisory board provides the perfect opportunity for this education.

The Advisor's Business Naïveté

The trouble with accountants (and lawyers, etc.) is that they don't understand my business.

There are right and wrong sides on this one, too. It is true that many professional advisors do not have an adequate understanding of many of their clients' businesses, but seldom is this because the advisors simply do not care to learn.

More likely, it is the business owner's reaction to his or her other complaints—high expense, tepid advice—that is the main cause of this general prejudice. This vicious cycle comes full circle when the client, believing the advice to be lacking in quality and not worth the cost, fails to use (and therefore fails to *inform*) the advisor.

I have yet to meet a student who could pass a final if he didn't have the texts and the teacher seldom lets him into the class.

Avoiding these issues by eliminating their cause is crucial. Ignored, as they generally are today, they impose significant negative effects on businesses, their owners, their employees. Such a consequence when combined with the general penchant toward secrecy in the closely held business, makes it obvious why "hermetically sealed" is a more apt description than "closely held."

Well, if we are to preserve and grow owner value in any closely held business, we must break that hermetic seal. We must seek the input of effective advice and prudent counsel to shareholders, owner-managers, and management teams in closely held businesses. The simplest and most effective way that I've found to do this is to form an *advisory team.*

CREATING AND USING AN ADVISORY TEAM

To repeat an important fact: family and closely held companies in transition face many questions they have not either the experience nor the expertise to answer. These are questions of successor competence, relative rights and benefits of owner-managers, selection of future key managers (including the issues of nepotism), and how to provide for the sensible, secure retirement of the present owner(s).

Further, the process of selecting new leaders, providing for retiring leaders, and all the general issues of family fairness must be managed in a way that is integrated with everything from estate planning to compensation systems to projections of future business value.

Along with a succession plan, agreement also must be reached on ownership transfer. This is not merely a question of estate planning, although the legal and tax elements of the transfer are critical and often complex. There are also questions to be answered concerning the ultimate ownership structure, who will have voting power and control, and what capitalization strategies and buy/sell agreements are appropriate.

An advisory "team" that is properly populated with qualified professionals is an excellent vehicle for accomplishing such things. The work needed is exactly the kind of work the advisors do every day of their professional lives. All we need to do is *bring them together* (hence "team") so we can leverage their experience and knowledge by vetting ideas as a group. Here are some specifics:

Who: Advisory Board Membership

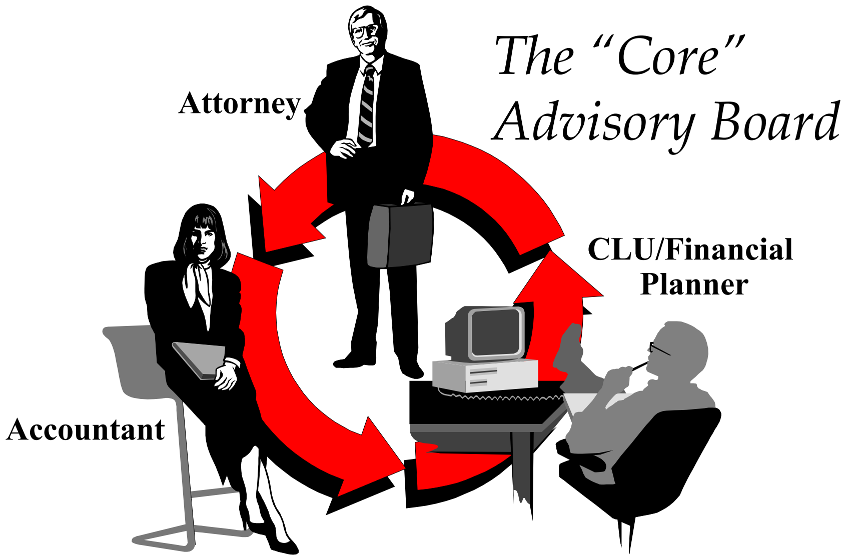


Figure 4-4: *The most basic advisory team or "board" consists at least of the key professionals, as above, together with the owner-manager(s). They should address the fundamental requirements of owner value management, such as sound shareholder agreements, an investment strategy, and strategic compensation. Once these are met, the structure of the advisory team can become more operational and/or strategic in nature, depending on need, and frequently evolves into and advisory "board," and, eventually, a true independent board.*

During the threshold period, when all the basic issues mentioned earlier are being dealt with, the business owner will benefit most if he seeks guidance from highly skilled professionals in law, accounting, insurance, and family business management. Such professionals working with the owners—and one another—as a team are most qualified to lay the track for professionalization of a business. Such a group usually consists of an accountant, an attorney, the senior owner-managers, a family business specialist, perhaps an industry consultant, and, possibly, a representative of non-participating shareholders. The professional advisors usually form the core—and most active—part of such a team.

Further, through the threshold transition, informed and familiar advisors can help resolve family issues and familiarize family members with their roles in the new structure. This involvement can be short-term or long-term, depending on need.

How: Advisory Board Costs

Since perceived excessive cost is the primary reason business owners hesitate to use their advisors effectively, a well-designed advisory team can be structured to eliminate this problem as a concern. The most efficient way to do this is to establish a retainer arrangement with the key advisors on the team.

Retainers are set in frank conversations, client to advisor, about the need for general help, the essential nature of cost control, and the advisor's legitimate income requirements. An advisory team relationship is not the same as a client relationship. It is a joint commitment to mutual education and general deliberation over general problems for the purpose of making it possible that the issues critical to the ongoing successful operation of the business will be recognized and properly addressed. A retainer can be used to cover the *team* involvement and activity. Specific *client relationship* issues (e.g., contract drafting, litigation, patent applications) are "off-line" from the work of the team and, therefore, compensated separately, preferably through some form of pre-defined project fee or, at least, on a project by project basis.

Under the retainer arrangement, the owner should be able to feel free to call the advisor to inform him on or explore general issues. Periodic meetings, say three to five per year, should also be covered, as should preparation for those meetings.

But enough retainer *theory*. Business owners like to get right to the bottom line: just what kind of "retainer" are we talking about? It does, as most realize, depend on the nature of the business, but a good rule of thumb is the retainer should be equivalent to the compensation of the CEO for a similar number of days' input. To put it another way, the number of advisor-days required could be estimated and multiplied by the equivalent daily salary of the company's top officer or CFO. If the number of meetings involved is unpredictable, a proportion of that same number can be used as a per diem for each meeting beyond, say, the primary four or five regular advisory board meetings. This per diem is intended to cover any meeting preparation time that might be required. Since advisory board service is general in nature, preparation time should not generally be extensive.

Let us say, for example, that a CEO of a closely held company is paid a base annual salary of $260,000. Assuming 260 working days in a typical year (ignoring the six days a week, 14+ hours daily reality of many entrepreneurial executives), that is about $1,000 per day. An advisory team expecting to meet four times annually would, therefore, be compensate by a retainer of $4,000 per year, per advisor. Committee and other special meetings could carry a per diem of, say, $1,000. Travel expenses would also be covered.

There are other possible approaches to setting retainers, of course. Often, for example, owners will treat the advisory board as an expense item on the income statement, and budget the total cost at 1% or .5% of sales, or whatever is comfortable. This dollar amount is then allocated per advisor as retainer and expense reimbursement. Still, others do something as simple as pull a fee number out of the air because it seems "about right." Since business owners are very sensitive to the value of money, such "gut" retainers often end up being appropriate to the situation.

Why would any successful advisor work for a retainer that almost always comes in significantly less than what would be charged if the time were billed on a traditional hourly basis? Because the advisory board relationship allows a much more intimate relationship with the client, a greater chance to be involved in (and bill) technical work beyond the board relationship, and the probability that the extra work will be more cost effective (hence profitable), thanks to greater knowledge of the client and the situation.

Additionally, an advisor serving on a closely held business advisory board is learning a business and an industry, valuable education worth a bit of discounted fee "tuition." And not to be overlooked is the stimulation and satisfaction to be gained from the positive sparks generated by a group of dedicated professionals working at what they know best in a setting designed to get things done. In two words, this all spells "job satisfaction" for any advisor.

What: Advisory Board Responsibilities and Objectives

Perhaps the greatest value of an advisory board through the threshold phase of business evolution is the assurance of continuity and coordination. Too often in family business transitions, the experts are allowed only to give advice in separate compartments, usually without a big-picture understanding. What work is done usually moves slowly, by fits and starts, because there is no formal process to manage it.

By setting up an advisory group that meets regularly, with agendas and minutes *(*see *Appendix A-9* for examples*)*, the owners ensure continuity in attention to the issues, coordinated action, and implementation of decisions. The owners also become comfortable with the notion of formal review by outsiders, which paves the way for the long-run ideal of a true independent *board* as the company becomes increasingly professionalized and formally governed.

SIGNS THAT YOU'RE READY FOR AN INDEPENDENT BOARD

Boards of independent directors become appropriate when an organization has achieved, or is close to achieving, "professionalization." Getting there requires the passing of a number of essential milestones:

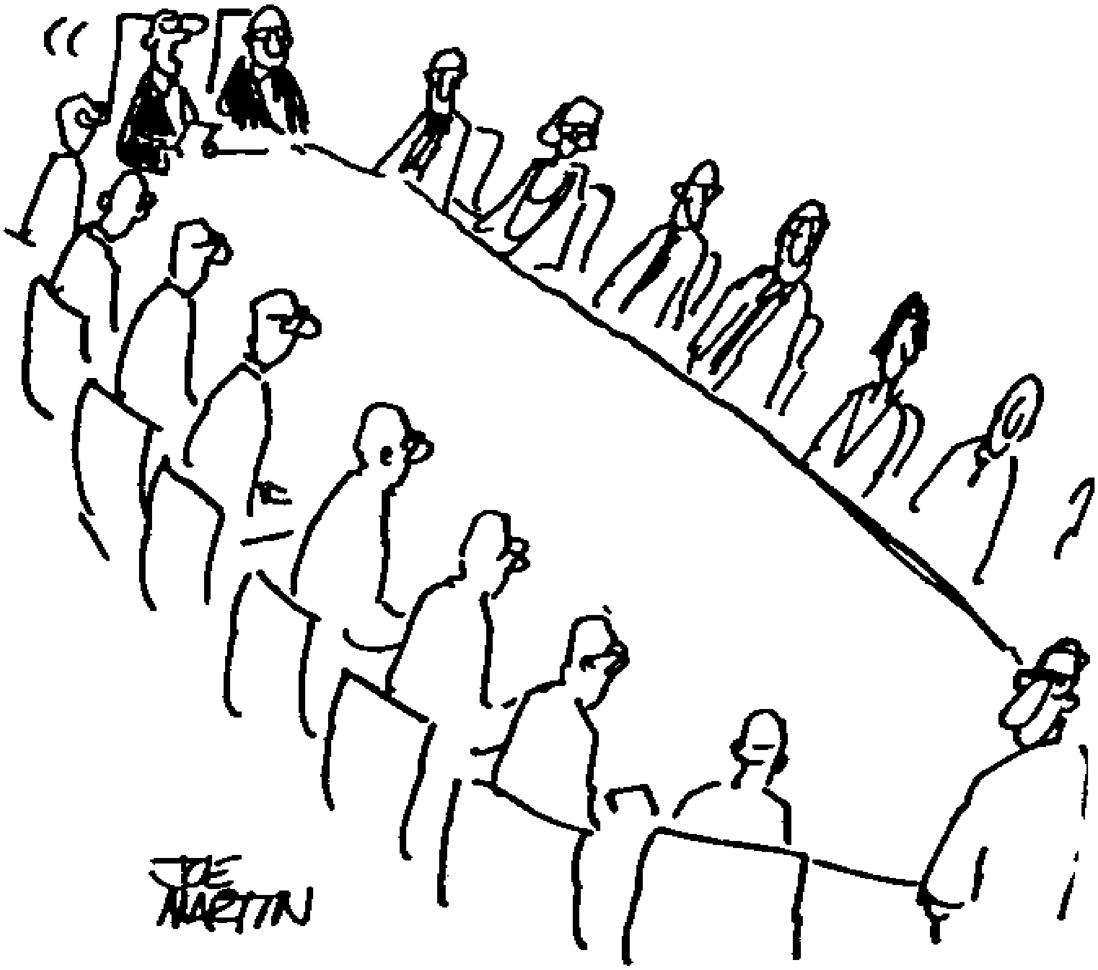
- Adequate, formalized owner (e.g., partner or buy/sell) agreements.

- Owners' agreement on goals and objectives for the business as an investment—growth objectives, tolerable risk levels, returns expected, etc.
- The beginnings, at least, of a plan for scheduling and funding the transition of management and ownership from the present to the successor generation.
- Timely, accurate accounting information in a form that facilitates planning, operational decision-making, and performance review (for example, operating and capital budgets, weekly and monthly key results reports).
- Strong, coordinated middle management operating on incentive compensation directed by performance goals.

These are the primary goals that the advisory group should help the business achieve. While every closely held company needs some form of outside review, an advisory team can get the owner-managers ready for the kind of teamwork a fiduciary board requires. Advisory boards provide a valuable transition phase for most closely held businesses—getting them to open up, getting them to really use their advisors, getting them actually to do the work and planning that needs doing.

This is the formal dance required for sound governance. When (and if) the owners are ready for "marriage" (a board with a majority of independent directors), they'll know it. Once the board of advisors has done its job, the independent board will actually have something to direct.

4: OWNER VISION: THE "INVESTMENT STRATEGY"



Let's see…that's nine "Aye's," one "what aree we voting on?" six "abstains" and one "Go to Hell!"

"Any further discussion?" the Chairman asked.

"Well, I feel awful saying this," Dorothy responded, "but we're voting to approve a budget, here, and I don't think anybody on this board, including the Chairman, whose budget it is, believes it."

"Wait just a minute, Dot," Paul (the chair and her brother) interrupted. "You're implying we're sandbagging the budget?"

Dorothy turned to him, flushed and uncomfortable.

"I'm not sure what 'sandbagging' means, Paul. And I'm not saying you're trying to put something over. Please, I'm just saying year after year, we miss our budgeted profits by a mile. You always have a justification, and I know you're not lying, but why should we take a budget seriously when it's never met?"

"We use the profits for other things than net income," Jim Greene, the CFO, said. "Acquisitions, capital expenditures, all aggressively expensed to reduce taxes."

"But that doesn't change the fact that we're not making money," Dorothy countered, some anger now replacing embarrassment on her face.

"But we are! You just can't understand accounting," Paul shouted.

"Well, what I CAN understand is anemic S-corp payouts," Dorothy's husband growled back. "You can call it anything you want, Paul, but this company just isn't giving us a return on our investment. It's a toy for you and a liability for us."

In the silence following her husband's outburst, Dorothy looked around the board table. Each of the directors (mostly cousins and siblings) looked worried and confused.

"See," she said, "this is exactly why I feel I can't bring up my concerns. They just cause trouble."

raising concerns in board meetings is not what causes trouble. It is the failure to deal with concerns like Dorothy's in an informed, objective, and constructive way.

Very llikely Paul and his managers have a clear (to them, at least) business vision. What this family corporation lacks is a clear *owner* vision.

When we hear terms like "vision" or "vision statement," most of us think of grand proclamations in a fancy type font. They are majestic and unassailable.

What is seldom discussed is whether anybody takes them seriously.

Some do, of course—after all, somebody had to write them in the first place. What about everybody else, those who see these declarations as so many words on paper—a meaningless wish list that takes valuable time to draft, but produces little tangible result.

What is needed is a clear statement of strategic purpose and associated objectives tied directly to maintaining investor commitment and business continuity.

We must come to terms with the fundamental issues that inevitably divide us as owners. We must find ways to meld our individual perspectives into agreement on goals and direction for the *investment* the business represents—in short, a clear definition of the fundamental purpose of our business. Agreement among all owners on an investment strategy is the most important, fundamental factor in preserving owner *value* in a closely held company. *Without it, sustaining a successful business strategy is almost impossible.*

If two people in a business agree on everything, Henry Ford once said*, one of them is superfluous.*

Translation: disagreement among thoughtful people is inevitable, but that does not have to mean anarchy. Disagreement, in fact, should help us come to ever more effective agreements.

Assuming they are communicating effectively, two heads are generally better than one. Even Einstein had collaborators.

We have already discussed why it is so important to separate the investor, director, and employee perspectives by developing a formalized meeting structure (*see Chapter 3).*

The next goal is creating an efficient process for making decisions. Sure, “process” is a bureaucrat’s word. Consultants use it a lot. So do academics for whom it has become a mantra, a liturgy. Entrepreneurs, however, hate process. They are built to do, not to talk. As a Jesuit teacher I had years ago would describe chatter: it was nothing more than a “barnacle on the ass of progress”!

This difference exists between the theorists and the entrepreneurs because they have different pole stars. Theoreticians think long-term. The entrepreneur is usually fighting to survive, lucky to be able even to think as far out as next quarter. Process is slow to respond to events, something that strikes the street fighter as a weakness, as almost suicidal. If you fail to throw the right punch, at the right instant because you have to “think” about it, you have lost before the beginning.

We each can only use the tools that are available, that work for us—and we should continue to use them. BUT we need also to realize what business builders need as they grow: *an expanded world view. Basically, a larger toolbox*.

Managing *success*, by definition, requires thinking in the longer term, to look ever farther into the future to make sure the right *questions* are being asked. Success inevitably brings a hailstorm of *purpose* questions arise. They are much less concrete and urgent than the survival issues entrepreneurs are used to and will always face.

Over many years and in many board rooms, I have worked elbow to elbow with business owners as they and their teams faced the inevitable pressures that come in the wake of success. In almost every case, the cold tail winds of intent proved to be fundamental to long-term business health. They eventually prove an essential compass for reaching and, later, as the mainmast grows taller, intent stabilizes and organizes the crew (read: family harmony).

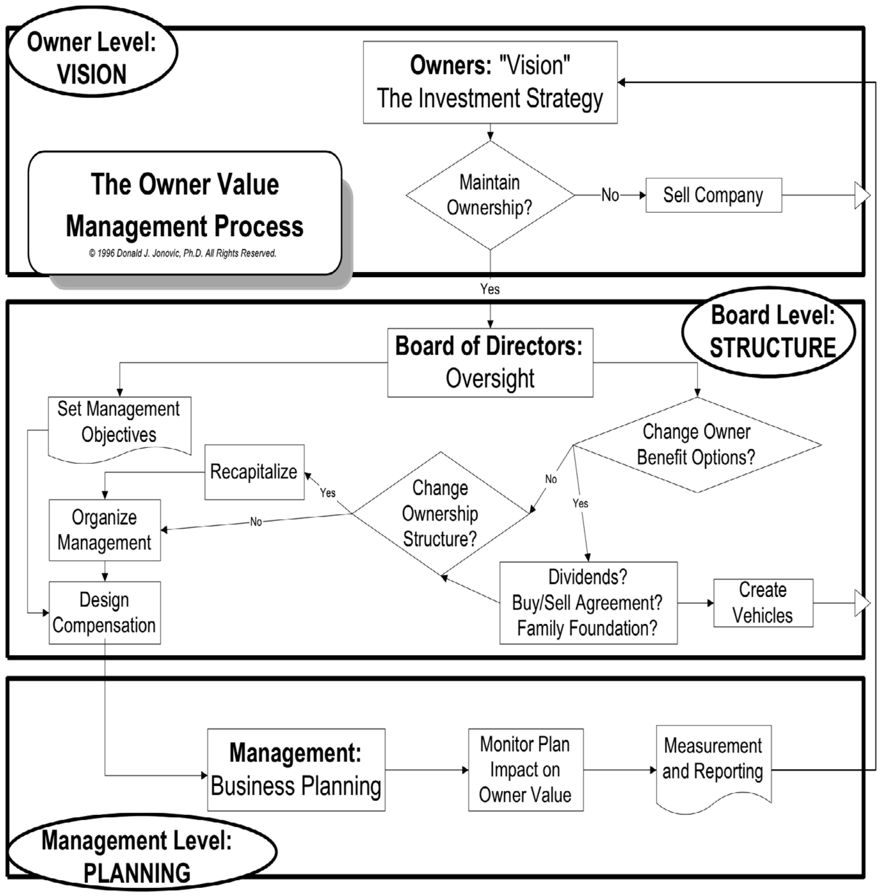


Figure 5-1: *Managing owner value is a way of life which ties together decisions on the owner, board, and management levels. Decision-making on each level must proceed simultaneously with, and in light of, decisions on other levels. This is a growth process, the effectiveness of which will evolve with time and experience.*

This evolution follows a familiar pattern. It begins with questions that seem, in the eyes of the owners, impossible to answer. Challenges drip out of nowhere, appear overwhelming, let alone approachable, but with a habit of disciplined discussion, good minds form an assembly line, creative ideas can be laid, side to side, connections connections emerge. Logical links are found among the challenges. These connections, yes, forming a process, are illustrated by the flow diagram already referred to in the *Introduction,* in *Chapter 4*, and reproduced above (*Figure 5-1*).

When broken down into component parts, the diagram shows which actions and what decisions must be taken on the three fundamental levels of interest and intent that live in the heart of any business: the *owner* level (expectation), the *board* level (vision and structure), and the *management* level (planning and execution). This chapter will focus on the first of these—owner vision, as defined through creation of the investment strategy.

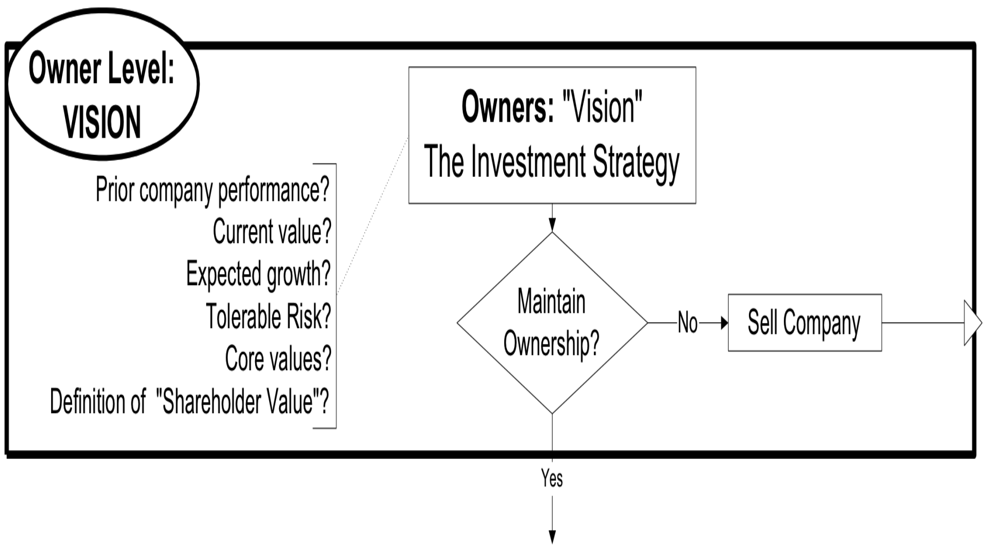


Figure 5-2: *This first portion of the "process" diagram focuses on the critical decisions owners must make about their investment. The role of advisors and other outsiders can be particularly critical here, since one of the fundamental decisions to be made is whether or not to continue ownership of the business.*

FOUNDATION: THE *OWNER VISION*

The most fundamental step, approving a statement of the investors' objectives for their investment in the business (*Figure 5-2*), is usually finalized or changed at meetings of partners and/or shareholders. Approving this budget, 5-year projection, Strategic Plan, whatever, is the principal function of the annual meetings of shareholders, or at least it should be.

Creating the vision is another matter entirely. The questions to be raised, analyzed and answered concern appropriate return on investment, business value targets, clarifying required annual growth rates, boundaries of risk tolerance, and expression of corporate values. These questions must e defined and answered *by the owners* "in congress assembled." Outsiders (variously: in-laws, independent directors, senior managers, consultants) can offer significant help in creating the vision, but the vote of approval cannot be delegated to anyone other than shareholders, trustees, potential heirs to ownership of the privately owned company.

Owners and/or shareholders of closely held businesses usually want to increase the value of their investments. There's seldom much disagreement over that. Where we run into considerable trouble is in the follow-up questions: what exactly is "value," and what do we consider an acceptable "increase"

Look again at *Figure 5-2*, at the list of questions to the left of the *Owners: Vision* box. To answer questions about "value" and "increase," these probes are essential. Seldom, however, do shareholders carry on these discussions in any objective way.

- *How has this company performed as an investment?* Most of us check our mutual funds and the market reports on a daily basis. A lot less often, if ever, do we look at the *investment performance* of our businesses. Sure, the income statement is always an agenda item, but there ia a vast difference between "net income" and "return on investment." In the epigram that opened this chapter, for example, Dorothy and her husband are convinced their company is not providing an adequate return. Based on what evidence? A "low" net income. The CFO tried to explain the returns that were coming in "above the line, and outside the balance sheet, in the market," but that offered little consolation to Dorothy who was probably looking for distributions in the form of dividends, or, at least, some visible increase in that line called: "retained earnings."

- *What is the current value of the business?* Before we can even begin to calculate return on investment, we'd better agree on what that investment is. Accounting statements have a ready answer: book value. The rest of the world must struggle with reality. Businesses are bought and sold based on EBITDA, market share, management team quality…
- *What growth rate is desired for this return. What growth rate is even possible?* We can want an annual growth rate of 25%, but turning that growth into reality without huge capital infusions to fund acquisitions and/or expansion may be very difficult—and risky. Are the understood by all owners?
- *What level of risk are we willing to tolerate as investors?* Risk comes in many forms. Business owners face liability risks, risks to capital, structural risks, environmental risks. Many of these can reach right through the corporate "veil" into the owner's personal pockets. Do we have the will, the wherewithal, even the *sand* to take the risk necessary to get what we want? While much of "risk" is hard to quantify, the variables covering significant facets of it (leverage, insurance, even *force majeure*) can be defined, discussed, debated and agreed upon by owners.
- *What are our core values as owners?* This is a "soft" question, but it has some very hard implications. For

example, I am a director of a company that continues to invest in a segment of the business that provides less return on its assets than could be realized elsewhere. They have agreed, as partners, that they will continue with this business because of the great benefit it brings to children, something that has been a core value of their family since the company was founded more than 60 years ago.

- *What process will we use to review and redefine "owner value" targets in the future?* If our purpose is to preserve and grow our investment, it seems obvious that we had better make sure we all continue to have the same definition of what constitutes "value." From this fundamental definition will spring everything starting with our decision to keep or sell the business, through our planning and budgeting process, to the system we use to compensate our management team.

There is no law of nature that decrees a closely held business must, or even should be preserved. It is also a fundamental decision related to definitions of *owner value*, and all the parameters of those key variables: risk and growth.

When the meaning of "owner value" is not defined by a shareholder group, all sorts of emotional and financial havoc can be wreaked. Otherwise healthy family relationships can be destroyed by trying, year after increasingly stressful year, to preserve a business weighed down by dysfunction and brimming with conflict (*"It would kill _____ if we failed"*). In a different but equally disastrous scenario, aggressive and talented owner-managers can destroy value for all owners through excessive focus on growth. (*"I know we're not making money now, but we can fix that by leveraging up and buying market share."*)

Defining a jointly accepted meaning for owner value, difficult though that can be, *is the first and most fundamental strategic decision to be made by a closely held company.*

Unfortunately, it's usually one of the last decisions to be made, usually in litigation.

Getting back to Dorothy's problem with her brother at the beginning of this chapter, theirs is an example of an attempt drafting such a definition at a family business board meeting. It failed because she and her brother were confusing the investor and manager perspectives. They *thought* they were having a board meeting. Instead, they were in the middle of a combined shareholder-management meeting. Had their meeting been defined, instead, as a *shareholder* meeting, with the appropriate agenda set beforehand, the discussion (with the essential help of the advisors) could have been much more productive.

A "Crash Course" in the Realities of Business Valuation

Anybody familiar with formal business valuations knows that the process is composed of equal parts of science and art. This is not the place to get into arcane methodologies for placing values on companies, but it is important to think about specific assumptions we may be (or should be) making about what the key components of value are in our specific business.

At the two extremes of the valuation spectrum, generally, are book value (heavy science, low art) and market value (light science, high art). Neither is a particularly satisfactory way to measure a business from the owner vision perspective.

Book value, that line on the balance sheet called "shareholders equity" or "owner equity," carries a lot of "generally accepted accounting principles" baggage (e.g., depreciation and at-cost value) that can lead to significantly misstated "investment" value. Market value estimates, unless there is, in fact, a willing buyer offering real cash for the business, are frequently matters of semi-supported opinion, themselves clouded by "noise." Even an actual offer at a specific price may not accurately reflect the investment value of the business to the current owners. A buyer might, for example, offer far more than a business is worth based solely on assets or profitability because the buyer has an unique, or strategic objective. Eliminating a competitor, for example, can often be worth a premium, a component that would not be considered by current owners evaluating their own investment.

Valuation for the purposes of defining shareholder value does not have to follow all the rigor and justification required of formal valuations. Owners primarily need to agree among themselves as to what they define as value. They can use as much rigor as they wish, as long as they agree the method is sensible and the resulting value acceptable.

The process is seldom excessively complex. My experience has been that, usually, some variation on either adjusted book value or capitalization of earnings, or a combination of the two, is selected by shareholders trying to define the value of their business. These can often be done on flip charts or small spreadsheets, but simplicity shouldn't imply the results are trivial. The definition, itself, is critical to the whole process of building value. The thought process involved can teach owners (as well as managers and prospective owners) a lot about the nature of their investment.

While each business will go about this exercise in its own unique way through shareholder/advisor discussions, some rule of thumb questions generally apply:

- *What adjustments to book equity are necessary to better define the actual value of our net investment?* Do we, for example, have two different kinds of investments, operating and non-operating? Have we "parked" capital in land that we expect to become valuable in the future, but is not being used today? If so, we may want to apply differing return criteria on the two asset classes. Do we have liabilities on the books (e.g., loans from shareholders) that are actually never to be repaid? If so, they really represent distributed profits, not debt.
- *What is the long-term earning power of this business?* This is an estimate, of course, but competent managers

(and their advisors) do it all the time when preparing annual budgets. With a few more extrapolations and more aggressive prescience, its usually possible to project an agreed-upon future earnings stream. Given that cash flow is one of the key "returns" for investors in going businesses, projecting earnings streams is an important analysis to undertake. It can also be a critical component in determining value if the owners decide a capitalization of earnings approach is appropriate.

- *What is the appropriate rate for capitalizing our earnings to determine a value?* With earnings defined, it is possible to analyze the value of the business, particularly relative to risk, to see what underlying value would make our earning stream attractive.

  For example, say we had an investment that generated annual earnings of $65,000. Further, say that our investment carries virtually no risk. How could we determine the value of that investment? The best way would be to compare it with other risk-free investments of known value and return, most typically, the average yield to maturity on long-term Treasury Bonds (which for our purposes we will set at about 6.5%).

  To get a $65,000 annual return on a Treasury Bond, on that assumption, we would d have to invest $1 million, or about 15.5 times expected earnings. That is a lot of investment for a relatively low return, but, remember, there's no risk. The more risk involved, clearly, the greater the potential return we would demand, or conversely, the less we'd be willing to invest to achieve a specific dollar amount as return.

  Let us say that $65,000 was generated by a business in a volatile industry with a limited product line and a high regulatory risk. Here we might add "risk premiums" to that risk-free 6.5%. We could first add a risk premium of

7%, because that's what investors in large publicly traded stock have earned over Treasury rates since 1926. We could further add another premium of 5.2% because this company is small and that's how much better investors in "micro-cap" companies have done over "large-cap" investors over the same period.*

On this basis, the required return rate has increased from the risk-free base rate of 6.5% to 18.7%. We would be willing to risk less (in this case, $348,000) to get the same $65,000 return. Thus, the cap rate of this business would be approximately 5.5 times earnings (versus the 15.5 risk-free rate). The higher the risk, the lower the multiple applied to earnings to estimate underlying value. In other words, the riskier the business is, the more earnings expected for a given investment.

There are other important factors to consider. If the company's earnings are growing at a significant rate, we could consider that growth as part of the return and deduct it from the required premium. If the company is closely held and has a lot of unique risk factors, we might increase the premium.

- *Should we use a combination of equity and capitalization of earnings to determine the value of our investment?* This judgment is made by analyzing the relative importance of assets and earnings in our sense of business value. Agricultural businesses, for example, often are heavily asset-based and generate relatively lower cash earnings than other manufacturing businesses. Service businesses, on the other hand, can have a relatively low asset value but relatively high earnings. Depending on the business, a weighting of the two approaches (e.g., 65% adjusted book value, 35%

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* These returns are only estimates for example use, but are close enough for our purposes to the realities and volatilities of the past century or so.

capitalized earnings) could give a more appropriate and, hence, *more likely to be accepted by all owners'* definition of value.

The answers to the above questions (more accurately the discussions leading to those answers), are essential to the process of setting investment strategy, and to managing owner value. Without them, it is difficult even to know for sure if the owners want to (or reasonably, should) continue investing in the business.

Without this analysis, the shareholders can easily divide into various factions, some happy with the return, some unhappy, others generally ignorant of the whole issue. Risk and opportunity will tangle hopelessly with each other in owner discussions, and decisions increasingly will be made by default, by powerful interest groups, or, worse, not at all.

Independent of the internecine conflicts and Byzantine politics that can result among the owners because of a failure to set an investment strategy, there is another problem that results in further erosion of owner value: *employees are very sensitive to confusion at the owner level, and can easily become confused and demoralized themselves*.

DEVELOPING THE INVESTMENT STRATEGY

Agreeing on a set of targets or mutually agreed upon goals for a closely held business is probably the most difficult strategic decision that business owners must make.

The "owner value management process" I have been describing and discussing throughout this book lists the investment strategy as logically prior to all other questions and decisions. That is appropriate…but only from a logical point of view.

Practically, it is very difficult to define a closely held business investment strategy in a vacuum. Publicly held corporations find it relatively easy to define return on investment, because standards for what is and is not sufficient return are determined by objective market forces for the Apples and Ubers of the world.

Private businesses are forced into much more dynamic and much less objective definitions of "good" investment performance. At the same time, owners of closely held companies have more control over that definition than shareholders of public companies. Components of private business value, particularly in family companies, tend to get fuzzy around the edges, as I discussed earlier, and can include non-financial considerations like career opportunity for owners and community name recognition.

Given all that, definition of an investment strategy—the statement of what we, the shareholders as a group, expect from our business—is a very fluid process. The definition evolves through analysis, goal setting, budgeting, action, measurement, and review. As time goes by, owners, board, and management become more experienced with the value-setting process and, therefore, comfortable with and confident in the investment strategy.

We must begin somewhere, though, and the best way to do that is to define a set of basic investment strategy components. My clients and I have found the following to be a useful list:

- *Minimum return on investment*[*]. This is generally the easiest component of investment strategy to define, since it represents a return level equivalent to what the owners could get through readily available and low-risk alternative investments. An example minimum ROI target would be the typical return on a portfolio of large capitalization stocks. This number often functions in the compensation system in defining a return level below which no management incentive bonuses are paid.

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[*] *Return on investment* (or "return on equity") is basically a ratio of the free cash flow from earnings available to common shareholders (numerator) to the owners' equity in the business (denominator). It is a product of profit margin, asset turnover, and leverage, the principal components of the income statement and balance sheet. The problem is in the meaningfulness of "book value."

- *Target return on investment*. Target ROI is more difficult to determine, including as it must considerations of the inherent risk in the business, the aggressiveness of the business strategy, and the psychology of the owners. Also, different components of the business could easily be expected to generate different target returns. Typically, Target ROI evolves through analysis of historic returns and owner comfort with those, comparison to industry benchmarks, and expectations of growth (investment in which can depress ROI in the short term).
- *Growth (reinvestment) rate*. It iss a truism that nothing generates cash like a declining business—for a while. Growth is essential to managing value. That growth must either occur within the business, or outside the business after the cash has been distributed to the owners. This is why a definition of expected or desired growth rate is so important to the investment strategy. It basically is a statement by the owners as to what extent they plan to keep their cash in the business. There are several ways to express this component. It can be the rate of increase in owner equity, year to year. It can be stated simply as a projected growth in sales volume at a set margin. In some cases (typically Sub-chapter S corporations), it's defined as a "reinvestment policy," which defines a cap on profit distributions to owners (e.g., only the tax liability is distributed in cash, the rest remains in the business).
- *Risk tolerance*. This might seem like a soft, indefinable quantity, but it can be captured in many cases through definition of a target financial leverage, or debt-to-equity ratio. In general, the less uncertainty the owners perceive in the marketplace, the more leverage they are willing to tolerate. Uncertainty is a combined function of external threats and internal confidence, and when owners agree

on target leverage levels, they are really forced to agree upon their perceived level of tolerable risk.

Clearly, every organization, every set of owners, is going to approach the investment strategy differently. Depending on the level of financial sophistication of the owners, the depth of performance and benchmark data available, and the power of the financial accounting system, this strategy can be complex or simple.

Level of complexity is not so critical as assuring the actual existence of a strategy in the first place. A simple statement of the above targets, based mostly on history, can be a good beginning point. For example:

> ***X Company Investment Strategy***
>
> *The owners of X Company expect a <u>minimum annual ROI of 14%</u> on combined operations, and believe that the company should be able to provide a rolling, five-year average <u>target return of 25%</u>. We expect to <u>grow shareholder equity by at least 15% per year</u> maintaining an <u>average leverage of .9/1</u>, and will <u>reinvest earnings as necessary</u> assuming achievement of the above targets.*

This is a simple statement, but its ramifications can and should be profound. From it, the board can make decisions as to capital structure, acquisition & divestiture, management performance goals and compensation design. With it, the management team will have clear objectives to plug into their planning process and will know where and how their incentives are determined. Everyone will know, too, just how committed the owners are to growth, and what they are willing to risk to achieve it.

Remember, though, that this is a strategy, not a law of the universe. It can, should, and will evolve over time to fit changing circumstances and an evolving owner group.

Dynamic though it may be, however, it is the fulcrum around which the stakeholders in the business will move the world.

5: STRUCTURE, "STRATEGIC" COMPENSATION, AND PLANNING

"As a final, desperate strategy, I've decided to put all directors on straight commission!

Jeff even surprised himself when he slammed his fist on his desk. Two of the associates outside his office looked up, surprised, at the sound, then looked away quickly, embarrassed, when they caught the CFO's ungentle eye.

He's going to raid the line until we lose the bank, Jeff was thinking, as he mopped up spilled coffee with a tissue. *I worked for months on that bank, and when they see what he's doing, they're going to flip!*

This was the third time in the quarter that Mort Spencer, the owner of the business, had demanded cash, and Jeff had to use the line of credit to cover it. Again.

It's bad enough we're paying "consulting" fees to Mort's kids and an inflated salary to him, Jeff thought. *At least those expenses were in the budget. Now he expects our cash flow to carry his real estate hobby.*

The cash went out as "loans to shareholders," and (probably) would be repaid, but cash was cash. They were at the low point in the budget cycle and Jeff was zigging and zagging like a high-wire unicyclist to keep to the cash projections.

Next thing he'll want, Jeff grumbled to himself, *is more salary to cover the loan repayments. With that goes the bank line, the profits, and the bonus pool Mort so generously created last year.*

Jeff remembered how hopeful he felt when Mort set up the bonus program that essentially had no upper end. It shared a piece of the business, in a sense, something Mort didn't have to do.

Maybe I was just too stupid to realize, Jeff decided, as he called up his draft résumé, *that it doesn't matter how big the pool can get if there's always a leak in the bottom.*

Are closely held businesses run for profit? You guessed right. It depends…on what you mean by "Profit."

Is that new branch office at Aspen a business expense—or is it "profit"? It depends, actually, on whether you're more likely to be selling ski equipment, or using it.

What about the company maintenance crew that keeps the shrubs trimmed and the garage painted at the house? That depends a lot on the size of the home office and, maybe, finding a way to get the neighborhood zoned commercial.

Then there's that corporate aircraft, membership in YPO, the country club dues, attendance at the Soda Straw Association meeting in Cancun. Business expenses? Profit? Depends.

The assumption is that it is not smart to show too much accounting profit. That gets taxed. Business "expenses" do not. It actually makes more sense to break even, higher and higher, every year.

Or so it seems to some...

I once worked with a family retail furniture company in the Southwest who had a unique approach to blurring this line between expense and profit. When Grandpa and Grandma founded the company, they realized furniture inventory could either sit in the warehouse or in their house. So, what the heck, they figured, use the house.

Of course, that filled their rooms, leaving no space for them to buy their own furniture. But, shucks, what was a little sacrifice?

Their pseudo-warehouse space increased proportionately with employment of their five children. Same reasoning, now becoming a family tradition.

By the time I met them, some members of the third generation were involved and others were considering the possibility. Predictably, they all wanted their piece of the tradition. This would have been fine, except the business was growing to where it needed some furniture *in the warehouse*.

All right. I exaggerate. A little…

Back to our retailer. Tension was pretty thick around the office and the backyard grills. The most recent family hires had access to less "warehouse" furniture than their older cousins, who, in turn, were reacting like Social Security recipients: *We got ours. You might not. Way it goes.*

And so it *usually* goes. Another pre-tax "perk" that was a reasonable idea 50 years before, was beginning to chill a family's soup.

Compensation in the family business so often is more related to loopholes and tax codes than performance or owner value. In fact, compensation is often the primary means of delivering owner value, dividends appearing as padded salaries, unearned bonuses, and genetically determined perquisites.

All this may be fine in companies where the owners are the only key managers, or where the investment strategy is to milk the asset. For those owners who have developed a vision aimed at our assumed ultimate legacy of preserving owner value long-term, this sort of “compensation abuse” leaves the dreamland of benefit and can begin to enter the nightmare of addiction.

If the goal is to grow owner value of a business, clearly, the management team must be pointed in that direction—which usually means using available cash to invest in growth. That pointing is best done via a compensation system purposed more toward building owner value than as a channel for creatively distributing positive cash flow to owners using pre-tax dollars. Founders are good at this. It’s natural. Multiple owners…not so much.

ENTER THE BOARD OF DIRECTORS*…*

Assuming that the decision to maintain family ownership has been made and, further, that the owners have agreed on an investment strategy, the governance process proceed, in theory, to the board or *structure* level. This is the level where, again in theory, the “directors” do their job.

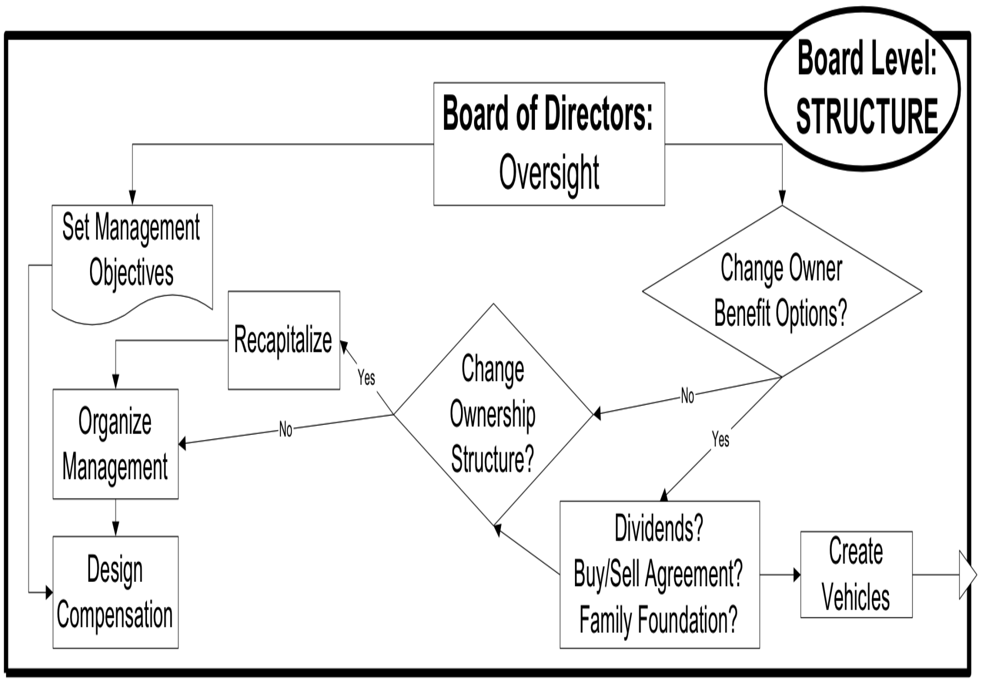

Figure 6-1: *Boards are generally charged with the responsibility for assuring that the organization is structured properly, the right management is in place, and the compensation program points managers toward achieving the owner vision defined in the investment strategy. The "board" can be an independent board, an advisory board, or even a group of committed owners, as long as focus on owner vision is the seen as the critical responsibility and fiduciary.* ***It just naturally happens that, in a successful business with numerous owners, an independent board eventually becomes the most effective form for meeting this fiduciary responsibility.***

Two fundamental issues are addressed at this level (*Figure 6-1)*:

1) What is the best business and organizational structure for meeting the goals of the owners?

2) What is the best strategy for meeting those goals and the best management team to implement that plan?

3) What are the most appropriate specific performance targets and related compensation system for the management team?

Often, these three key strategic questions are given far less attention than their importance requires. When they are considered, often it is on an ad hoc basis as threats and opportunities arise. Under the focused leadership of talented entrepreneurs, that is okay. It is likely the source of success. It's okay ... until it's not.

Add generations of owners or new partners, or other ownership complexities, and these board focus points continue to be ignored, the formula for chaos takes over the boardroom. Actually, the "board of directors" doesn't really exist. It is merely a fantasy creature brought to life by the bylaws. The typical closely held business board has no reality or function beyond providing a header line for dusty boilerplate minutes of meetings that never get held.

It is true that many businesses do quite well without a functioning board of directors, and not every company must have one. The point here is not to imply that boards are essentials or panaceas. To expect that of a formal board would be unrealistic and considerably naïve. In fact, in some ways, installing a functioning board too soon can be potentially destructive to private company success (*Appendix A-9*).

But this is not a book about achieving *entrepreneurial success*—no NPR "How I Build This." *Our focus is on continuing a successful, multi-generation privately owned* business and managing the value of an existing successful business for the long term. For *that* purpose, a body that actually provides the oversight functions of a board—whether it is an advisory board or even a committed group of owners—*is* essential (see *Chapter 4* for a discussion of advisory board roles in this capacity*)*.

Whatever form the oversight body takes, the questions of structure and goals/compensation are prime responsibilities. They have differing urgencies, however.

Structure is, basically, an *ad hoc* issue. It arises periodically with changes in growth rate and profit, ownership composition, and the tax laws. Few companies change their capital structure regularly. Divestitures and acquisitions are not regular agenda items in most companies.

I do not deal with structure questions in this book precisely because they are so situational and unique to specific businesses. It *is* important, however, to remember that the structure should at least be reviewed regularly, and when changes are required, they should be implemented as needed. This is a responsibility the "board" cannot ignore. It just is not a continuing agenda item.

On the other hand, a much more regular and urgent review item for the board is the whole area of management performance and compensation. How goals are set and measured, how people are rewarded, and for what, are critical factors in managing owner value; and they have impact almost daily.

Before we look at how things should be, however, it's necessary to understand and fix the way things are now.

FOCUSING ON VALUE: "STRATEGIC" COMPENSATION

Before discussing the actual procedure for designing and implementing a "strategic" compensation system, we should consider the following assumptions that underlie (or *should* underlie) compensation system design:

- **Owner benefit logically precedes employee benefit.** Key employees should produce value for the owners of the business before benefiting from incentive or equity compensation.

- **Compensation is a pointer, not a motivator**. Motivation is a function of personality and working conditions and is usually only *negatively* affected by inadequate or poorly designed compensation. A well-designed ("strategic") compensation (via base salary, incentives and/or equity participation) will (1) allow employees consider other factors than money and (2) will serve as a tool to encourage employee "focus" or fine tuning of behavior. Our design should, therefore, be both generous and highly directive (i.e., goal-oriented).

- **Incentive should ultimately and obviously "point" toward increasing owner value.** The key purpose of compensation should be to drive company objectives, true, but principally *to encourage achievement of the investment strategy*. For example:

  ◊ *Increasing Cash Flow (Sample Objective: 20% annual growth).*

  ◊ *Significant return on invested capital or ROIC (Sample Objective: 12% annual).*

  Note: There are several possible ways to define "invested capital," which is another way of describing "owner value."

- **Incentive should be based on *both* organizational and individual goals.** While individual performance is important and should be recognized, owner value is enhanced primarily through *organizational*, not *individual* success. Incentive determined solely on individual goals/performance can inhibit both teamwork and cooperation.

Strategic compensation plans accomplish the above objectives through careful and value-related design of three components of pay: the base salary, the incentive bonus, and long-term growth participation.

For What I Know: The Hygienic Base

It was Frederick Herzberg who first made the observation[*] that pay is less a motivator of people, than it is a tool for encouraging existing motivation to work in the employer's benefit. He believed that the factors that produce job satisfaction are separate and distinct from factors that produce job dissatisfaction. Pay people too little, for example, and they will become dissatisfied. Pay them "enough" and they will not become satisfied. They simply will be *not dissatisfied*.

There have been many studies over the years that show most people place money far behind quality of work, variety, and co-workers in evaluating their jobs. More important, common sense and experience teach seasoned managers that focusing people on money *distracts* them from their own internal goals, which are the source of their motivation.

When compensating key managers in the closely held business, we assume (or should be assuming) that we are blessed with motivated and capable people on the team. Base salary, seen in this light, is not a reward. It should be an enabler, a tool which frees an employee to focus on his or her true source of energy: *internal motivation.*

As compensation iconoclast, Alfie Cohn, put it:[†] "Pay people well, pay them fairly—and then do everything you can to take their minds off of money."

Typically, base salary is the fixed portion of a manager's income and does not vary with company or individual performance. It is a recognition of a manager's basic economic value and the economic value of the job to the company. Since this is an employment market issue, benchmarking analysis of whether a

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[*] Herzberg, Frederick. "One More Time: How Do You Motivate Employees?" *Harvard Business Review:* January-February, 1968, pp. 13-22.

[†] Kohn, Alfie. "Why Incentives Fail." *CFO:* September 1994, pp. 15-16.

given base is adequate for a given experience/skill level, competitive in the region, industry, etc.—and affordable to the company—are necessary and appropriate.

What is *not* appropriate is using base salary as a *reward*. Since a base is fixed, rewarding exceptional performance (which is not fixed) through a raise is illogical. Further, given the prudent objective of controlling fixed costs in any business, salary "inflation" is something any business owner wants to avoid.

The most sensible way to manage base salaries for key managers is to allow for increases only under the following conditions:

1. *Increase in the general cost of living—allowing base salary increases tied to positive changes in the cost-of-living indices.* Dissatisfaction is a predictable result of salary decreases, whether caused by an actual cut or eroded by inflation.
2. *Merit increases to gradually increase base for key managers who are substantially under market value.* An "underpaid" key employee is an open invitation to a recruiter.
3. *Significant increase in responsibility level.* This is simply recognizing the higher economic value of the new job to the company.

There are many companies that still vary raises in salary, or even *hourly* pay, according the kind of year they had, but this is counterproductive. In Herzberg's words: "Have [spiraling wages] motivated people? Yes, to seek the next wage increase."

For What I Do: Capped and Uncapped "Incentive" Systems

If people are not motivated by money, why even consider using a bonus or incentive system? Because, while people may not be *driven* by cash reward, they certainly do take money very, very seriously. This makes the "bonus" a powerful *pointing* tool.

Navigators use a dead-reckoning (DR) track on their charts to correct course after taking an actual "fix" to make sure the ship is always on the most direct route to the objective. Think of the incentive program as a DR track provided to key managers, defining for them the best course to reach the company's (and the shareholders') goals. This is what I mean by *strategic* compensation.

There are two alternative philosophies of incentive design one "strategic," the other more common, but less strategic in nature. The more strategic approach, an **"uncapped"** incentive, uses an incentive pool that is *return on investment-based and, thus, inherently lacks a pre-defined upper limit*. Less strategic (but somewhat strategically salvageable through careful design) is the **"capped"** incentive approach which generally defines an incentive pool which is *fixed as a percentage of base salary, although it may vary with individual performance*.

The Uncapped (Strategic) Incentive

In an uncapped, or profit-based approach, all, or a portion of profits in excess of required owner return could theoretically be distributed to management (including, of course, owner-managers).

A frequent concern about uncapped programs is that the managers could do much better than individual owners in an exceptionally profitable year. This can be managed by using a proportional division of profits in excess of budgeted owner return.

Incentive pool determination would proceed something like this. Assume that net income before tax (NIBT) is $x. From that we deduct the desired minimum owner return (e.g., 14% of prior year-end book value) to get $y. Of this "excess profit" amount, z% will form the incentive bonus pool for management, the remainder will go to the shareholders or be retained in the company.

For example:

Prior year-end book value:	*1,000,000*
Owner minimum return requirement: (14%)	*(140,000)*

Current year-end NIBT:	300,000
Less minimum ROI reserve:	(140,000)
Profit excess for distribution:	160,000
Management portion (z=40%)	**64,000**
Shareholder Portion (1-z=60%)	**96,000**

Generally, *strategic* uncapped incentive programs have the following key characteristics:

- They are based on financial results rather than a percentage of salary level
- Bonus pools are best funded out of current earnings
- Bonus pools are generated *after* predefined minimum shareholder returns are deducted from earnings
- Defined minimum shareholder return levels must be met for a bonus pool to be generated in a current period
- Shareholders *and* management share earnings above the required minimum in a defined proportion
- There is no cap to bonus pool potential
- This structure is open ended, but rising profitability raises both shareholder and management boats equally

An example of an "uncapped" incentive system used in an actual company can be found in *Appendix A-3.*

The Capped (Less Strategic) Incentive

Under a capped system, the compensation system could define a "standard" bonus as a specific percentage of base salary. A higher standard bonus can be defined for key managers, a lower "standard" for managers with less responsibility, essentially defining more than one range. This standard bonus could then be adjusted up or down by the reviewing superior during the annual review process according to each of the following two cumulative "multipliers," which could range from 0 to 1.5:

1. *Organizational multiplier*—this could be set at the end of the compensation period by the Board of Directors based upon achievement of ROIC targets for the overall company or based upon achievement of those targets for individual profit centers. Also, since teamwork is so important to management effectiveness, the organizational multiplier could be based on the success of the management team in achieving certain key goals or initiatives, or the overall achievement of strategic milestones* by the company or the individual profit center, as appropriate. Generally, in order for a department to achieve a 1.0 organizational multiplier (standard), shareholder value increase targets must be met **(organizational multiplier range: .5 to 1.5).**
2. *Individual multiplier*—based upon specific performance of the individual and/or his profit center or responsibility area **(individual multiplier range: 0 to 1.5).**

As an alternative, a single multiplier could be used. In this approach, the "standard bonus" would automatically apply if shareholder value targets are met. Increasing that 1.0 multiplier, to any level up to the 1.5 maximum, would be discretionary. If ROIC targets are not met, the standard bonus would be decreased by the percentage target shortfall.

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*"Strategic milestones" are organization-wide goals whose achievement will increase the shareholder value of the company, and which require the cooperation of all managers. E.g.:

- ◊ Finalization/implementation of a key long-range plan (e.g., capital improvement).
- ◊ Achievement of specific improvements in employee performance (without requiring a capital investment).
- ◊ Accomplishment of a specific increase in market share.
- ◊ Development of specific macro-level process improvements (e.g., customer service, administration).
- ◊ Development of a successful new product or service.

An example capped incentive bonus system can be found in *Appendix A-4.*

For What I Build: Long-Term Compensation

Incentive compensation, by its nature, is short-term in focus. This means that the "pointer" for management is also short-term in impact. Focus on immediate returns can, in fact, be detrimental to the long-term growth of shareholder value of a closely held business. Depreciation depresses earnings, for example, so one way to inflate short-term results is to minimize the capital expenditure budget, year after year. A truly strategic compensation system, therefore, must include a long-term pointer or component: growth participation in some form.

Again, I should state my "equity" component design assumptions at the outset:

- Growth participation programs generally apply only to key managers
- The objective should be to enable each participating manager to see some form of personal net worth appreciation that parallels growth in owner value
- Given the general desirability of maintaining close control, a well-designed plan avoids dilution of voting control wherever possible.

Here are the most common approaches to rewarding long-term performance:

1. *Incentive Stock Options.* These are plans that provide selected key employees with the option to buy actual shares (usually non-voting) in the company at a predetermined price.
2. *Appreciation Rights or Phantom Stock Programs.* These are programs which use "shadow" (i.e., not real stock, and therefore no ownership rights) equity to give

selected key employees the status of general creditor of the company. The increase in value of appreciation rights are handled, usually, as an accrued bonus, and are tied directly to increases in the value of actual company stock. While determining the definition of "value" is problematic, it is a healthy process to go through.

3. *Unfunded, Non-qualified Income Deferral Plans.* These are "non-qualified" because they are provided on a discretionary basis to selected employees. They are generally exempt from ERISA requirements, require no advance approval from the IRS, and need not be funded on a current basis. Benefits are not deductible or taxable until actually paid. These plans supplement the qualified pension plan and, again, make the participating employee a general creditor of the company. Accounting treatment and the nature of the contract with the employee vary, and professional advice is essential in designing these plans.

See *Appendix A-5* for a general discussion of each long-term compensation option. Some sample phantom stock design provisions are provided in *Appendix A-6*

SECRECY, PERKS, AND ACCOUNTING—REVISITED

While there hasn't been much discussion here devoted to financial and management accounting, it should be evident that any company that plans to implement strategic compensation along lines similar to those described above must clean up—and open up—its accounting system.

The secrecy discussed in *Chapter 1*, while natural and understandable, clearly would make strategic compensation impossible. Managers cannot *manage* for results if they cannot *see* the results. Further, shareholder indulgence in pre-tax dollar habits almost invariably will make it difficult to determine appropriate return on investment targets and actual ROI results.

One thing that experience has made crystal clear to me, however, is that effective management in closely held companies arises principally from assuring that three important factors exist:

1. **Quality Employees.** Closely held companies which intend to focus on shareholder value cannot afford to become way stations for non-performers. Where loyalty issues arise, it is, in fact, usually more sensible, strategically, to provide excessive severance or maintenance packages, than to allow non-performers to keep their positions in the mainstream of the management group.

2. **Accurate, Functional Management and Financial Accounting**. This means designing and implementing a financial reporting system that is focused on management use rather than tax avoidance.

3. **Clear Investment Strategy Clearly Communicated.** This is the "vision" thing, the result of shareholder work, with key advisors, at defining exactly how this investment called the family business should be performing, and what the owners are willing to risk to enable that performance.

Do not take this to imply that "motivational" and organizational techniques, like empowerment, team development, matrix organization, re-engineering, etc., are useless.

My point, simply, is that even if we do not have the time or inclination to get into all that fancy stuff, we must, at the minimum, assure the above three fundamental elements exist in our organization. Otherwise, it is unikely that the management team will be able, effectively, to focus on growing owner value, long-term.

MONITORING *THE PLAN*

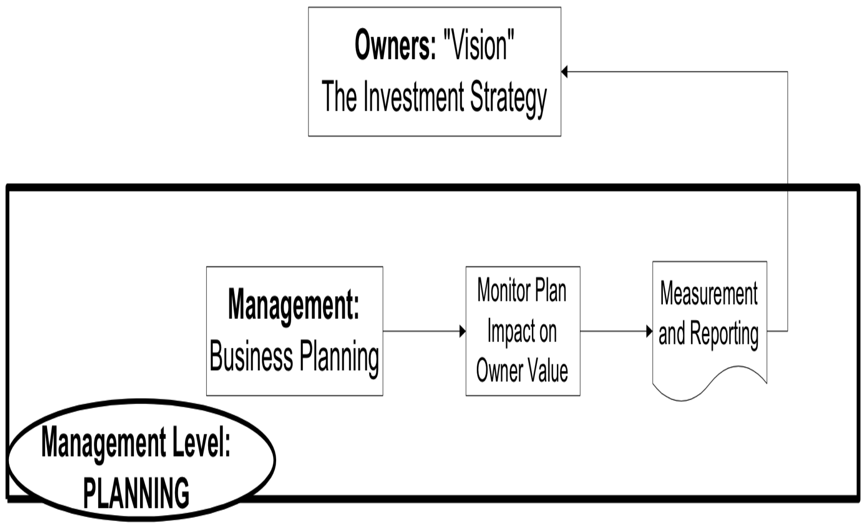


Figure 6-2: *Developing a business plan and putting that plan to work are the responsibilities of management. The process of managing owner value ensures that the management team knows what results they're expected to achieve, and then the process must consistently monitor their success or failure in meeting those responsibilities.*

In the capstone step of the process, the management team must ask and answer the myriad questions concerning the best ways to meet the targets set for them and for the business (*Figure 6-2*). The planning process is guided by objectives and goals set for management by the board, all drawn from the investment strategy of the owners.

The subject of business planning is beyond the scope of this book. However, over the years that I have worked as a business advisor and corporate director, I've been through planning processes with management teams many times. From those experiences, my clients and I learned some important lessons about the real planning needs of the private company.

The Strategic Planning "Myth"

The most important lesson is that formal strategic planning can, at best, be a waste of time. At worst, it can be a very costly mistake. As one of my more outspoken clients put it:

"Strategic planning makes no sense for a business like mine," he said, wincing a little, knowing he spoke the unspeakable.

He was the second-generation owner of a $50 million cleaning supplies manufacturing company. His growth was steady, his profitability was good, and his market share was expanding slowly—all in a market undergoing massive change. He was riding a wild wave but managing to keep his feet on the board through a responsiveness that was almost athletic.

I compared him with a friend who'd barely survived a three-year romance with strategic planning that skirted disaster which he temporarily avoided by putting together an emergency merger with a competitor. That unfortunate fellow had been practically obsessed with strategic planning. For three years he had kept his eyes on global objectives, writing some of the best-formatted and researched business plans I'd ever seen—only to lose half (eventually *all*) of his company.

He spent more time planning the future than he did running the business.

Most of us can think of a customer, a supplier, or a friend who got deeply involved in strategic planning and wound up sinking under the weight—too much detail, too many assumptions, just plain too much paper. A participant in a strategic planning course put it to me very well after the course was over, *"All this planning is starting to overwhelm my instinct."*

Great Tool, Wrong Application

Strategic planning evolved as a large-organization tool and was translated for the smaller business by academicians and consultants because there were no other models to work from.

I remember taking part in a family business strategic planning seminar back in the early 80s. It quickly became obvious to me as the business owner-participants struggled with all the detail, that the whole process represented a significant overload for these brilliant entrepreneurs. This was not a matter of managerial retardation. Business creators are smarter than just about anybody. When asked to develop strategic plans, business owners are not so much fish out of water as they are fish forced to swim in molasses—or, more apt—race horses who've been hobbled.

We're older now. We have been through many strategic planning applications in the real, operating world of the small and mid-size company. We have seen how the process can dilute the very essence that gives the business owner his advantage.

The dirty truth of it occurred first to business owners and has only slowly been spreading to advisors and consultants: *Strategic planning can be a cumbersome, artificial, restrictive, and numbing process*. That's what my friend learned, to his chagrin, when, one day he looked up from his planning manuals to see that his expansion had run away with his margins, and his controller had run away with the store.

The strategic planning process can translate very badly into the language of closely held companies. Private companies generally don't have the experience, the staff, the money, the time, or, most importantly, the stability, for traditional (and, therefore, complex), strategic planning.

Planning has its place, of course. As companies get larger, as investment levels expand, and as management teams increase in number, "strategic planning" becomes relevant and necessary. ook inside a DC-10 cockpit sometime. With so many crew members and so much aircraft, going so fast, there is plenty of reason for all those instruments. In a single-engine Beechcraft, however, that kind of instrumentation would be overkill—destabilizing dead weight.

The large organization *must* look far ahead and contemplate broad changes in course, while at the same time it can usually ignore intermittent turbulence along the way. When you are big, you can just fly through the stuff.

We smaller guys have a different problem. Turbulence is the name of the game. We need to keep our eyes outside the cockpit, because one unexpected down draft can auger us into the dirt faster than we can utter "mission statement" or spell "action plan."

Triathlon Athletes Have No Need for Play Books

To repeat: the problem with strategic planning is not the idea behind it. Thinking long-range and managing above the grindstone are as important for the closely held business as for any organization. The problem with strategic planning is the lengthy and involved process usually associated with the concept.

That process, typically, is highly analytical—it pulls broad objectives apart, specifying, in exquisite detail, individual responsibilities, numerical goals, timeframes. It's a process not unlike a game plan for the Super Bowl, breaking broad strategies down into individual play combinations, which are further analyzed into individual responsibilities and highly choreographed movements.

A well-played Super Bowl provides a reasonable analogy for the large-company's planning environment: lots of interchangeable players, predictable conditions, understandable rules, definable objectives…AND the ability to call a new plan when assumptions prove to be wrong.

A family business runs solo. Unlike preparation for the high-stakes *team* sports, training for individual competition usually concentrates on conditioning, practice to develop coordination and sensitivity to feedback, and, quite simply, building strength and experience. There are few coaches who advise runners to learn control of each muscle individually. There is no surer recipe for a spectacular pratfall than thinking too much about what you do well naturally—and can improve through practice. Just know the key variables, and where to look.

Fr most smaller and mid-sized companies, an *accurate and timely feedback system* is the closest they need to get to the kind of detailed analysis typical of strategic planning.

Focus on the Right Instruments

There are basics to business, just as there are to aviation. A pilot of any airplane, large or small, simply cannot fly without certain essential information: an artificial horizon, altitude, airspeed, fuel volume, and so forth. Similarly, every business owner, to get where he wants to go, must have timely information on sales, costs, inventory, and general market conditions (e.g., commodity prices, interest rates, RFP's). But, beyond such essentials, further analysis tends to become fluff for the smaller organization, or small-craft pilot. There's too much long-range uncertainty for "prediction," too much overall data available to synthesize into even a long-range guess.

In the smaller company, in-depth analysis quickly loses cost effectiveness. For the closely held business, protracted strategic planning can hobble instinct, confuse talent, obstruct communication, and dissipate coordination. It represents too much "getting ready to get ready" and not enough coordinated action.

Over the years, like most business owners, I have developed a great and abiding respect for instinct, that ineffable "strategic sense" that shines a spotlight on the right decision. Maybe we should call it an evolved "genius." Whatever it is called, the most important long-range steps that the business owner can take are those that *focus*, *define*, and *enable* that instinct to operate to its full capacity. Fortunately, these steps are few, and relatively easy to take.

- First, an *efficient and accurate accounting system* is required. This gives The Boss the critical information and feedback he needs to follow the terrain and avoid the mountainsides. A little "quality time" spent regularly with one's accountant can do wonders for understanding and control.

- Second, *the organization chart of the business has to be clean, clear, straightforward, and understandable*. Everyone must know who is supposed to respond to which threat or opportunity, and the organization must allow them to respond smoothly and quickly. This clarity of responsibility structure is the "conditioning" that translates mental commands into movement.
- Third, and finally, *long-range expectations must be clearly understood and shared by all the key people in the business.* This is fundamental and, perhaps, the closest in concept to strategic planning.

We need to answer questions like these: Are we in the service business long-term? Are we in the oil business long term? Are we going to grow by gaining market share from competitors, or by adding new territory/product lines? Are we a low-margin, high growth business—or a high-margin, steady growth, niche business?

Without agreement on issues like these, the internecine fighting and confusion in the cockpit leave the airplane on autopilot. You wonder who is checking the fuel gauge, not to mention who's flying the plane. Not a comfortable situation. Not at all.

Meetings and discussion—reaching agreement—is essential. But once accomplished it is critically important to get back to the business. In fact, once agreement is achieved on general direction, risk levels, growth rates, and returns, it's usually past time to get everyone's hands back on the stick, and all eyes back out of the cockpit. Continuing to focus on the flight plan will not help avoid the towering clouds outside the window.

Street fighting. Jungle warfare. Triathlons. Bush flying. Those are the models that best fit small and mid-sized companies. Certainly, we need to set the basic mission, define a few important rules of engagement, but then it is fundamental that we get on with the day-to-day job.

We are really much better off leaving the global strategies—and the strategic plans—to the bigger guys. They need to concentrate on instruments and flight plans. We need to survive the scenery. Once we get big enough, however…

Protecting the Investment Strategy

It is the responsibility of the board to ensure the management team orients itself, and positions the business, in ways that are appropriate to both the investment strategy and the realities of the marketplace.

That done, however, the board, and particularly the non-managing owners, should get out of the way and let the management team work the plan. Do not confuse the need for oversight with an obligation to meddle in day-to-day operations.

The role of the board is to review the plan and monitor progress and operational results compared to plan. Only a few simple tools are required for this:

- *Operational budgets.* These are simply statements of how we plan to get where we want to go, operationally. There is nothing sacred about a budget. It has no corner on truth or predictive ability. It simply enables the board and management to see if the business is getting off the intended course, so action can be taken to correct problems.
- *Capital budgets.* These represent plans for using capital resources to make sure we meet the operational plans. Capital is precious, and usually scarce, and must be managed as carefully as the business itself.
- *Regular board and committee meetings.* It is always preferable to avoid rocks and shoals rather than assign blame for a shipwreck. The oversight group, whoever they are, board, advisors, or owners, must have a formal

process for reviewing results at least quarterly, and often more frequently.

- *Management performance reviews.* These meetings with managers close the loop between the owners' investment strategy and management compensation. They are often difficult. They also absorb valuable time. Without reviews, however, the whole value management process is short-circuited.

Managing the "ultimate legacy" is, and will always be, a *process*. It involves owners, advisors, and managers in a dynamic relationship of definition, delegation, and oversight that can only be managed by constant attention.

Sure, the swamp is deep. The alligators are grinding and gnashing their teeth all around us. Effective operation, current profitability, and immediate response to opportunities and threats are critical to survival.

But through it all, we should remember our *purpose.* Purpose—defined and measure—is the rifle barrel that makes sure all the flash and energy we expend is more than just temporary noise and smoke. Instead, we assure it has a positive result.

Creating and implementing a process for managing and protecting owner value, in the end, is the only real way to assure that we provide the greatest reward for ourselves and our partners—and our ultimate legacy for those who follow.

6: THOUGHTS FOR TODAY'S OWNERS

"I don't know how to tell you this, Dear, but I liked you better when you went to work every day."

"Mal's planning on retiring, Judy," Mary told her friend in a quiet voice. "I don't know what I'm going to do."

"What's his plan?" her friend asked, concerned.

"That's part of the trouble. He's got it all worked out in his head—or so he says—and I'm worried about whatever it is he's 'worked out.'"

She withdrew into silence, gazing at pedestrians strolling outside the café window. The waiter served the coffee as Judy could tell by the distant look in Mary's eyes that she was truly worried. Mal's retirement was no passing issue.

"I know everybody retires," Mary continued after the waiter had gone. "Our lawyer's been pressing us that it's time to begin transferring stock to the kids. Mal is tired of all the problems he's carried for 40 years. All that makes sense, but when he starts saying 'how much we love to travel' and 'now we'll have time,' I get really worried."

"But retirement could be good for both of you, Mary. You've always wanted to travel more, and now he *will* finally have more time for it."

Mary stared at her friend.

"Travelling is all he's done since he started the business.

"Mal *hates* traveling, Judy! He just can't admit it."

With Mal, the dream is "travel." For others, it may be "fishing" or "all that golf I never had a chance to play" or "finally writing my memoir." Whatever specifics these sunset Valhalla's take on, they tend to be little more than pipe dreams, illusions rooted in wistfulness, and driven by a vague anxiety.

Those are fairly strong assumptions, I admit, but you cannot spend a near half-century working closely with business owners without developing some well-earned biases. This is one of mine—particularly because I am feeling some of that same anxiety myself.

It is not that golf or fishing or travel do not offer great pleasure in retirement. Many people—even including business owners—engage in them happily. The real question (and Mary had her finger right onto it) is: if The Boss never could find time for personal travel (or fishing or golf or tell-all memoirs) while he or she was driving and building the business, was it really the lack of time? One of the greatest benefits of financial success is the increased ability—and power—to choose how to spend our time.

We should take a close look at the trail of evidence as to the choices we actually make, in real (not imaginary) time.

CONFUSING SUCCESS WITH TALENT

It is worth the effort involved to think clearly about this thing called "letting go." I remember very clearly a cockpit conversation my client and friend, Will, and I had, a conversation about succession that provides a good example of what I mean:

"But don't you see, Don," Will said to me over the cockpit intercom. "It's hard to find anybody who knows this business."

I was silent for a moment as he went into a steep bank and dropped the helicopter in for the landing. My white knuckles were absorbing most of my attention.

Will was a successful electronics distributor with a powerful weakness for rotary wings and bubble canopies. He involved himself in his hobby with the same fierce intensity he devoted to his business. But his most recent expansion—the new warehouse we were visiting that day—had taken him into uncharted territory.

He was worried.

"How well do *you* understand it, Will?" I finally asked as the skids bounced on the landing pad.

We had been discussing some major inventory and computer problems he was having, and I had suggested that he talk to other people who had likely experienced the problem.

like so many of the business owners I have worked with over the years, Will believed that the uniqueness of his business made it impossible to get competent help from outsiders.

Lonely heroes that they are, entrepreneurs like Will just keep adding new burdens to their own shoulders as the business grows.

Eventually, inevitably, the hero bends under the load. Some even break. Will was not anywhere breaking, but his shoulders were getting very near to the ground.

Loneliness is an occupational hazard, and most successful business owners succumb to it at least once during their careers. Some never get beyond it. Truth is, to the extent that any of us are going it alone, we are confusing success with having the ability to *maintain and grow* that success.

Fact: we build businesses on our strengths, compensating for weaknesses by hard work, fierce determination, and more hard work. This can be successful—for a while. But strength and determination cannot add hours to a day, or clarity to a tired mind, or energy to a tired body. Those limits are reached long before the business reaches its limits of growth and complexity.

Will had reached those limits with his new warehouse. He knew electronics distribution, but suddenly he needed to become a warehouse automation expert, a telemarketing specialist, a real estate developer, and, yes, even a politician to fight with a zoning board.

"I can handle it," he told me months before as he embarked on the project. "Always have."

As a potential epitaph, this sounds real good…until you think about it. The logic is seriously flawed. It equates "always have" with "always can."

There is an infinity of issues to decide and manage in a successful business. For each of those issues, there is usually somebody who has been there before, or who has made a study of the subject, or who knows what works and what won't. Sometimes, the best person for the job is Yours Truly…but not always.

Will, for example, was in urgent need to decide how to process the greatly increased volume that would come because of his expansion. He needed to expand his customer service department, automate the ordering process, and computerize scripts for inside sales to handle. He also needed to negotiate the approval of a new sewer connection that came at him out of the blue.

He needed help desperately. Sure, he had good people on his management team, but they were not co-pilots. Navigators, yes. Stewards and mechanics, of course. But to none of them could Will turn and say: "Help me land this thing. I'm tired."

It is a law of the universe that, after a certain peak of success, we each become increasingly ineffective at what we know and do best. A major reason is that we know too much. Just ask yourself when you made some of the best decisions of your entire career. If your birthday cake holds more than 50 candles, your answer if you are honest will be it was back when you were too dumb and naïve to realize you shouldn't do it.

What the growing business needs is a steady stream of smart, aggressive, energetic managers who, basically, do not know enough to realize what they "can't" do.

That means that we "old goats" are precariously balanced between the very sharp horns of a very perplexing dilemma. We love involvement and have proven our effectiveness, yet, at the same time, we need to step aside if the next generation is ever going to make its real contribution.

The transition to the younger generation of managers is, in short, a transfer of control to committed, trained, intelligent, aggressive men and women who are too "dumb" to know what they can't possibly do.

Would we *really* have gone to the Moon if we thought about what it *really* required?

PLANNING THAT *NEW* CAREER

For those of us who have done little other than work hard over the years, planning on a full-bore retirement can be as much of a disaster as hanging around, semi-retired, screwing up the business part time.

Even so, we are not carrion yet. We can still fog a mirror, move a stone, make a buck. The implication is that we should forget about retiring, and aim, instead, at a new career with a more sensible level of risk than the one we have been lucky enough to survive.

What does that look like? Different folks: different strokes. But common sense implies:

1) **A steady shedding of the *risk interest* in the business**. This accomplishes two critical objectives: First, it helps the current owner-manager relax and stop worrying so much about successor-manager work habits, commitment, etc. As the risk increasingly becomes theirs, it gets easier to let them do it their way. It'll never be truly "easy" to let somebody else take over our businesses, of course, but "easier" is sure better than "impossible.
2) **While we self-promote to jobs *WE* enjoy.** This will, for sure, require some honest self-evaluation, but it is aimed at allowing current owners to harvest the fruits of those 40 (or whatever) years of hard work. Three key elements are essential in meeting this objective: flexibility, independence, and significance

Lets take a closer look at those key elements in the formula for “successful retirement”:

Flexibility

Since there is nothing easy about even a gradual change in lifestyle, it's important at least to have the *time* and *opportunity* to travel, or play more golf, write that novel or just go fishing. Hence, this new “job” should not be closely tied to the day-to-day demands of the business. “Gradualness” means that the retiree should be free to dip in and out of responsibilities that are meaningful—*but NOT time sensitive, critically important, or significantly dependent on the contributions of others.*

This is usually what we mean when we talk about "retirement." Better terms would be "easing up" or "taking some regular time off." The touchstone of success? When you walk into the office, everyone smiles.

Independence

By the time he or she reaches retirement age, it has been years since The Boss has worked for anybody else. Sure, it sounds good to "work with the Sales Manager" or "help the Kid out," but that's about as realistic as expecting a former President of the United States to become a Cabinet officer in a new Administration.

Ignore this one at your—and everybody else's—peril. Kings do not become subjects. They become respected (we hope) mentors and councilors to their successors. Fortunately, the young generally have respect for their elders, but only if those elders are, in fact, wise and nurturing. This coin has another side, certainly: this respect is meaningful to the elder only if *self respect* also exists The key to that is *significance…*

Significance

The fundamental measure of any activity in life is this: is this activity important enough to make it worthwhile getting out of bed? "Significance" has no objective measure It's more of an inner sense, an instinct or judgment that is unique to each of us, and which each of us will recognize as being real or imaginary.

It is not necessary for any of us to keep working like a lathered mule, but it is important to avoid the pasture unless (and until) we are absolutely sure we will enjoy munching grass all day.

I once met a business owner who was "retiring" at 55. The company he founded and built had been sold to his sons, and he was using some of the proceeds from that sale to start another business, one that would require only half of his time.

With the other half, he planned to "see the world."

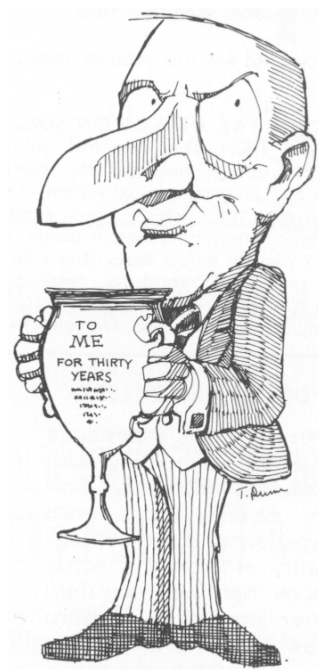
We bumped into each other some years later in Dallas.

"How's the retirement?" I asked.

"It didn't work," he answered. "Remember that new business I started? It's now generating twice the sales volume of the original business.

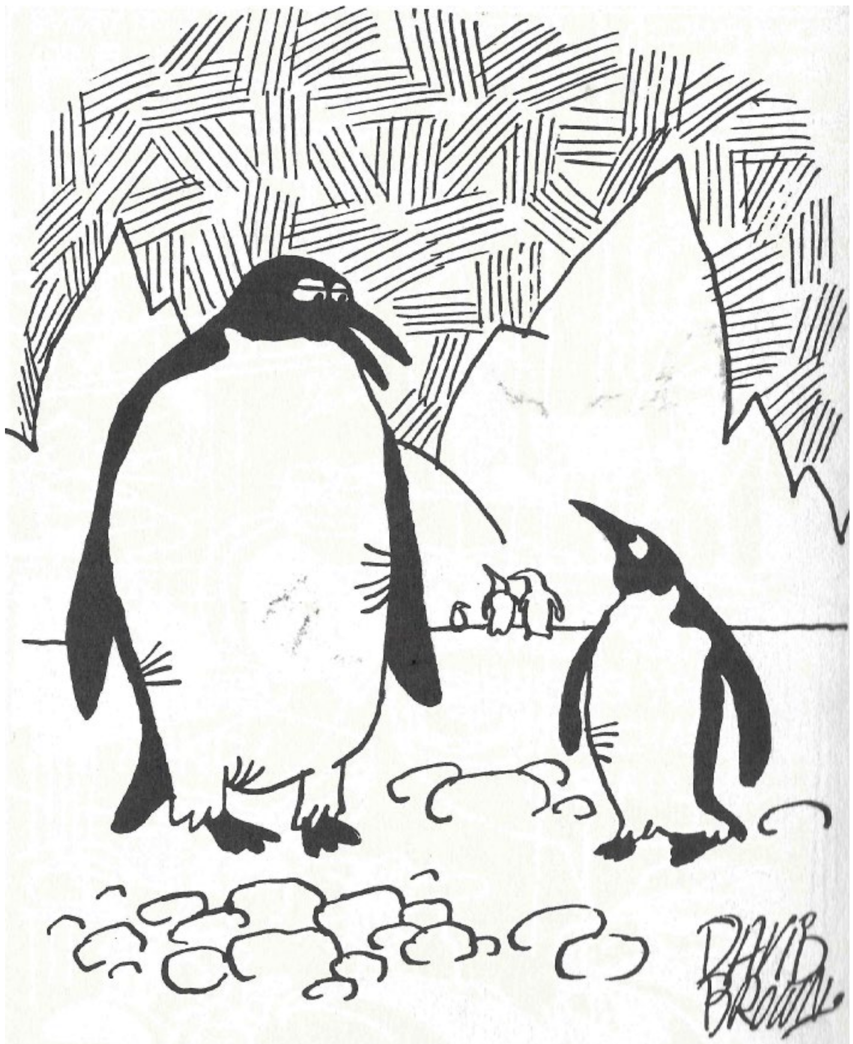
"I have to retire all over again!"

It was significant, I think, that he reported this "failure" with one of the broadest smiles I have ever seen.



The moral to that story is personal to each of us…and I am sure you know exactly what I mean.

7: THOUGHTS FOR TOMORROW'S OWNERS



"We're not trying to manage your life, Son, but when you grow up, we do sort of expect you to be a penguin."

The silence is so thick, Jim thought, *you'd think the smoke alarm would go off.*

He looked across the kitchen table at his wife. Sheryl was staring down at her salad, playing with the lettuce in random, uncoordinated movements. The scrape of the fork skated across his nervous system.

The sudden fight had been totally unexpected. *Most of them are,* he realized. He was telling Sheryl about some things happening at work. She wanted that. He tried to do it when he could…and now he remembered—again—why that was not such a good idea.

"Uncle Sid mentioned bringing Sam into the company again today," he said to Sheryl, as he spooned dressing on his salad. "Dad asked what I thought, and I said okay. Sid really wants his kid in, so I figured we might as well get it over with."

"Did you remind Dad about *your* stock?" Sheryl asked, the tension pulling at the edges of her mouth. He right away saw he was hurtling toward a long, long patch of black ice.

"Well…thought about it but didn't seem like the right time. You know how Dad doesn't want to upset Sid, and things were tense enough without me adding another sensitive issue."

"Adding?" Sheryl shouted, her voice resembling the fork on her plate. "*Adding* another issue?

"You don't understand…" he stammered, pumping the emotional brakes to control the sickening skid under him.

"I understand *perfectly*, James Sidney Clark," she interrupted, and the black ice took over his rear wheels. "Don't you ever again give me that pat on the head. I get more than enough of that from your father."

She set down her fork, slowly, with fierce calm.

"I understand way too much. You've worked for him and your greedy Uncle Sid for 10 years, breaking your back and stretching our marriage to the breaking point, all for vague promises and out of some misguided sense of family duty."

Jim could only listen in sick silence. The looming wreck was only seconds away.

"You're paid less than you deserve. You have no power, control, or influence. 'Someday, it'll all be yours' is an insulting joke they've told us too many times. You don't have the guts to stand up to them and demand the stock they promised, even though we agree again and again that you will.

"And, now, surprise, surprise, your cousin is tired of his life as a ski bum and wants to collect *his* half of what *you* built—

> and *you tell your Dad and Sid that it's okay because you don't want to* upset *them!*"
>
> He saw a tear form in the corner of her eye as she glared at him in silence. He almost longed for the blessing of hitting a bridge abutment head on, at high speed.
>
> Sheryl was right about the facts, but she didn't understand all the complexities, the politics, the loyalties, the frustrated dreams.
>
> *No surprise, since we can't talk about it*, Jim thought as the familiar depression pulled him down one more time.
>
> *...because I don't understand it, either.*

Jim's not alone. In fact, he's a member of a relatively large minority group—but it is one you won't find listed on any government lists.

There are no movies about the family business successors of the world. They have no organization, no national leaders. Generally, they do not even see themselves as a group. They are heirs and successors to business owners, a group usually seen by outsiders as members of a lucky sperm club, an over-privileged and under-endowed bunch of lucky ingrates who are "probably going to louse up the good deal that's being dropped in their laps."

Successors are isolated. Family insiders don't know how to help. Outsiders see them as lottery winners. Ignored by the former and muttered about by the latter, successors do not understand their situation, either. Smart, capable, energetic, and talented thought they might be, they end up hobbled and confused by this almost universal prejudice.

On one hand, they think they should be able to figure "it" out and do whatever "it" takes to get "it" done. On the other hand, in their isolation, they have no idea where to begin or where to find the allies they need.

CROWN PRINCE(SS) WITH AN IMAGE PROBLEM

If you are a member of this "lucky sperm club," it is essential at the outset that you recognize how critical your role is. Our economic future is in your hands. In spite of all the flip comments and prejudicial assumptions, you, as an heir and successor to today's business owner(s), are expected to preserve the family's major asset through into the future. It is you who must build new and greater opportunity on assets that Fate has entrusted to your care.

Other successors have done it in the past. You will, too. ..and your descendants are likely to have to do it again.

You have an image problem, though—in your own eyes as well as the world's. Succession to ownership just does not generate the excitement or the romance of *founding* a business. It is a classic old film: The Founder, braving bombardment and crossfire, disappointment and setback, discouragement, and dejection, building a dream.

As "The Kid," it's assumed, you get it all solely because you won the office gene pool, not because of any particular merit on your part.

That is the way most of the world thinks. Regrettably, that is even the way too many potential heirs and successors think, even those who don't have a career in the family's business. Notably, however, those who have successfully run the gauntlet of inheritance and transition, who own and manage the assets, generally have shed this sense of unwarranted privilege.

While it may be true their jobs or wealth did not come to them because of any particular merit, it's also true and more significant that they nurtured and built on both because they were tough, hard-working, and smart. They survived the crossfire, their own disappointments, conflicts and discouragements, to build their own dreams.

They have *earned* what so many others see only as an undeserved gift of Providence.

Many of those surviving successors are now the owners. They have left the minority we're talking about here. Some remember what it was like and manage to help the next generation onto a smoother, wider road.

Too many forget, however, and, instead, donning the mantle of "The Boss," they allow the whole cycle to start all over again.

A Mix of Blessings

If you are an heir to a closely held business, it is critical that you clearly understand the demands and requirements of that position, that you learn the full truth and operate on the basis of knowledge.

There are two sides to the business inheritance coin. The advantages do not make up the whole picture, as most successors learn very early. Unless you understand completely what you are in for, you stand to end up with severely muscle-bound prejudices and family problems of your own, as have so many of your predecessors.

Along with the benefits of being to the manor born, you also inherit pressures, loneliness, frustrated expectations, and heavy, ill-defined responsibility. In return for opportunity, you must accept these *and* the burden of having complex and potentially explosive assets placed in your hands.

This is the full picture, one few successors are able to see and understand before they get deeply involved in either or both of the succession and inheritance processes.

The benefits of inheritance are often overrated. The privileges of wealth can have some very sharp edges. Economic advantage is only a long-term benefit to those with the preparation, motivation, and talent to make something of it. Without such ability, the person with advantage can be in a short-lived and difficult position.

As a business heir, you *are* fortunate. No sense denying that. You have at your disposal many open doors, options that exist because you are the child of specific parents. Because of the position your parents hold in the community, you also have the acquaintance of powerful, successful people. You are more affluent than many, if not most, of your contemporaries.

But there are pressures, too, special challenges and demands that you share only with other business heirs. These pressures, often more than the advantages, define the true uniqueness of your world. Fate is very evenhanded. It delivers every pat on the back with a mailed fist. With every privilege, a responsibility is delivered.

This is the other half of your inheritance, the half that is seldom recognized, let alone discussed, struggled with, understood, or acknowledged.

Working Heirs: Be careful what you wish for…

An heir who chooses to work in his or her family business is choosing an unique and difficult career path. It requires a combination of talents and abilities few people come by naturally. It requires management "techniques" that have yet to appear in established textbooks or the curricula of MBA programs.

Consider some of what will be required of you:

- You must prepare yourself for a job that may be available to you independent of your preparation, or lack of it.
- You must gain the respect of everybody around you, when they very likely assume you got the job solely because you are an owner's kid.
- You are expected to be objective about people with whom you've been emotionally involved since birth.
- You must, before you can have any realistic dream of your own, become deeply committed to somebody else's dream (i.e., family legends and the current owners).
- You must, on top of all that, become a competent professional manager with some key qualities of an entrepreneur, despite the evident fact that the two abilities are almost always mutually exclusive.
- Your job is to find a way to work into an existing (and relatively closed) organization. You must be adaptable,

> tactful, smart, and flexible as an acrobat, while you successfully sell, administer, produce, and manage—all often in the face of a dubious and sometimes hostile audience.

The current owners, and their hand-picked key people, are probably at the peak of their careers, careers that were built up with great pain and labor over many years. They have set the standard that you must now follow.

But you are new to the fight. You have yet to win all your hash marks and battle ribbons. For you, each accomplishment is a true victory, but to your elders and superiors, you are just learning. Didn't they do the same thing many years ago, when times (of course) were a lot tougher? Their early victories were breakthroughs. Yours, it seems, become little more than "about time." You find, if you repeat history, it still just isn't enough.

Your predecessors built the train you are expected to board while running alongside. The founders laid the tracks. With every new generation come new cars, better engines, more freight and passengers. With each passing generation of ownership, the new owner-managers will be asked to board an ever-accelerating train.

Expansion and growth are still the order of the day, but as a new heir, you have serious work to do long before you get to the creative stuff. You must catch the train, which is moving *very* fast (albeit erratically) indeed. You must find a seat when seats aren't pre-assigned, and in some cars there's standing room only. If you complain this is a lot to ask, you will probably be called ungrateful. "Most people have to make this trip on foot, you know."

The pinnacle of the current owning generation's success has now become your base camp!

I know of a business founded by an old-world craftsman and cabinet maker. He tried for years to make a living building cabinets but couldn't compete with the cabinet factories. Through a combination of serendipity and shrewdness, he discovered the kitchen *remodeling* business, and his success grew.

The sale of his first remodeling job was a cause for celebration. He hadn't expected it. He was trying to sell his own cabinets when the customer asked him if he could install somebody else's. While he was at it, the customer asked, could he knock out a wall and redo a floor. Suddenly, he had a bigger job than he expected, but one that brought him more money with less work.

Today, 35 years later, his son and daughter work with him in his successful remodeling business. These two successors sell the same kind of jobs involving the pre-manufactured cabinets, relocated walls, tile floors, etc., but now, when they close a contract, it is not another success. There is no celebration. It is just "business as usual," one more repetitive step in an endless apprenticeship.

To make things worse, what they hear from the founder sounds like nothing but a string of deflating comments. He will say, for example, that the only reason they sold the job in the first place is the good will *he* built over the years. It is all in the company's name and reputation, he tells them. Besides, there is really no money in single cabinet-and-floor jobs anymore. The big money is in selling the big developers on whole subdivisions of new kitchens. Then he tops all that encouragement off with the corker:

"In fact, this job you brought us may even wind up costing *us money!"*

Is all this unfair? Is some of it even untrue? Maybe, but the only real certainty is that it tends to come with the job "successor."

It *is* unfair when teachers so easily and conveniently forget what it is like to be learning. It *is* unfair when successors are measured by standards that are artificially high or arbitrarily defined. It *is* unfair when successors are denied recognition of their legitimate victories solely because somebody else has done it before. It *is* unfair when anybody is judged against a benchmark of somebody else's history…in a different world.

It *is* unfair, but it happens all the time.

Still, can we really say it is unfair to be asked to do more than those who came before us? The same challenge has been placed at the feet of every generation. To the extent that each generation learned to build on past efforts and knowledge, our civilization has progressed. Maybe we have not advanced in skill and wisdom as quickly as we could have, but that does not imply that the challenges were unfair. They were only *difficult*.

There exists a great difference.

Being Proactive about Your Career

The responsibilities that come with inheriting ownership in a family or closely held business are great, and much of this book is about how to define, understand, and manage those responsibilities.

When employment is added to ownership for an heir, however, the complexities grow enormously. Your very survival—spiritually, psychologically, and financially—depends to a great extent on your ability to respond to and handle those complexities. Jim's discussion with his wife at the beginning of this chapter is evidence that he is not managing that complexity very well at all.

Unfortunately, there are no simple answers, no panacea. Fortunately, the experiences of many others who have gone before you provide a few rules of thumb. These may help as you wend your way through that unique experience of being a "next-generation" owner-manager:

Start Elsewhere (when possible)

No matter how much you love the business, beginning your working career in a company owned by your relatives is almost guaranteed to be a mistake. The business may need you desperately. There can be a lot of pressure to "pitch in and do the right thing." Often, there can be no choice.

But where a choice is available, your own credibility, understanding, self-confidence, and knowledge are best built in the outside world. There you will rise or fall on your own merits, not your relationship to the donors to your gene pool.

Also, outside experience has a direct, positive correlation with owner value. With the world becoming as complex as it is, over the coming decades, more closely held businesses will be looking outside themselves for key managers with wider experience than what the company has internally. Bring that experience, and you bring value.

It only makes sense to become qualified as one of those “outsiders” as early as possible.

Develop a Résumé

It is wise and prudent to build your career with an eye to employability—obvious, maybe, but a truth that is far too often overlooked. Whether or not you work in the family business, approach each job as part of a record on which you will be judged by prospective employers. The operative question should be something like, *“If I were to explain what I did in this job, would it be meaningful and impressive to a future employer?”*

Functioning as a general troubleshooter or a perennial student of internal management structure in the business is not enough. While interesting and educational, such jobs only tie tighter the apron strings of the family business. The skills you develop will be either specific to that specific business, or impossible to sell to others outside.

The lack of a résumé results in a lack of options, which leads to claustrophobia and insecurity. Under those conditions, you are even more likely to make bad decisions about your career path. The results can be disastrous.

Instead, focus on building a track record in “foreign” stadiums, something no one can take away from you. This is accomplished, specifically, through a devoted…

…Focus on Performance

Accept only those jobs where you are certain performance will be defined and judged objectively (see *Chapter 6* for a discussion of strategic compensation and performance).

Insist on being held to clearly defined goals. Make sure you have the resources and skills to reach those goals. Make sure they are public and that your success or failure are public, also. This is the only way the current owners, your peers, advisors, suppliers, and customers will know if you are an asset to the business or not.

It is also the only way you will build essential credibility within yourself.

And, finally:

Work Like Hell Is on Your Tail (sorta the fun part…)

A FUTURE WORTH HAVING

The successful closely held business is a treasure vault filled with potential and opportunity being stored for future generations. It is something no "job" and few other investments can provide.

This is why failure to manage the value of a business is so wasteful, and why settling for a status quo of frustration, disagreement, misunderstanding, and conflict is unacceptable.

The worst thing about such failures is that nobody wants them to happen. They happen despite our wants and needs. They happen despite our hopes and expectations. They happen despite even of our love for each other.

Built into the family-owned business are almost all the tools necessary for success. The real lack is in the understanding, accommodation, and process necessary to put those tools to work.

As an heir to ownership and, potentially, management of your closely held business, you have the most to gain by success and the most to lose by failure. Much depends on your ability to recognize and use those tools.

You are being asked to accept a major responsibility. In many ways, all the stakeholders in the business, the suppliers, the customers, the employees, their families, your family, and your children depend on you to take a proactive, professional approach. If you fail in that responsibility, you not only let yourself down; you let all of them down, as well.

If you succeed, and it will take aggressive and proactive attention from you for that to happen, then one of the greatest economic ways of life available in our society, becomes a viable option in the future of all the stakeholders.

You will, in fact, have played a central role in building the owner value of *your own* business.

Not bad for a life's work...

"Of course I'm enjoying myself. Where else could I be both irresistible force AND immovable object?"