Paying Fair

Salaries in a family business should be based on performance, not sentiment. When owners can't establish a rational compensation system for their kids, it's often a symptom of a company-wide — and a family-wide — problem.
By Kenneth Kaye

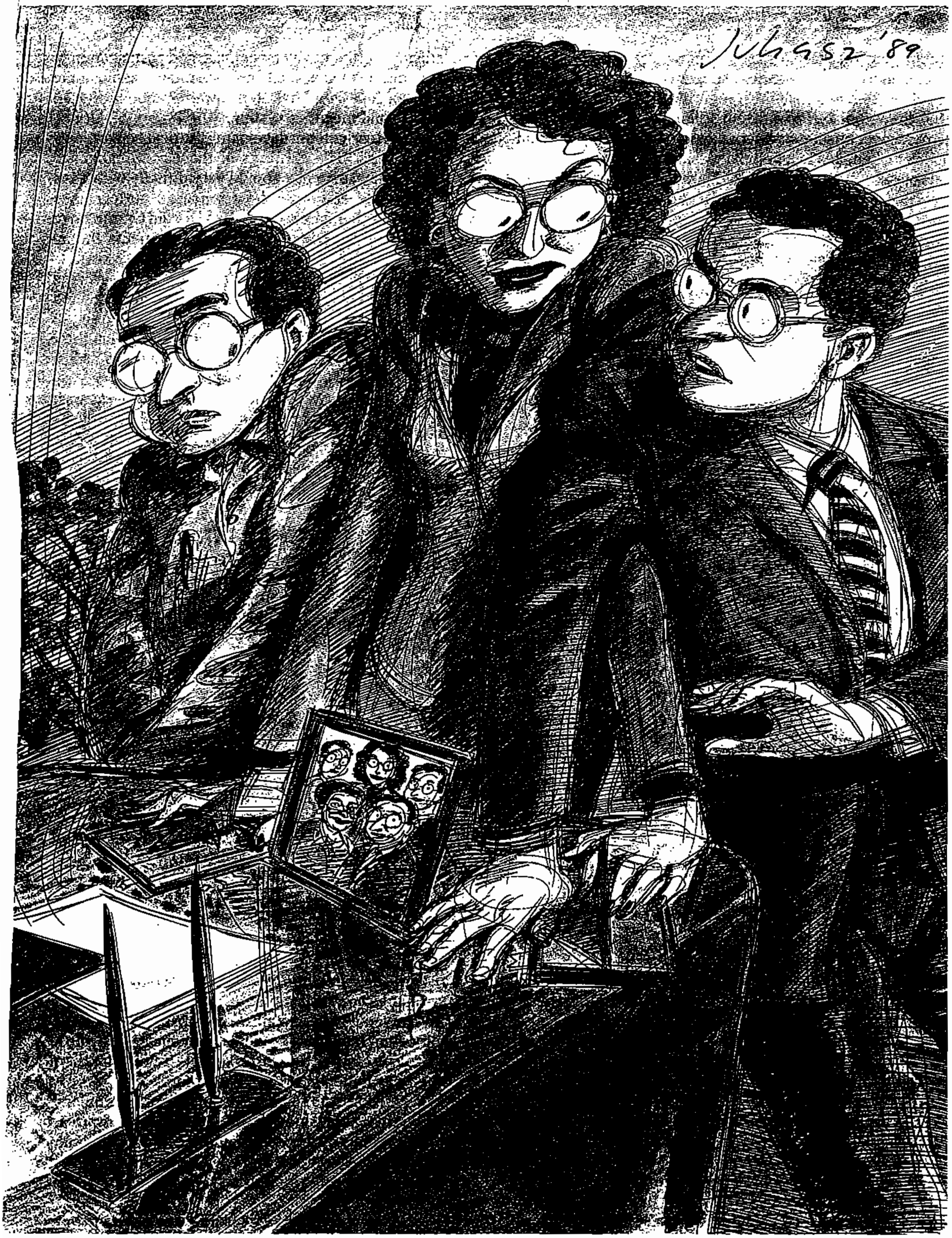
Illustrations by Victor Juhasz

ALAN CRANE purposely underpays his son, daughter, and nephew—but not because he is stingy. The founder of Chicago's Crane Carton Company, a box manufacturer with $25 million in annual sales, believes that the company's value—ultimately, to his kin and their children—grows as a consequence of their work. They probably could earn a good deal more working elsewhere, and they know it. His son Bruce, the company's vice president and current president of the Chicago Family Business Council, doesn't get the commissions Crane pays its other salesmen.

"Salaries have a way of getting out," Alan Crane reasons. "If anyone thinks the boss is playing favorites with his relatives, you're going to have even more resentment than you've already got because they're seen as having been born with a silver spoon."

Jennifer Crane, customer service representative, agrees. "Being accepted by your co-workers is tough enough. I came into the business late, in my 30s. One person took early retirement, partly because she assumed I would take over her job. It would be much worse if anyone felt I was overpaid."

Many family business owners, on the other hand, err on the side of overpayment; treating salaries, bonuses, and perks as matters of entitlement. Some owners pay their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children on the basis of age, seniority, or the number of grandchildren their take-home checks support. Others pay equal salaries to all siblings, regardless of contribution. A 1987 Laventhol & Horwath study found, however, that only 43 percent of business owners have a written compensation policy that applies to all employees, including family.

Professor Bruce Kirchhoff of Fairleigh Dickinson University concluded, in a 1987 research study, that in very small businesses, family members who are paid at all are generally *paid more than average*. The owners are not just being generous, says Edwin T. Crego Jr., organizational consultant for Laventhol & Horwath: "It's often because the owner feels guilty about laying a trip on them to come into the business in the first place."

The consequences spell disaster: fostering sibling resentment, hurting morale among other employees, and encouraging irresponsibility. Just when the business has won its struggle for survival, there's a new struggle among family members over who gives more to the business, who is unappreciated, and whose compensation is the least fair. Symbolically, the siblings may see their earnings as tokens of their worth to their parents.

Consultants dispute many issues, but they tend to agree on one thing: owners should pay family members just what they'd have to pay anyone else to perform the same job, based on the market value of that person's knowledge, talent, and experience.

Most consultants would advise Crane to pay his family members exactly what their knowledge and effort are worth—no more, no less.

When owners can't establish a rational compensation system for their children, openly stated and based on job performance, it is often a symptom of a company-wide problem. As Chicago-based management and business psychologist Bernard Liebowitz puts it, "They haven't faced up to the need to tie compensation to performance, performance to work responsibilities, responsibilities to an overall strategic plan, and all of those things to a company work ethic."

Liebowitz advises most of his clients against a simple salary system. "A reward system based on productivity," he says, must have three components: "base pay (compensation), individual productivity incentives, and participation in a shared-bonus incentive plan." In short, rationalizing family members' portions is a vital step toward rationalizing an entire payroll and incentive system.

It is also a vital early step in developing the next generation's owner/managers. "The earnings of those who expect to own the company some day should vary directly with their own performance and with the company's performance even more than other employees," says Donald Crampton of Chicago's Crampton, Lewis & Company, a benefits and insurance consulting firm.

A good sign that earnings don't have much to do with performance is when an owner or a son or daughter calls their pay a "draw." Most often, they aren't simply referring to an advance against salary. As used loosely by many owners and their family members, the word suggests drawing off water from a reservoir and thus confuses salary with profit. While our tax structure may make that "draw" advantageous in the short run (to the extent the IRS accepts the family's "draws" as salary rather than dividends), any such tax benefit is far outweighed by the company's inability to function efficiently and compete aggressively. A company simply cannot price its goods or services competitively if it is saddled with a bloated payroll.

An unrealistic salary also may cater to self-delusion regarding the "draw" to which a son or daughter is really entitled. Many a family learns too late that a relative with an addiction, say, to alcohol, drugs, or gambling, has "drawn" not only more than his reasonable compensation, but even more than the company's revenues can sustain. Even those who are potentially competent may learn to view the business as a goose that lays golden eggs — the worst possible training for them and a sure way to debilitate employee morale.

An owner who tries to solve tax and inheritance problems through salary manipulation is getting bad advice from an accountant or attorney whose vision may be limited to narrow financial considerations, and not focused on the health of the family—or, for that matter, on the welfare of the business.

Compensation and incentives for members of the family

Bad Business
(Good intentions don't count)

These models of misguided compensation policies are all too familiar in family companies:

Someday Enterprises "You're not making much now, but some day it'll all be yours." (No matter how little you contribute.)

Love, Duty & Co. Everyone is close, cooperative and mutually supportive. But the future is left unspecified—and not to be discussed.

Fair Shares Holding Co. The compensation scheme, business roles, and expectations about future organization are designed for egalitarian treatment of siblings. They have little or nothing to do with business needs, individual abilities and performance.

Marx Brothers From each according to his ability, to each according to his needs.

Golden Eggs Ltd. The kids are overpaid and the business is considered a perpetual source of revenue for all. Dad or Mom finds a place for them regardless of ability or motivation.

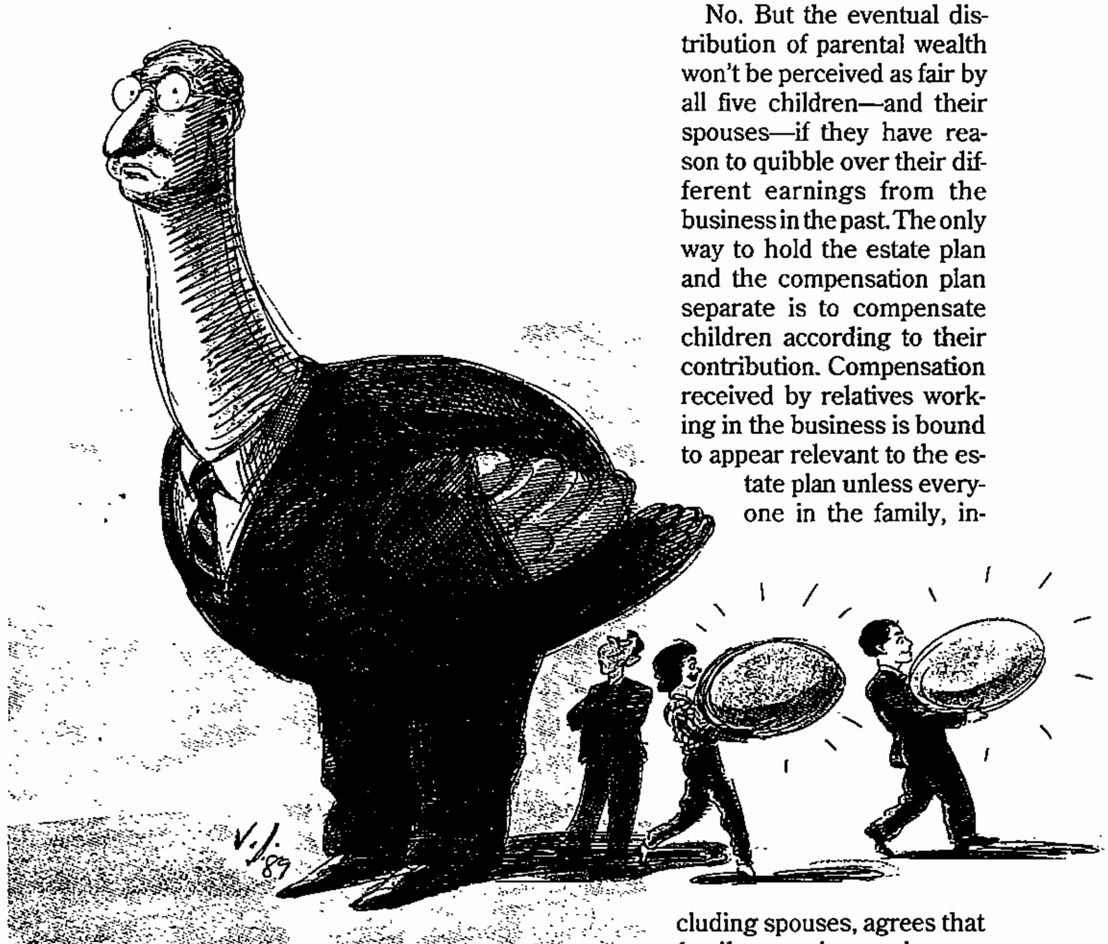
Primogeniture Corp. Like children's allowances, salaries are ranked according to age or seniority.

Prove Your Worth Inc. Pay is clearly based on performance, as is a secure place in the business. Unfortunately, esteem and status in the family are in doubt and are conditional upon earning the boss/parent's approval. —*K.K.*

do raise important issues in connection with both the family's estate plan and the company's succession plan:

- Unrealistic salaries will have made the company look more or less profitable than it really is. A fair valuation of the business must take into account either uncompensated labor or excessive "draws."
- If a successor has accepted low pay because he expects to inherit a larger piece of the company than his "outside" siblings, or to purchase their stock at a discount, there had better not be any surprises later — for him or for them.
- If the chosen successor's earnings are perceived as excessive by the siblings, that too may threaten his succession as well as future relations among all the siblings and spouses.

Although all relatives' paychecks should be performance-based, the way they are formulated might be different. Suppose an owner with five children, all in their 30s, employs two of his daughters and one of his sons. With a master's degree in labor relations, Susan is personnel director. She has ambitions—when her children are older—of directing a human resources program for a much larger company or of starting her own consulting firm. Bob is a plant foreman; his personality and intellectual limitations make everyone realize that he is all but unpromotable. Karen has an engineering degree and has already worked in product design, plant management and sales, impressing her co-workers as well as her father.



Karen is the clear successor to ownership. However, she recently married and her career plans could change. Dad is only 57 and imagines Karen as chief executive officer in about 15 years, himself as chairman for life.

Dad is right not to *give* the company's stock to any of his five children. But while Susan is on straight salary and Bob's tenure with the company qualifies him for profit-sharing, Karen's compensation could include stock options or shares to be purchased back by the company if she leaves, and/or quarterly bonuses based on company performance. Her base salary might be less than she could earn elsewhere, while the total package, when she thinks of herself as an owner, is greater.

Karen's father would thus begin early to prepare her for eventual leadership and ownership. Making her earn the stock shares, rather than giving them to her, keeps his alternatives open, and puts the differential treatment of five children on a rational basis.

Business succession planners distinguish between "sweat equity" (the wealth that is built up by family members in the business) and "blood equity" (all children's fair shares of the parents' estate). The growth of shareholder value is often ignored when setting a salary. Should cumulative past compensation received by Susan, Bob, and Karen in this case figure into the calculations of their share of the estate?

No. But the eventual distribution of parental wealth won't be perceived as fair by all five children—and their spouses—if they have reason to quibble over their different earnings from the business in the past. The only way to hold the estate plan and the compensation plan separate is to compensate children according to their contribution. Compensation received by relatives working in the business is bound to appear relevant to the estate plan unless everyone in the family, including spouses, agrees that family members who are working in the business have been neither overpaid nor underpaid.

There is no substitute for open communication about both compensation policies and estate planning. Charles Benton learned that lesson painfully during his father's chairmanship at Chicago-based Encyclopaedia Britannica. When Benton headed EB Educational Corporation in his mid-30s, he owned most of that company's common stock. However, the voting shares were held by his parents. The Britannica companies were wholly owned by the family, but controlled by Charles' father, former Senator William Benton, who was a Democrat in politics but an autocrat in business and at home.

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Charles says his father's biggest mistake was stifling any open discussion of the simmering jealousies that had divided his four children—Charles, his younger brother, and two sisters—since childhood. The resulting feud escalated and eventually forced Charles, after his parents' death, to divest himself entirely of his Britannica stock and to strike out independently.

Today, as chairman of his own company (Public Media Incorporated, including Films Incorporated and Home Vision), Charles advocates open discussion with all family members, in or out of the company, of current business involvement and compensation as well as long-term family financial matters. His son, Scott, is production director of his company; two older children have independent careers.

"If you're fortunate enough to be able to have a family business," he says, "you want to learn from, not repeat, the mistakes of previous generations. In fact, our children took the initiative to start a series of regular family meetings with the kind of open, frank discussion my father would never have encouraged." FB

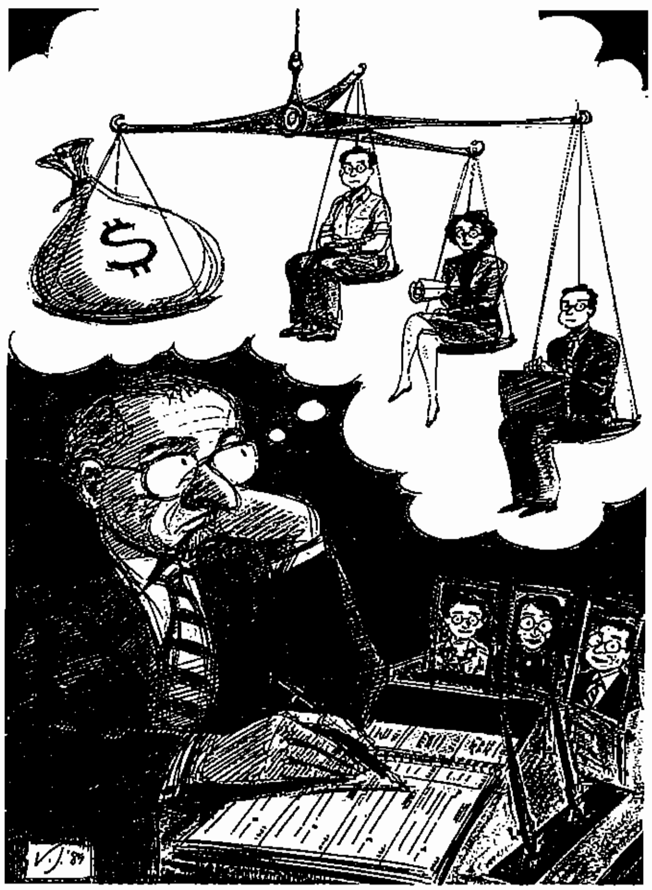
Kenneth Kaye is a Chicago-based consulting psychologist who works with family businesses.

Getting Sensible About Salaries

How do you change over to a rational compensation scheme when you have a tradition of "share and share alike," or of underpaying or overpaying family members?

Set a date for change. Plan to make the change with some fanfare—don't minimize it. Treat it as a significant step toward preparing the company to endure and prosper in the 21st century. Announce to all those involved that the change will take effect, say, January 1. Then have a family meeting to finalize the details.

Hear everyone out. A consultant's role in facilitating that meeting—ensuring that everyone's views are heard and that the family plans just how they will review the new system periodically—may be more important than that consultant's advice about the best specific scheme.



Be consistent and clear. Mid-sized companies have tried a variety of methods for determining family members' salaries, bonuses, and advancement. Some make it a rule that siblings don't have firing, promoting, or salary-setting power over one another. Others set all family members' compensation annually at a family meeting. Still others refer management recommendations to a committee of outside directors. Whatever method you use, have a clear policy about family compensation, one which is consistent with your business philosophy and psychological working environment.

Don't mix money and emotions. Compensation should not be a means of distributing parental resources, nor of keeping children dependent, nor of buying their devotion to the family or the business.

Pay for performance. Every dollar of compensation and dollar in incentives paid to employees should be tied to achievement and aligned with the market value of that person's contribution.

Measure performance. Every family employee has a job description, and his performance is reviewed, in the same way as that of other employees, at least once or twice a year.

Communicate. Even if it is too early to choose a successor, the family's estate plan is thoroughly reviewed and discussed openly by all adult children, those working in the business and those not, with respect to catastrophic contingency plans as well as long-term prospects.

Explain inequalities. Thoroughly discuss, with all siblings and their spouses, any anticipated inequalities in business ownership that may result, for instance, if employed shareholders exercise stock options or if an insured stock-purchase plan might be instituted.

If anyone isn't convinced that the plan is fair, the parents may finally have to say, "We're sorry that you don't see it as we do. Having heard all points of view, we feel it is the best way to be fair and to maximize the value of the assets we'll eventually be able to leave all of you. We hope you will someday become convinced it was fair." End of discussion. —*K.K.*