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Wealth Planning Update

Family business governance

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Jeremy Miller
Senior Business Transition Strategist
Wealth & Investment Management,
Wells Fargo Bank, N.A.

David Specht
National Family Dynamics Strategist
Wealth & Investment Management,
Wells Fargo Bank, N.A.

Key takeaways:

- There are many steps to transitioning a family business beyond determining timing and means of transfer, including family business governance.
- As the owner, you handle all aspects of ownership, control, and operations, which need to be considered when preparing for transition. Family business governance can support the next generation in the transition.
- Family governance tools include buy-sell agreements, a family employment policy, a distribution/dividend policy, a professional board, a family board, a company mission statement, an estate plan, and the business governing documents (operating agreement, bylaws, etc.).

What this may mean for you:

- As a business owner, you have many things to consider as you transition your business to the next generation. Putting the proper governance tools in place in advance can prepare the next generation and may increase the likelihood of a successful transition.

For family businesses in America, the chance of successfully transitioning the business to the next generation is approximately 30%.[1] While there are many factors outside the family's control on which business success is predicated, there are several internal factors that are within the control of the family. If addressed, these internal factors may increase the likelihood of a successful business transition to the next generation.

Family business governance

As a business owner, you may believe that transitioning the family business means having the next generation step in and take over when you determine the timing is right. If you have decided that you wish to transition the business to your heirs, it is important to realize that the process goes beyond engaging your legal and tax professionals and transferring via a gift or a sale, either outright or in a trust. These are important considerations, but there are other key factors that can help the transition have a higher likelihood of success.

One of these key factors is family business governance. This is a system of correlated tools and actions to support the next generation with the control, ownership, and operation of the business. It can assist your family in their interactions with the business, the setting of expectations, a business vision, and asset oversight. It also puts in place a framework that contains business protocols, describes how future ownership changes occur, and establishes a precedent for making business decisions.

Family business governance can help address the following:

- How each family member may participate in the business
- Ownership structure
- Distributions made to the owners
- How major decisions should be made
- Who makes the decisions in the business
- How disputes are addressed
- Protocol to handle changes in family dynamics

The three aspects of the family business

As a business owner, you may have viewed ownership, control, and operations singularly. You have likely handled all three aspects as you have grown your company. However, as you prepare for transitioning your business, you may have to make a paradigm shift in the way you have approached ownership, control, and operations. Each of these areas should be considered on their own, not as one.

Ownership: The ownership aspect is where you may face making an equal versus fair decision when it comes to transferring assets to your heirs. Every situation is unique, and you must determine what is correct for you, your family, and your business based upon your situation and belief system. You may believe that equal is fair and that each child will receive equal ownership in the company. On the other hand, you may believe that only those involved in the business should receive ownership and nonbusiness assets can go to the other heirs. This can be a complex decision in which many factors may be taken into account. Estate planning strategies and techniques that are outside the scope of this article can be used to address equal versus fair depending on how you answer this question alongside with your tax, legal, and financial advisors. . As you think about ownership, you may wish to consider these questions:

- How do I define equal versus fair when it comes to the next generation?
- Who should have ownership?
- When should I transfer the business ownership?
- By what means will ownership be transferred?
- What restrictions will be placed on family owners' ability to sell or gift ownership?

Control: Business control is an important decision, and you may find this to be a more difficult decision than the allocation of ownership. It may be difficult for you to step aside and cede control; it's not unusual for some owners to have some control until their death. Control is a central tenet to the family business governance system, as those with control not only direct the business but also may influence the governance tools. Determining who should have control and their level of preparedness is an important decision that needs careful review. As you contemplate control, consider the following questions:

- What qualifications or characteristics are important when determining who will have control?
- How will future changes in control be decided?
- If more than one individual is in control, what protocols will be used to make decisions?
- What is the right timing for the change in control?

Operations: Business operations for the next generation may look very different than they do under your leadership. The skill set of the next generation may not be in running a business, or they may not have the desire to operate even if the requisite skill is there. You may wish to promote non-family member employees or look to the outside for this skill if it does not exist in house as you prepare for your transition. It can take years to develop the right talent for the role of operator, and it may take trial and error to find a good fit. This process is a balancing act that requires timing to get the right employees in place and trained as you prepare to exit, so it is important to put a plan in place and start this process early. Consider the following as you address who will lead operations:

- Does the next generation have both the skills and drive to run this business?
- What skills and education does the next generation need, and how will I help close those gaps?
- Are there any non-family member employees with the skills and drive to run the business?
- How will this be communicated to both family members and key employees?
- What needs to be in place to transition operations?
- How do I properly incentivize both family and non-family employees to perform at their best?

Family business governance tools

There are several tools that can be employed as part of the family business governance system. These may include buy-sell agreements, a family employment policy, a distribution/dividend policy, a professional board, a family board, a company mission statement, an estate plan, and the business governing documents (operating agreement, bylaws, etc.).

A **buy-sell agreement** is a legally binding contract that stipulates how an owner's share of a business may be reassigned if triggering events occur, the price that will be paid, and the payment structure. These agreements can be very important in a family business governance structure to help guard against potential future disharmony within the ownership group and can provide a path out for certain shareholders who would rather cash out of the business. If a buy-sell agreement is not in place, an otherwise healthy business may face some challenges. In order to help minimize the impact to the business, strong consideration should be given to a buy-sell agreement in some format depending on how your business and estate planning documents are structured.

A **family employment policy** is a document that can be written and kept within the family for private use or incorporated into the human resource documentation of the business. The family employment policy sets expectations for heirs and spouses about such issues as how they can obtain employment in the business, the requirements to attain key positions, the compensation standards to be used, and incentive language for family members. For some business owners, nepotism may abound in this document, and for others, it may provide market terms with no favors provided to family members.

A **distribution or dividend policy** is key in setting expectations with the family members regarding what distributions they should expect to receive from the business. Business owners must balance the need for cash to maintain or grow the business with the desire to receive distributions. If a policy is not set before the next generation is involved, this can be a source of friction due to the potentially conflicting goals and desires of each family member.

A **professional board of directors** is a governing body that helps oversee the business and makes major decisions within the business. A board is generally comprised of three, five, or seven professionals from various industries that have the subject matter expertise to assist your company strategically. The board is selected by the owners of the business. They have a fiduciary obligation to the business, they meet at regular intervals (usually two to four times per year), and they generally serve for a specified time period. They do not run the day-to-day operations but may be involved in selecting and overseeing those that do. While a professional board is not appropriate for all businesses, you may wish to consider it as you think about the next generation and what support and insight they may need to have the highest likelihood of success.

A **family board or council** is a group within the family — or may include the entire family — that comes together to make decisions about the business on behalf of the family. This group can create subcommittees to make decisions, interact with the professional board (if there is one), and make decisions for the business if a professional board is not in place. The purpose of this group can be narrow or broad in nature, as detailed and outlined in the governing document. The family's business vision can be shared in this document and may be aligned with the mission statement for the business.

A **company mission statement** may be a document that you already have in place for your business. This can be valuable to your employees and your family, as it addresses the purpose and vision of the business. It is important for the future of the business and will help guide future leaders of the company as it has you.

Your **estate plan** can be a critical tool in family business governance, as it can address ownership, control, distributions, and several other factors. Control of a trust can be given to a trustee or to one or more trust beneficiaries. Distributions are generally addressed in the document as well and can be tied to the distribution policy of the business. Another document that is generally addressed at the same time as the estate plan is a power of attorney. This becomes important to the business should you experience a period of incapacity because it allows the named power holder to make decisions on your behalf and a business owner should engage their tax, legal, and financial advisors to discuss.

The **business's governing documents** should be reviewed at the same time the family business governance system and tools are put in place. Depending on the business's legal structure, this may be an operating agreement or articles of incorporation and bylaws. Revisions to these documents or corporate resolutions stored in the corporate minutes may be needed to align these business documents with the company's governance system.

Voice of the next generation

In contemplating what to put in place for the next generation, soliciting thoughts on what should be created becomes an important part of creating a well-thought-out plan. An important group to consider eliciting input from in this process is the next generation. Ultimately, their buy-in and support of the system and tools is important for the success of the business in their generation. The next generation may have different thoughts for the future, and they could have additional insights you may not have considered. Additionally, giving the next generation a voice in the process of creating this system will allow you to confirm or alter your understanding of their desires and goals.

Communication is key

A key part of the success of this system and the business as a whole is the open communication you provide to your heirs regarding the business governance system and the tools you have put in place. The system and tools should be openly and regularly discussed during family meetings. Depending on the system you establish, it may take multiple meetings to share the entirety of what you put in place.

Conclusion

Transitioning the family business down to the next generation is much more than transitioning shares. A well-thought-out and documented plan in which you address ownership, control, and operations builds a strong governance system for your business. We believe that this system, combined with communication with the next generation, is key for a higher likelihood of success.

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1. Family Business Institute: **https://www.familybusinessinstitute.com/wp-content/uploads/2019/01/Family-Business-Succession-Planning-White-Paper.pdf**