



Wealth Planning Update

Owner or Operator: distinct differences that matter

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Key takeaways:

- As a business owner, wearing many hats may be typical; however, the owner and operator hats have uniquely different roles, responsibilities, and rewards that are not always aligned.
- Distinguishing the owner and operator roles can make it easier for owners who are interested in stepping back from operations but are not yet ready to transfer ownership.
- Aligning rewards with roles helps owners distinguish among active and inactive heirs, easing the challenge of fair versus equal.

What this may mean for you:

- Separating the owner and operator roles and understanding the differences can help provide clarity and flexibility and is especially important when it comes time to pass the baton.

As the founder of a business, you started the enterprise wearing two hats: one labeled owner and the other labeled operator. Initially, this made sense: You invested your savings to start the enterprise, bought the equipment needed, and even secured bank loans to fund your working capital needs. You also assumed responsibility for sales,

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marketing, and managing the finances. Hence, hat #2 — you were the chief operating officer. As the business grew, continuing to wear both hats seemed reasonable and provided a sense of control — you could make the decisions about growth, leverage, investment, and profitability. You had absolute authority while wearing both hats, pulling the investment lever simultaneously with the operating lever.

However, as companies grow and become more complex, simultaneously wearing these hats becomes more challenging. Typically, the challenge arises because the owner objectives and operator objectives no longer perfectly align.

Potential friction between ownership and operations

An owner, as an investor in the enterprise, has the primary objective of earning a return on investment by seeking profits and growing the value of the business. The operator may not be focused on these same objectives. Often, the operator is concentrated on the more tactical aspects of the business: growing revenue, managing expenses, and hiring talent, not to mention keeping the operations running smoothly. These are amongst the “right priorities” for the lead operator. The challenge can occur when these objectives do not directly align with those of the owner.

One example of a friction point is revenue growth. The operator, responsible for sales and customers, may be very keen on customizing a product for a top customer because it means significant revenue upside. However, it also means constraining capacity for other customers. This can be an operational challenge, but it can be an even more significant owner issue. While top-line growth is often a priority for an operator, not all revenue growth is equally attractive, especially if it is less profitable or increases customer concentration. Compromising profit margins for revenue upside may marginalize value building in the long run. Likewise, minimalizing customer concentration is a key value-creation metric. Reliance on a few significant customers introduces risk in the operations of the company, especially cash flow.

In a status quo ownership scenario, the separation of the owner and operator hats can become even more important when you are no longer interested in spending 80 hours a week running the business. You, as the owner, love the business and want it to continue to grow, but you, as the operator, are getting burned out and want to spend time pursuing other interests.

Without separating the two hats, many owners may feel compelled to find an outside buyer or sell to a management team that isn't quite ready to assume the reins of ownership. However, by separating the owner and operator duties and responsibilities, it may be possible to have a reduced role as a fully active owner, limiting focus to the strategic vision of the company and spending less time in the office while allowing other key people to wear the lead operator hat, seeing to the day-to-day operations of the business.

In an ownership scenario where the goal is to create a multigenerational enterprise, the two-hat approach can become even more complicated. When bringing family members into the business and assigning roles, often the operator responsibilities shift to a few individuals. This may create a potential for leadership legacy, but if not equally or appropriately assigned, it can create friction among active and inactive heirs. The active heirs assume both the owner and operator roles and responsibilities, and the non-active heirs assume only the ownership role. This imbalance of responsibilities can lead to disagreement among owner-heirs and become a source of misplaced expectations.

Often, the founding generation believes they are offering the active next generation career opportunities coupled with the opportunity to enhance their ownership value. However, if ownership is allocated equally among all heirs, regardless of contribution to the enterprise value, this can be seen as equal but not fair. Active heirs help create value for all family members who are shareholders, but if the active heirs are not being fairly compensated for this value creation, then they may feel resentment or not be as motivated to continue in the operator role.

Distinguishing the owner and operator roles

The primary responsibilities of an owner can include providing capital to an enterprise, provide stewardship of the investment through oversight of the operations, and ensure risk is judiciously managed to generate a return on the capital invested. The operator focuses on the performance of the enterprise within the boundaries of risk and return expectations set by the owner.

The rewards of each role are often different as well. The owner participates in profits and value creation, in return for keeping capital invested and appropriately supporting the needs of the enterprise through the work of the operator. The operator typically is compensated through a market wage, with bonuses for exceeding shareholder expectations. Operators are often also compensated through equity-type rewards to help keep their interests aligned with the owners' interests.

With a family enterprise, especially one with active and inactive shareholders or heirs anticipating ownership, clarity regarding the role differences can avoid conflict and resentment. Providing clarity around the roles and the expectations of the next generation of owners and operators can be critical to the ongoing success of the business as well as maintaining family harmony. In addition, reevaluating compensation and ownership interests in light of these expectations can help ensure the future owners and operators are properly positioned to support the long-term success of the business. For example, considering equity-based compensation for active heirs in an executive role may help bridge the rewards gap for these current or future dual owner-operators.

As a founder or managing generation owner, the blurred lines between owner and operator can erase the distinction between the roles and the rewards. It is a best practice for owners to ask themselves, "Am I pleased with the performance of my operator to build enterprise value so I may reap the return on my investment?" Likewise, wearing the operator hat, one should ask, "Am I receiving sufficient direction to operate the enterprise so that the outcomes align with the shareholders' value creation expectations?"

As a best practice, consider the following matrix to guide your thinking:

	Owner	Operator
Role	Provide capital in the form of equity or debt	Manage and lead the performance of the enterprise
Rights	Voting shares; controls the equity decisions	No equity decisions; may offer insights regarding topics that influence shareholder outcomes
Responsibilities	Fiduciary obligation to achieve shareholder objectives and safeguard shareholder investment; provide management with a mandate on return and risk, among other priorities	Manage the operations of the enterprise consistent with shareholder expectations and risk parameters
Reward	Return on investment, either through current cash flow (distributions or dividends) or via increase in enterprise value to be monetized or transferred in the future	Market compensation with appropriate executive level incentives when shareholder expectations are met or exceeded
Duties	Hires executive talent; approves the strategy and budget; ensures ownership decisions support operator priorities and undue risk is not undertaken	Develops an operational strategy; hires the management team to execute the directives; informs ownership of performance challenges to minimize operational risk

As you can see, separating the owner and operator hats and delineating the roles, responsibilities, and rewards of each can be illuminating and instructive, even for the founder. If you would like more information, contact your advisor.

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