The Management File

Inisght for Business Owners and Risk Managers Provided by Brady, Chapman, Holland & Associates

Unique Risks of Family-Owned Businesses

Family-owned companies comprise approximately 90% of businesses in the United States. With increased employee loyalty and deep-rooted pride in their products and services, family companies are the backbone of our economy.

While any business' relationships can be complex, adding a family dynamic to the mix creates a labyrinth of unique issues and risks to navigate. Many family business owners believe they are at low risk for claims; however, the opposite is true. Directors and officers liability (D&O) claims, employment-related lawsuits, fiduciary liability issues and more afflict family businesses just as much as other companies. In fact, they may even have more of an impact, since many family companies typically lack the business plans and established policies to mitigate those risks.

To leverage your family dynamic and create success for your company, use this list as a starting point to identify and understand the unique risks of family-owned businesses so you can create a risk management plan to address the issues and avoid costly lawsuits.

1. Informal Business Plans and Company Policies

Do you document responsibilities and expectations for each member of your family? Does your family have a written policy of who'll walk the dog? Do you make your teenagers sign a contract when they want to borrow the family car?

Family life isn't usually dictated by a formal corporate structure, written policies or strategic long-term planning. Unfortunately, this informality tends to carry over to a family-owned business as well, which is dangerous when the majority of a family's assets are tied up in the business. Some family companies lack solid business plans; company policies, if documented at all, tend to be informal. Long-term strategizing, including who will take over the business, is often nonexistent. As a result, the company fails.

Investing the time in creating a detailed business plan, clearly-written company policies that are consistently enforced and defining roles for everyone—especially family members—involved with the business, is important. Devise a plan that balances family goals and business goals, and meets the needs of both.

2. Employment-Related Issues

In family companies, family members fill roles as owners, employees, advisors and shareholders. Unfortunately, business interactions get complicated when family roles blend—or clash—with business roles. The dissonance between someone's role in the family and their role in the business can create confusion.

Hiring nonfamily employees or attracting nonfamily board members brings a fresh perspective and a certain degree of impartiality that can benefit any family-owned company. Unfortunately, sometimes these talented individuals shy away from these roles in fear of nepotistic practices. Management duties such as hiring, firing and disciplining both family and nonfamily employees can be a challenge.

One of the biggest exposures for any company continues to be employment practices liability claims. Be cognizant of how you treat and compensate both family and nonfamily employees, and make sure it is consistent and fair to avoid claims. Furthermore, selecting the most qualified individuals to fill roles at your company—whether they are family members or not—will benefit your business in the long term.

3. Family Conflict Becomes Business Conflict

"Leave your personal problems at the door"—an old adage that means keep your personal matters separate from work life. Is this really possible in a family-owned business? In many family businesses, it's difficult to separate family conflicts from business conflicts. Some conflicts are deeply ingrained and have been recurring since childhood, such as sibling rivalry. On the other hand, the effect of a single, family-wide crisis—such as a divorce, sudden illness or financial troubles—can create turbulence in the company as well.

Keeping family conflict totally out of business matters may be difficult to achieve, but it's important to continue working toward establishing healthy boundaries between your family life and the business. Family conflicts are often emotionally based. Avoid allowing these emotions to lead to irrational decision-making for your business.

Communication is crucial; manage family conflict by identifying the issues that cause conflict and stress, discussing these issues with the family and developing a policy to address them.

4. Lack of Communication

As with any business, communication is the fuel that keeps the company moving. In a family-owned business, issues arise when important things are shared with those family members, and nonfamily employees and shareholders are left behind.

Communication should be a two-way conversation and it's critical to include both family members and nonfamily employees. It's also important to speak to all employees in a professional manner. The informal communication, like teasing and joking, with family during personal time is one thing; avoid speaking in this way while conducting business. Family employees have been known to file harassment claims, too.

5. D&O Concerns

Large, family-owned companies have the risk of D&O liability, especially regarding how the business is being managed. Family companies are at risk for lawsuits that arise from employees, customers, competitors, shareholders and regulatory agencies.

Since family and business goals become intertwined, you may make decisions for nonbusiness reasons that do not maximize the shareholders' welfare. Whether shareholders are family or nonfamily members, they hold all directors and officers of the company liable for effectively managing their investment.

Be aware of D&O liabilities, including:

- **Conflicts of interest** occur if the majority shareholder gained benefits from the sale or purchase of company assets they controlled.
- **Freeze-out mergers** occur when the minority shareholders are forced to sell their stock or less than market value.

Directors and officers of a family-owned company have the same fiduciary responsibilities—such as duty of care, duty of loyalty and duty of obedience—as executive management does at any other private or public company. In many cases, family shareholders have invested a considerable amount of their assets in the company. Fiduciary duties should not be neglected, even if all of your shareholders are part of the family.

6. Complying with Government Regulations

One of the biggest areas of compliance for family-owned companies involves estate plans. Without an estate plan, family companies will pay higher estate taxes than necessary. Estate taxes can be quite costly if the family wishes to continue the business when ownership is transferred. Most family business owners want their estate to go to their heirs and not taxes.

You want to optimize the transfer of ownership while minimizing estate, gift and transfer taxes. Consult an attorney who understands family business laws concerning transferring business assets across generations. Tax laws are constantly changing. When you establish an estate plan, you should already begin saving money for taxes.

7. No Succession Plan or Exit Strategy

In the event of major illness or death, who will lead your company into the next generation? This may be a question you don’t want to think about, or you may feel no one can do the job as good as you can, or that your successor is not ready for the job. However, having a plan for succession is critical if you want your company to have future success. Some business owners plan their exit strategy and groom their successor under their tutelage for years; some are forced to do this quickly in the case of a sudden illness or unforeseen death.

Succession planning can take years; don’t wait until a crisis hits to start planning. To ensure the ownership or management transition is as seamless as possible, use a comprehensive succession plan with four phases: initiation, selection, education and transition.

Choose a successor based on their qualifications and competency—this may not necessarily be a family member—but make sure they are qualified for the job and have the company’s best interests in mind. Then, give the reins of your company to your successor, one at a time.

You may have to engage the assistance of outside advisors during this process. A professional business consultant or an advisory board made up of nonfamily members who can take the “family dynamic” out of the planning process can lead your company to a successful future.

Contact Brady, Chapman, Holland & Associates at 713-688-1500 to learn more about the insurance tools and resources we can offer to help you protect your family business now and prepare it for future success.