Why Compensation for Family Members Should be at Market Value

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One of the greatest struggles of operating a family business is separating the family from the business. Oh yes, there are many great benefits to having family in the business and to being a family member in a family business, but the most difficult problems result when "family values" and issues take over, leaving business values and needs wanting. There is no greater source for family business problems -- nor more fertile ground for their cure -- than the family business compensation system.Â

Starting with the premise that family members' compensation should be a market value, let us look at the various considerations -- often conflicting -- in a family business, which will in turn demonstrate that this premise is correct.Â

I.Â Effect on Family MembersÂ

When compensation is based on performance, there is no better tool for advancing productivity. This is no less true for family members than for non-family members. In my experience, I have seen many cases where family members know that their compensation is completely dependent upon their performance, and I assure you their performance is greatly enhanced. In addition, their security and confidence grows significantly because they realize that they are not "handcuffed" to the family business; i.e., they could move to the outside and obtain the same compensation for the same services. Likewise, I have seen situations where the "family values" have taken over and, for example, all of the children earn the same salary. This works a wondrous effect -- it reduces the incentive for everyone. The stronger family members feel that there is no reason to "push" since their compensation is determined by fiat anyway. The weaker family members have gotten what they wanted and for the most part, will work to an even lesser level than their capacity.Â

The business obviously suffers; true team work is lessened and incentives lost. But the real sadness is that the family members themselves are in never, never land. They are tied to the family business because they cannot see themselves earning as much elsewhere, and they become deeply insecure in their employment flexibility.Â The business becomes the be-all and end-all and any change in that business; i.e., sale or restructure, is fought against.Â Obviously, this may not be in the best interests of the family member or the business.Â

II.Â Effect on Non-Family MembersÂ

The effect of market value compensation for family members on non-family members is excellent. They feel that they are on an even playing field and a true member of the team.Â While they recognize a "difference" between their status and that of family members, they also recognize that it is kept to an absolute minimum. If they make a larger contribution to the business, they are going to be rewarded. They also have a much greater respect for the family members than they would where the "family values" compensation system takes over. As a result, they don't resent them and they are helpful to them in their sojourn through the various ladders in the business.Â In short, the morale throughout the business is enhanced.Â

III. Intra-Family RelationshipsÂ

It is quite evident that the family business' long-term success often depends on how the family members "get along." One of the major problems with the family compensation system is that once the senior family member passes on, there is no one to lay down the law with regard to what the compensation should be. As a result, family members begin in-fighting, and the stronger contributors resent any equal sharing of compensation with their family members.Â Thus, the "system" that is based on "family values" rather than market value compensation falls apart at the worst possible time for the family business.Â And too, because all family members are compensated at a very high level (or an extraordinarily high level for their value to the business), the never leave, causing stresses on the business, which often can be fatal. One of the beauties of the market value compensation system is that when it is done right, including careful, routine and regularly-scheduled evaluations, it is not dependent on a strong senior family member for its efficacy. Because it provides for lesser compensation for those contributing less to the business, it will often result in the weaker family members leaving the business, which creates a lesser strain on the business in tough times. Conversely, the stronger family members -- those who are contributing more -- find themselves rewarded and in turn, are incentivized to contribute even more. Finally, the benefit at the death of the senior family member is clear:Â the compensation system continues, and the dislocation which occurs at the death of the senior family member is kept to a minimum.Â

IV.Â Effect of the Market Value System on True ProfitabilityÂ

Family businesses are notorious for masking profitability.Â Masks can be either positive or negative. For example, how many family businesses do you know which enjoy a "sweetheart" lease from a related family entity? When one looks at the profits of the family business, they are often exaggerated since the amount by which the rent falls below market value is essentially added to the profits of the business venture. When one considers that the real estate could be rented at market value to others, this results in an inflated picture of the profitability of the company. Much the same occurs with compensation. And again, this can be either positive or negative.Â Where family members' compensation is based on "family values," one often sees the parents' compensation being excessive and the children's compensation being much less than their fair market value.Â This would give an inflated picture of the company's profitability.Â In other situations, the children's compensation is excessive, often based on housing and family needs of the family members as opposed to their worth to the business. This would give an unrealistically low portrayal of the profitability of the business.Â

The system where market value compensation is the rule helps in many ways. Obviously, the true profitability of the business is established. This has significant effects on decisions of family members to stay in the business and further provides fairness in the payment of dividends by the business which can, in turn, be used to benefit those family members not active in the business. If fairness can be achieved in this regard, one finds that family members are not working in the business to "protect" their investment and do not become a drain on that business. Where family members stay in the business, it is because they are making a contribution, that contribution is recognized, and they too are being treated fairly.Â

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While some may view the message as radical, I cannot overemphasize that the system (market value compensation) is designed to enhance the longevity of the business, and reduce the conflictsÂ both intra-family and intra-business that often exist due to compensation factors. The system enhances the separate aspects of the family and the business to create a more healthy environment ultimately beneficial to the growth of the business and the family's wealth. In short, if this system represents a change in culture, it will be worth the effort. Clearly, such changes should be attempted with the greatest of care, by first building consensus among the family members and an understanding of the overall benefits of the system by everyone. Outside advisors should probably be brought in to manage the transition since a key element of its success will be the evaluation system, which must be objective -- i.e., not family oriented -- as possible. The use of non-family members in the evaluation system, for example, is critical.Â

As with many things, one need not make this change overnight. The long-term benefits of paying market value salaries to family members are so great that easing in the program -- to be sure that it does become adopted -- will be worth the wait.Â

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