How to fund NEW IDEAS

Using a family bank to encourage entrepreneurs

BY CHARLIE CARR

Family banks are often mentioned at conferences and in articles, but when we ask family business owners to define the term, they typically struggle with an answer. If they can define it, they usually think such programs are too complex for their own family and business.

We are currently helping a client create a family bank policy. This family wants to encourage the next generation to be entrepreneurs, hopefully seeing those businesses grow the overall family wealth. The new "family bank" will consist of a formal policy, as an amendment to the family charter, describing the purpose and use of family investments.

What is a family bank? It is not a commercial bank; it doesn't even have to be a real legal entity. It is a concept created by a family to fund endeavors, putting their collective financial capital behind the family's human capital. Funding can be loans or investments. Endeavors can be businesses, investments or even charitable donations. This flexibility leads to confusion, prodding families to miss out on what could be great educational and financial gain.

Let's walk through some of the key components of the family bank and the options you might consider.

Purpose. Our current client's purpose is to encourage entrepreneurs in the next generations. We have seen families include education and philanthropy within these structures, but generally feel that makes it needlessly complex. We suggest that families limit it to for-profit endeavors, such as forming businesses or investing in real estate or similar structures.

Eligible investments. The family can put their fingerprints on what they are looking for. Most common are venture start-ups run by a family member. Some families will consider commercial real estate, multi-family property or even rental houses with enticing prospective cash flow. Other families include ventures run by non-family members, where they can take a controlling or at least board-level role. We saw one family that specified business investments must be technology-oriented. For our current client, given their stated purpose, we are limiting it to ventures run by family members, and we are agnostic about the industry.


Charlie Carr

WHAT IS A FAMILY BANK? IT IS NOT A COMMERCIAL BANK; IT DOESN'T EVEN HAVE TO BE A REAL LEGAL ENTITY. IT IS A CONCEPT CREATED BY A FAMILY TO FUND ENDEAVORS.

Entity. Some families fund the bank using a dynasty or similar trust. Alternatively, we find that many of our family business clients are constantly investing in real estate, outside businesses and stock portfolios, diversifying their investments and risk. In many cases, these investments are owned by a separate entity (or multiple entities) rolling up to the family enterprise. Family bank investments can be owned similarly, funded out of cash flows or by selling stocks, and owned by the overall enterprise. There is no need to create a new structure.

Funding. Will the family bank invest in the endeavor or provide a low-interest loan, or even guarantee a loan from a commercial bank? If you provide loans, then profits from successful endeavors go to the individual family member. If you invest, then profits can be shared by the entire family, as well as funding future endeavors. Some families require recipients to obtain outside investments in addition to the family bank (e.g., the bank will match other funds – if it is really a good idea, then they can convince outsiders to invest in it). Our client anticipates funding investments through cash flows and will not require outside investors.

Governance. Who will make decisions on investments? Often, families leverage an existing board, such as the business' board of directors or the family council. In other cases, they have established a specific board for the family bank. Families should take care that decisions are fair across family branches; it hurts family unity when applicants from the business president's branch are approved while those from other branches are declined. Often, families assign someone (another family member or an adviser) to coach applicants, helping them improve their business plans and oral presentation to the board. Governance also includes overseeing investments after they are made — what reporting is required, to whom, and at what frequency?

Requirements for approval. Applicants are required to have a formal, written business plan and to make an in-person presentation on the business to the governing board. Some families provide detailed examples of business plans, specifying sections and content.

Compensation. If the family bank provides loans, then this is a moot point. For investments, however, it is important to discuss how the applicant will be compensated. Will they be paid a salary from the new business and, if so, how will that compensation level be determined? Some families deem the applicant as having some portion of ownership, perhaps 20% (typically a varying level based on the size of the investment), giving them a specified portion of profits.

Recourse. What happens if the business fails? If the family made a loan initially, they typically absorb the loss and the applicant walks away free. If an investment, the family also typically bears the loss. The more difficult question arises if the family member applies for new investments in the future: Are they welcome to do so? Some families might automatically prohibit new deals following a loss. We're reminded of a story about someone who made a serious mistake that cost his company $10 million. The employee was called to the executive's office and "raked over the coals." Afterward, he was surprised to still have a job. The executive, on the other hand, asked, "Why would I fire you? I just spent $10 million training you."

Another consideration is to use the family bank for encouraging and training very young entrepreneurs. Our above client wants teenage family members to work together to come up with a business idea and run with it. These businesses are expected to be much smaller investments than those by adult family members. The teenagers will learn life skills such as working together, creating a business plan, pitching the plan to the board, managing the financials and running a business. Whether the business makes money or not, the family wins.

Each of the above items should be written out in a carefully designed policy. Involve a broad cross-section of the family in creating that policy. Once it is finalized, roll it out at a family meeting, and make sure it is available and discussed at future gatherings. We have spoken with many business founders over the years, too many of whom are lamenting that the younger generations don't have the same entrepreneurial drive and interest that they did. A family bank is a great mechanism for encouraging and fostering that drive. FB

Charlie Carr *is president of Big Canyon Advisors LLC, which advises family businesses and family offices (bigcanyonadvisors.com).*