Co-Investing Between Families and Family Businesses

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The topic of the Sept. 10, 2012, broadcast of Radio Entrepreneurs was the pluses and minuses of families investing in one another's business. Hemenway & Barnes partner Fred Marx appeared with co-host Jeffrey Davis.

During the 15-minute segment, Mr. Marx walked listeners through an overview of key issues and best practices, beginning with a look at what might motivate investment between families. "We get approached by clients – family businesses – who like the idea of doing things with other family businesses," Mr. Marx said. "They think family businesses understand each other, they have similar situations and that type of thing." This makes sense and seems natural, he continued, as privately-held family businesses tend to have shared values. Plus, it provides a way to diversify economically and opportunistically.

Co-investment is often seen as a way for families to provide new avenues for their members by creating a new context and putting it into play. This may be "because of the limited number of spaces in their company, because nobody in the company knows about the particular business or because the business has outgrown the family."

In other words, there might not be enough opportunity in the existing business for every family member to be occupied according to what interests them. Co-investment also appeals to families with too many eggs in one financial basket who want to diversify their risk into other ventures and entities, whether new or existing.

With new opportunities, the reason driving a co-investment might be lack of capital, financial and human. Candidates typically include families that…

- Know one another
- Are actively looking for new blood or new interests
- Don't want private equity involved, do a sale, etc.

In addition, they "want someone who's wedded to the idea of a family enterprise."

Risks and rewards

Co-investment cannot, Mr. Marx explains, be based on one or two inter-family friendships or relationships. They must be deep and flexible. Because families grow and change, there's an element of risk of things breaking apart.

In other words, don't do things on a handshake. "You really need to set out the roadmap," in a shareholder, operating or some other kind of joint-venture agreement.

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The key, therefore, is to put the emotional component aside. Cultural compatibility notwithstanding, be sure to establish the business rules of the road. For example:

- Be prepared for either success or failure of the joint business, recognizing that the latter might be cleaner and easier to handle – legally and emotionally – than the former.
- In the case of a huge success, be sure to ask in the beginning what might happen if one family wants to sell and the other doesn't.
- Remember that everything is magnified, meaning that all of the protections typically built into a single family business must be built into a new co-invested family business. That's because what you've effectively done when you co-invest is to make one bigger family out of two.
- Be sure to put independent directors in place, "who can look at either side" and make arm's length decisions.
- Ask about the upfront intention of the agreement; is it primarily for the purpose of creating on-going income or is the co-investment mainly for the purpose of creating a business that will grow and be sold?

To believe that such matters can be decided on the fly is a mistake that too many families make. And, it's a tough fit for many entrepreneurs, who tend to have a ready-fire-aim attitude and approach. According to Mr. Marx, "They keep my litigators really busy."

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