The Five Paths to Effective Family Business Governance

When governance is appropriately structured to serve the unique needs of the organization, the business goals of the family are more readily achievable.

By Douglas Baumoel

There are five corporate governance archetypes that can be considered with each evolutionary stage of a family enterprise—from the entrepreneurial phase to the professionally governed business with fully independent boards. Not all family firms travel this entire journey, but those that do must be as vigilant in evolving their governance structure as they should be with their other enterprise management structures.

Several factors guide the development of a governance structure in a family business. A publicly traded company, with its wide and diverse set of shareholders, is primarily driven to advance the economic interests of its shareholders through corporate growth and profitability.

In contrast, a family business often functions to achieve additional objectives that can compete with the goals of profitability and growth. These may include:

- Serving as a place of employment for family members, often in leadership positions.
- Conducting business with specific or preferred vendors that sometimes may avoid doing business with others.
- Refraining from certain business practices for ethical or religious reasons.
- Maintaining business practices that reflect the particular risk profiles of a few shareholders.
- Implementing business practices that incorporate the strategic interests of a few shareholders.
- Retaining ownership that is not subject to negotiation at any price.
- Delicately balancing ownership and employment opportunities with the distribution of power among family stakeholders to effectively manage potential conflict.
- Responding to evolving economic and other needs of a growing group of family stakeholders through dividends and liquidity options.

Within the context of these, and possibly other additional constraints, the family business must also be successful and sustainable. Responsible governance practices, such as transparency, the ability to hold executive management accountable, and ensuring that there are reliable strategic and succession plans, must comport with the constraints emanating from the family and ownership systems, so that business performance and family needs are in sync.

Founder Stage: Statutory Board

The typical progression of family business governance be-

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gins with a basic, statutory board. A founder/entrepreneur will establish a statutory board to meet regulatory obligations upon the founding of the company. Such a board generally consists of the founder and his/her spouse, a good friend, and their attorney or other trusted advisor. Board meetings might be conducted informally, over a social dinner or quick cup of coffee, and held only once a year for the sole purpose of checking off the box confirming that the meeting was held.

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A founder may later include additional family members as a way to pay children or to promote the next generation's interest in the family enterprise. Annual meetings may be incorporated into family vacations when children acquire ownership (or ownership in trust). There is often little benefit to this type of board. The founder's family, who may be named as board members, might neither realize they have such a role nor understand the responsibilities that come with it.

Founders typically don't feel they need a formal or active board of directors during the early stages of their corporate development. In a small, growing company there is often little time for reflecting on strategy, and founder-entrepreneurs generally sense little benefit in being accountable to anyone. In cases where the CEO/chairman is also sole owner, they may indeed only be accountable to themselves.

It is a missed opportunity, however, for a business to not leverage the advantages of having a contributory board. Even in a simple statutory board, the process involved in carving out time and place to think strategically about the business and its future, and how that governance structure could evolve to enhance the business and family, can be extremely valuable.

Advisory Board

As the business scales and becomes more complex, it often outgrows the experience and skill sets of the owners and executive team. The process of bringing in new advisory board members who have the needed experience and skill sets can be transformative for the development of the enterprise.

It has been said that "if you can hire it, don't put it on the board." A board, even an advisory board, is not a vehicle for acquiring consulting advice at a discount. Consultants deliver the greatest impact by focusing on challenges that demand specialized problem-solving experience or appropriate knowledge. Advisory board members, in contrast, not only have experience and skills that may be useful for specific systemic issues, but also are trusted for their perspective and judgment owing to their vested role over the long term.

Putting consultants or paid advisors on a board can also be a conflict of interest. Such dual relationships set up the possibility that advice from those board members may become colored by their own interest in paid advisory opportunities. Additionally, it makes changing out those consultants potentially more difficult.

It should be noted that advisory boards address governance issues such as those involved in strategy, M&A, executive review and mentoring, succession, regulatory affairs, and capital investment. Many businesses also have technical advisory boards that are focused on the company's advancing technology, legal, and legislative impacts, or industry trends.

Mixed Family and Independent Fiduciary Boards

The transition from first- to second-generation ownership and business leadership can offer an ideal opportunity to introduce independent governance. With the rising generation, issues of fairness and the potential for ensuing conflict abound, with some children joining the business and others expecting ownership. Adding to this complexity might be a contingent of trusted long-term employees, essential to the business, who do not want to see their own career paths compromised by the rising generation.

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To avoid the "branchism" and suspicions of self-dealing that often undermine family businesses operating under shared ownership, an independent board has many advantages over an all-family board selected by proportional ownership. Independent directors can be significantly more objective in reviewing family employees, and they do not carry the baggage of family-branch grievances and politics

that could cloud good decision making. In addition, independent directors can be chosen based on needed expertise or experience critical to the success of the business.

While family members can still be valuable contributors on the board, the addition of several independent directors can provide a balance to family control that helps assure non-employed family members that there is transparency and perspective that only non-family can bring. When board decisions and actions arise that might pose concerns of bias for family directors, or fear of damaging important family relationships, family directors have the option of recusing themselves, leaving these concerns to independent directors. Family board members may also engage with a family council to guide them on the family's wishes for the company, thus unburdening the corporate board of family-focused discussions.

All-Family Boards

Sometimes, families take a different path at the inflection point between first and second generations and replace the statutory board with an all-family board. It can be extremely difficult for these boards to avoid branchism and the appearance of self-dealing, especially when some of those family directors also work in the business. It takes an extraordinary team of family members, coupled with a reasonably conflict-free history, to make this form of governance work. Being able to rise above personal, family, and family-branch interests to make decisions that are in the interests of all shareholders is not easy. Holding family managers accountable by reviewing their performance and determining their compensation can make for very uncomfortable family relationships.

In addition, the talent pool of candidates for an all-family board is small compared with that of available independent board members. To get best-in-class directors who are able to address all the complex needs of a family enterprise, choosing from family members alone may not be sufficient. Nevertheless, family members offer a unique commitment and an institutional knowledge that cannot be duplicated.

Some family enterprises are able to function well with all-family boards—at least for a time. With high levels of transparency, family directors of relevant skill and experience, built-in conflict management resources, clear rules and accountability, and meticulous record keeping, all-family boards can succeed. But this system of governance is inherently unstable and if vision alignment dissipates or conflict surfaces, it can quickly spin out of control. When this happens, a common solution is to dismantle the board and rebuild it, with a limited number of family members and some experienced independent directors who have experience with family business dynamics.

Majority Independent Board of Directors

A majority independent, fiduciary board of directors adds the highest level of professionalism to corporate governance. With majority decision-making control ceded to professional directors, the focus of governance can be on business growth and profitability with limited concern for the range of family and ownership constraints. Family board members, perhaps guided by a family council, can provide a degree of influence regarding these constraints, but they are not in a position to force these issues on the board.

However, family shareholders still ultimately control a family business even with an independent board. If the decisions and recommendations made by the independent board are unacceptable to the owners, they can replace directors, according to the bylaws, with those who are more in line with the family's values and goals. Changing directors because owners do not like their decisions, however, is an extreme remedy that should only be considered infrequently. Family companies that routinely replace independent directors will find it more difficult to seat talented independent directors in the future.

Effective governance policies and systems give family businesses the experience, judgment, and skills of individuals who can enable owners to achieve the kind of enterprise that perpetuates a legacy. Choosing a board structure that is appropriate for where the business and family are in their evolutionary progression, and selecting the most relevant and qualified board members, are essential to achieving long-term success for the family and the business. ■

A WORD ABOUT TRUSTEES

As families grow, and as their businesses become more valuable, sophisticated estate planning typically enlists the use of trusts to hold assets for the rising generation. In some families, an unexpected death of the business founder may hasten the empowerment of trustees. When trustees oversee a significant ownership position in the family business, a common misstep is to give them a direct role in governance. Herein lies a problem: A director or advisory board member must be able to put the interests of the company first. A trustee has a fiduciary obligation to put the interests of the beneficiaries of the trust first and foremost. This, therefore, is a clear conflict of interest that may be avoided by having the trustee select independent directors or advisors as allowed by the bylaws.

In some cases, when trustees simply must be on the board, it is advisable to see if the trust document can stipulate that the trustee will be considered as acting in the best long-term economic interests of the beneficiaries when they exercise their director duties as a fiduciary to all shareholders. In times of conflict, however, even this clarification may not provide the assurance that trustees need to be both effective directors and trustees.

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