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Organizing the Family-Run Business

Part Two: The intricacies of creating a board for the family-run business.

by John A. Davis

As described in the first article in this series, the "Three-circle" family business system is composed of three overlapping subsystems: those employed in the business, the shareholders, and members of the family that has a controlling ownership stake in the company. 1 Each of these three subsystems influences the direction and operations of the family company, as well as of the family. It is essential, therefore, that each subsystem has a defined role and a clear voice in the governance of the overall system. These three subsystems and their governance structures are illustrated in Figure 1.

Senior management is the organizing mechanism and voice of the employees. The family council and family assembly are the organizing mechanisms and voice of the family. The board of directors is the principal organizing mechanism and voice of the owners. The shareholder meeting is another way to organize and provide a voice for the shareholders. Shareholder meetings I believe should be annual, brief and rather formal, focusing on the election of board members and auditors and updating corporate by-laws. While these shareholder activities are legally required and important, the board of directors, the family council and the family assembly generally are more effective forums for shareholders for setting direction and creating policies.

Fundamental to the effective governance of these complicated systems is the proper separation and balancing of powers of the governance structures. The board—not the shareholders (directly), the family or the family council—sets the direction and policies for the business. Likewise, it is the family council that sets the direction and policies for the family, usually ratified by the family assembly. While making sure the family council and board do not intrude on each other's territory, the board, management, the shareholders, and the family council must cooperate, coordinate their activities, and communicate well with one another in order to have consistent and mutually supportive goals, plans, and policies.

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Here I focus on the functioning of an effective board of directors, which is legally elected by the owners and has legal responsibilities and powers. My recommendations about a board of directors also apply to a board or council of advisors, one that is appointed and does not have the same legal responsibilities or powers.

Generational Changes In The Family Business Board

The board of directors in the family firm usually changes over generations and as the ownership of the firm progresses through three distinct stages. 2

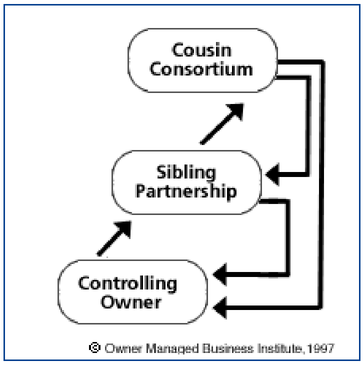

Figure 2: Ownership Stages of the Family Business

Most family firms begin as Controlling Owner businesses where one person has voting control of the organization and makes most of the key decisions. During this stage, the board, if the company has one at all, is most often composed of other family members, friends of the owner, and/or business colleagues. This type of board typically is only a "paper" board, existing only on paper, or acts as a "rubber stamp," validating whatever decisions the owner makes.

During the Sibling Partnership stage, where two or more siblings have voting control of the company, siblings generally take seats on the board. It is rare that sibling dominated boards accomplish much. Siblings, who are typically quite sensitive to one another, often either avoid confrontations or quickly escalate disagreements into disruptive conflicts. Siblings also often see their board positions as birthrights that allow them to protect their interests in the company, rather than as a responsibility—based on one's qualifications—to guide the firm and protect all shareholders. Such boards rarely provide guidance that is valuable to management. At the Sibling Partnership stage of the family business, major shareholders cannot be legitimately denied a seat on the board. But draw a line so that the siblings do not appoint their heirs to assume their board seats when the ownership transitions to the Cousin Consortium stage.

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—John Davis

Family companies that progress to the Cousin Consortium stage, where two or more cousins control the company, can have bloated, highly political boards. But over time many family businesses learn the value of a well-composed and well-run board. By the Cousin Consortium stage, the shareholder group is often too big to have everyone participate on the board so the board starts to become representative. Plus, shareholders recognize the value in having the objective, professional experience of external board members.

I see well-functioning and poorly functioning boards at each stage of ownership. All family businesses, beyond the start-up phase at least, can benefit from the guidelines presented here.

Composition Of The Board Of Directors In The Family Firm

There is little debate about the most effective composition of the family business board at any stage. The addition to the board of experienced non-aligned external members can help to change the dynamics of board discussions to be more objective and constructive. Smaller boards, not dominated by family members, tend to work better. And all board members should be focused on the best interest of the company, not on the interests of any particular individual or branch of the family.

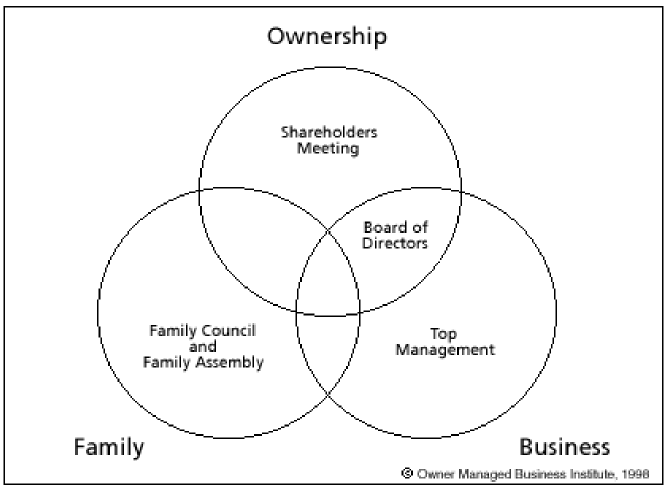

Figure 1: Governance structures of the family business system

Most experts agree that a family company board should be a relatively small group of about five to eight members. It should include the CEO of the company, a majority of external board members (meaning not family members or company managers), and a small number of family representatives. Family representatives are not necessarily family owners and may or may not be family managers. Family representatives to the board can be chosen by the shareholders, the family or the family council. It is complicating to put on the board family member-employees who are working their way up the organization ladder. Their supervisors too often complain that it is not clear if the family employee reports to them or vice versa. I advise against putting family employees on the board until they are in very senior positions or are the designated successor and close to assuming this leadership role.

A board should not include the company's service providers such as banker, lawyer, or accountant. One should also resist enrolling on the board friends of the CEO, of other family members. And be especially cautious about appointing company managers to your board. Company managers tend to steer discussion to operations issues and away from more strategic topics, and also make it difficult for the other board members to openly evaluate the quality of company management. Because company managers can be present for as much of the board discussion as the board feels is valuable, there are no clear advantages to having company managers serve as board members.

Responsibilities Of The Board Of Directors

Most boards can best fulfill their duties by meeting once each quarter for one or more days. One meeting each year should be a joint board-management retreat mid-way in the company's planning cycle to plan next year's activities. Additional time between meetings is typically required of board members to work on special assignments, prepare for board meetings and meet—often over the phone—to resolve issues that crop up.

Each member of the board will typically have a different experience base and a unique perspective on the business, but all members of the board should have in mind the same responsibilities. The primary duties of the board are to:

- protect the interests of shareholders; company;
- help develop policies that help the company and its shareholders achieve their goals;
- provide performance feedback to senior management, especially the CEO;
- ensure that the business remains decisive; and
- oversee the family's involvement in the business.

Protecting The Interests Of Shareholders

Good boards balance their commitments to company and shareholder needs. For instance, the board should not necessarily authorize large dividends or help promote other shareholder goals like family employment or family leadership of the business if the board feels these actions would weaken the business and ultimately reduce shareholder value in the company.

Helping Make Big Picture Decisions

This is the most important duty on the list and the most typical weakness of a family business board. Boards should advise and help senior management think about "big picture" topics important to the company, such as its vision, strategy, growth plans, ability to compete, development of human, financial, and physical resources, strategic relationships, and succession. I like to say that boards should fly at 30,000 feet, meaning that they should think broadly about the company's goals and challenges, concentrate on the big issues facing the company and avoid getting involved in day-to-day management or operations issues. Occasionally, the CEO may request that the board help solve a particularly thorny operations issue. What one should see at board meetings is brainstorming about future goals and the company's strategies, where board members can analyze and forecast industry trends and decide what moves the company should make. Board members should also be willing and able to contribute their own business contacts to help the company plan ahead and meet its needs.

Family issues, as much as possible, should be managed by the family and the family council so that the board can focus on ensuring that the firm is well-positioned for the future.
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Setting Policy

Technically, the board of directors sets all key policies for the company. In reality, only the policies that have broad importance for the company reach the board level. The rest are created and implemented by managers. In family companies, the family council also has a policy-setting role.

The board of directors should assist the management team and family council by providing direction and guidance regarding policy formation. For example, the board of directors may recommend that the family council develop a draft policy regarding the hiring of family members. The board would then review, recommend changes or approve and enforce the policy. Or the board could request that the CEO develop a policy for company debt. The board's job is to see that these policy statements are carefully designed, are internally consistent, and help to achieve the goals of the company and its shareholders.

Reviewing The Job Performance Of The Ceo And Senior Management

The board of directors should formally evaluate the performance of the CEO, identifying his or her strengths and weaknesses and helping the CEO to establish trusted leadership of the company. Board members should provide ongoing feedback and insights on the above and help the CEO establish challenging goals for personal and company performance. The board needs to be composed of individuals who are capable and interested in giving feedback. The board is also responsible for recommending an appropriate CEO compensation structure, including salary, bonuses, benefits, and long-term incentives. This latter activity is usually organized through the compensation committee of the board.

The board should also give the CEO their impressions of the qualifications and contributions of members of the CEO's management team. The board does not directly evaluate these other officers and typically is not involved with the compensation of company officers below the CEO, except to make sure that compensation practices are well designed and fairly implemented.

Guarding Decisiveness

Because of a family's desire to avoid conflict or protect traditions, family companies often avoid addressing issues and pressing for decisions. A board must insist on maintaining a company's decisiveness with the same energy it devotes to increasing shareholder value. This does mean rushing decisions but rather knowing when enough has been learned to make a sensible decision.

Overseeing Family Involvement In The Company

For the family-owned company, board members have an additional area of responsibility beyond those in non-family firms. Board members need to understand the family's goals, relationship issues, and politics, and:

- help to see that the family's reasonable long-run goals (as the board defines "reasonable") for the business are met;
- mediate the family's influence on the firm so that neither the financial and employment needs of the family nor family conflicts endanger the long-run viability of the company; and
- provide helpful mentoring and feedback for family managers, especially when such help is difficult to get from managers in the company.

The board of directors should not be expected to resolve issues it is not designed to tackle. Family issues, as much as possible, should be managed by the family and the family council so that the board can focus on ensuring that the firm is well-positioned for the future.

This last point, leads us directly to the topic of family governance, which we shall discuss in the next issue.

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ABOUT THE AUTHOR

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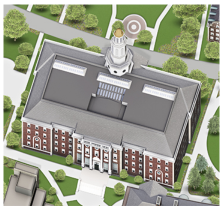

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